

The background of the entire page is a composite image. On the left side, there is a vertical strip of the German flag, showing the yellow, red, and black horizontal stripes. The right side of the background is a black and white photograph of a dramatic, cloudy sky, suggesting a storm or a crisis.

GERMANY'S INVISIBLE CRISIS

and How the World
Should See It

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[Germany is the world's fourth-largest economy](#). It is also Europe's largest economy, and any European economic recovery depends in large part on Germany's trajectory. Germany is the third-largest exporter in absolute terms in the G20 and is nearly as dependent on exports as [Saudi Arabia](#) and [South Korea](#).

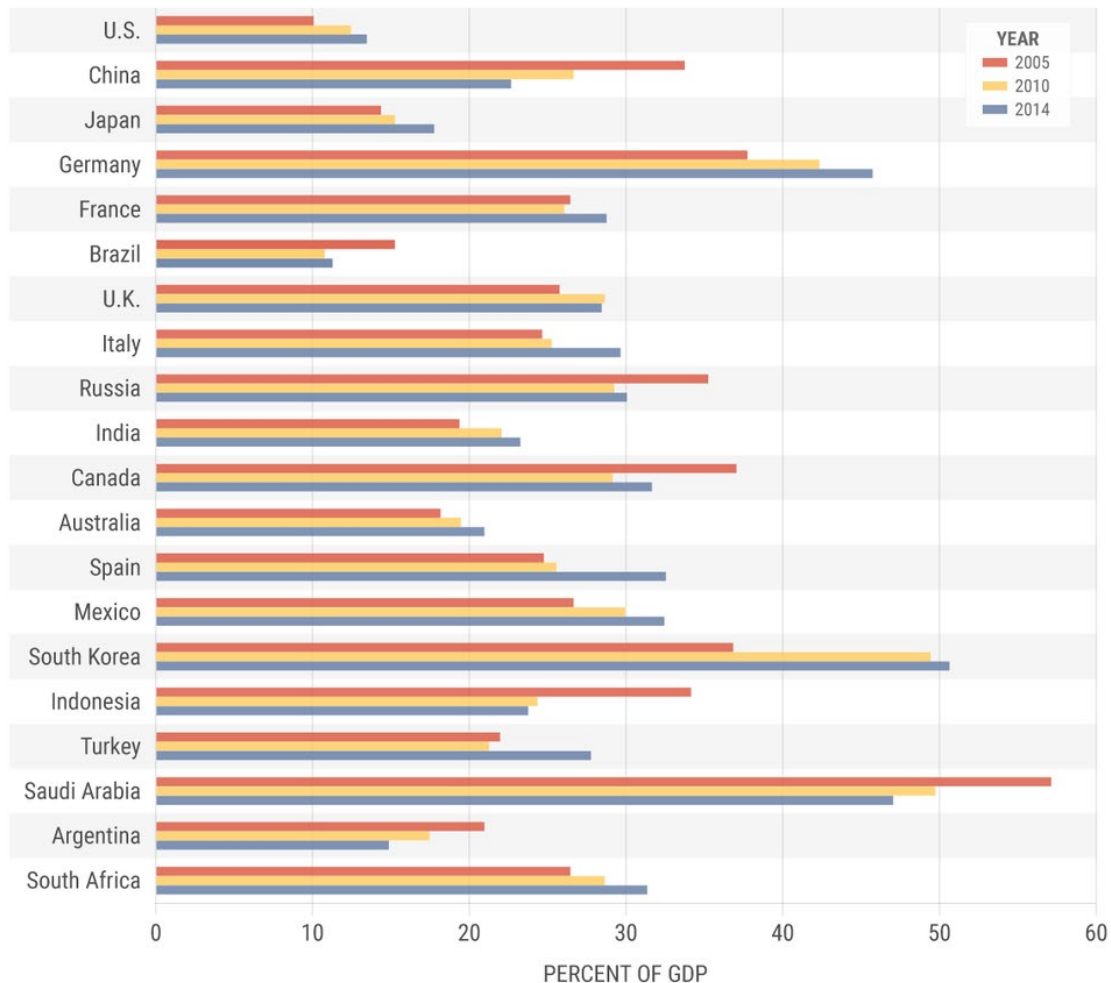
Given the enormous size of the German economy, the country must export vast amounts every year to maintain social and political stability. Prosperity for exporters depends on the appetites of their customers, and since 2008, their ability to rely on exports has been diminishing. While other major exporters have been struggling, Germany has actually increased its export levels. Germany has thus created a significant vulnerability for itself and will be the next country to face an export crisis. Given the country's high dependence on exports, this crisis will likely be extreme and destabilizing with negative implications for other European countries.

Two principles govern much of today's economic thinking. The first is that free trade is universally beneficial. The second is that high levels of exports indicate economic efficiency and build the economy. These principles are being severely tested in the current geopolitical crisis. Since 2008, the global economic system has been struggling to regain its footing. Free trade and export-based economic growth have both benefits and vulnerabilities, but the ongoing crisis is highlighting the economic imbalances and political instabilities created by this model.

Major exporting economies like [China, Russia, and Saudi Arabia](#) are vulnerable because they depend heavily on external demand, and exports have declined because of economic problems and severe price competition. Exporters of manufactured goods (like China) and exporters of primary commodities (like Russia and Saudi Arabia) have both been hit. We are seeing a generalized crisis for exporters. This crisis, in turn, is creating political and social instability in these exporting countries.

One country that has not yet experienced the effects of this crisis is Germany. This anomaly is significant because Germany is, in absolute terms, the third largest exporter in the world after China and the United States. Germany's economy is heavily dependent on exports: Germany derives 46.8 percent of its GDP from exports, according to the World Bank's latest available estimates from 2015. In China, on the other hand, exports equal only 22.1 percent of GDP, and in the United States only 12.6 percent. Germany is the fourth largest economy in the world and its export dependence is by far the highest of any G7 economy.

EXPORTS OF GOODS AND SERVICES



Source: World Bank

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Over the past few years, there has been a shift in the export dependency levels of some of the world's top exporters. China's exports as a percent of GDP have declined from 33.7 percent in 2005 to 22.1 percent in 2015, with the bulk of the decline coming after 2008. Russian exports have declined from 35.2 percent in 2005 to 29.5 percent in 2015. Others have held steady. Germany's trajectory, however, has been the opposite: the German economy's dependence on exports has only grown. The country's exports were 37.7 percent of GDP in 2005 and 42.3 percent in 2010. Five years later, it was close to 47 percent.

Germany appears, on the surface, to have weathered the crisis well to this point. However, in our view, Germany's growth model will not help the country avoid a crisis for much longer. The strategies Germany has used to maintain high export rates are unsustainable.

In order to evaluate Germany's challenges and the prospects for a German economic crisis, we need to understand four things: first, the ongoing geopolitical crisis that is engulfing the Eastern Hemisphere; second, the relationship between the Eastern Hemisphere's crisis and a breakdown of the export system; third, the condition of the European Union; and fourth, how all this converges in Germany and why the country is likely to experience significant economic disruptions.

The Eurasian Crisis

In 2008, two pivotal events happened within seven weeks of each other. On Aug. 8, 2008, Russia and Georgia went to war. On Sept. 16, 2008, Lehman Brothers collapsed. The first event shifted the strategic dynamic. The second transformed the global economic situation, particularly in Eurasia (understood as Europe and Asia combined). The economic crisis was immediate and painful, but it was not, in itself, unusual or significant. Financial crises are built into capitalism, and for the United States, this was the fourth such crisis since World War II: the municipal bond crisis in the 1970s, the Third World debt crisis, and the savings and loan crisis in the 1980s preceded it. It was the combination of the strategic and economic crises, however, and the unique difficulties major powers in Eurasia had in dealing with the dual problems, that led to general and interlocking crises throughout the region.

When we look at a map of Eurasia, an extraordinary pattern emerges. Virtually all the components of the region have destabilized. [China's economy](#) is slowing down, and the regime in Beijing is moving to strengthen and further centralize its power, as well as using increased military assertiveness at sea to boost morale and avoid potential social unrest at home. [Russia has entered an economic crisis](#) and become more assertive in the Middle East and to its west. [The Middle East](#) is experiencing a political crisis that has destroyed two states, Syria and Iraq, while oil-exporting countries are destabilizing as prices decline.

Finally, the European Union has fragmented with the decline of coherent decision-making and the unwillingness of individual states to adhere to any central authority. Meanwhile, southern Europe remains in a deep depression [with more than 23 percent unemployment in Greece](#) as of October 2016, according to Eurostat. Britain via referendum decided to leave the EU and independence movements in places like Catalonia have strengthened. On issues ranging from economic dysfunction to the migration problem, Europe's central crisis has been political. The EU has been unable to make, implement, and enforce effective decisions. As a result, it is facing informal dissolution—a situation where the EU exists, but it is increasingly ignored.

The regional crises are no longer sequestered. They are interacting with each other. [Russia is putting pressure on Europe and the Middle East](#). Europe is reacting to Russia and involved in the Middle East. The Middle East is affecting Europe and drawing in Russian involvement. In the western part of Eurasia, it is as if separate storms are beginning to merge together into a single, much more powerful storm. And that is what makes this important.

Destabilization stretching from the Pacific to the Atlantic and from the Arctic Ocean to the Indian Ocean hasn't occurred since World War II. Except for India, which has problems but is not undergoing systemic stress, all of the land mass is unstable. That means that 5 billion out of 7 billion people in the world exist in a state of economic and strategic turmoil. This is the heartland of humanity. In World War II, this entire region was drawn into a systemic crisis that manifested as war. Parts of the region are now at war, other parts face the threat of war, while others have problems confined to economics and politics. There is no likelihood of a generalized Eurasian war, but there is the possibility of more localized conflict or war coupled with internal instability in all of these countries.

Germany has thus far remained stable, with low unemployment, a strong government (until recently) and an economic system that continues to function. This has been seen as evidence of prudent management. There is much of that, but there is also an anomaly. Germany is following a path that had shattered the expectations of other countries. It is resisting a tide that it should be unable to resist: the general crisis of exporters.

The Crisis of Exporters

There is a crisis of exporters plaguing countries from South Korea to Saudi Arabia, Russia, and China. Germany has not yet been affected but is, nevertheless, vulnerable. In order to understand Germany's dilemma, we must first ask how we got to a global exporters' crisis in the first place.

The 2008 financial crisis triggered recessions in the United States and Europe, two of the world's largest consumer markets. The recessions turned into long-term stagnation in Europe and slow growth in the United States. This decreased consumer demand, which was compounded by the process of deleveraging consumer debt. This decreased demand for imported consumer products, while the general economic stagnation also lowered industrial production and, therefore, the need for industrial products.

This had a substantial effect on China, which had been the previous generation's major low-wage, high-growth economy. Such economies are a particular niche within global capitalism,

able to off-load low-margin production and focus on more complex, higher-margin products. The two previous low-wage, high-growth economies were Japan and Germany. In the late 19th century, it was the United States. These economies are critical, tend to last about a generation, and then rotate out of that role into a more advanced industrial power. Japan began rotating out of this role in the 1980s, reached a transformative financial crisis from 1990 to 1991, and then transformed itself into a mature economy.

China had been moving toward the end of its low-wage, high-growth phase by the time 2008 came. Its position as a low-wage economy was being challenged by multiple other economies, which for various reasons were able to undercut Chinese prices while maintaining quality. This put Chinese exports under pressure, both in term of absolute sales volumes and profit margins. China is a much poorer and more diverse country than Japan, so its path will likely be rockier: 2008 hit an already pressured China even harder than others.

China is a victim of its own success as an exporter. The problem with exporters is that they are entirely dependent on their customer's ability to buy what they have to sell. The 2008 crisis reduced demand in Europe and the United States, China's two biggest and most essential customers. China could only control exports by finding other markets—none of which could match Europe and the United States—or by cutting prices. Given the global crisis, alternative markets and price cuts had limited effect. Both were tried, but in the end, export growth was maintained primarily by decreasing profit margins. As with the Japanese, this inevitably generated financial instability because exporters were unable to service debt. The government intervened, trying to allocate capital to prevent unemployment, and the economy engaged in an economic-political spiral into gridlock.

China was the linchpin of the global industrial commodity system. Its inability to sell made it impossible for China to continue purchasing large volumes of oil, copper, iron ore, and so on. Prices for commodities should have fallen dramatically because of this. They didn't fall immediately because of two things. First, China is a semi-command economy with key processes in the hands of the state. Purchasing industrial commodities had a dimension of centralized control, which meant that demand for these commodities did not shift in line with falling need. Both bureaucratic inertia and Chinese expectation that its export problems would be handled kept Chinese imports at unrealistic levels.

The second reason is that, in many ways, China was a bubble to which irrational expectations were attached. As with all bubbles, the irrationality endures after the position is untenable, and then, when reality can no longer be escaped, the bubble bursts. The Chinese bubble was particularly strong, as many assumed that China's growth rate, which had remained at

preternatural levels for more than 30 years, was eternal. Therefore, even though China's growth pattern had been broken in plain sight, the belief was that the problems were minor or temporary. This perception maintained industrial commodity prices at a level higher than they should have been for some time. Given the increase in supply of commodities generated by irrationally high prices and technological advances, [the break was more severe for having been delayed.](#)

The global economy thus faced a dual crisis: exporters of both manufactured goods and primary commodities saw demand and prices fall. Exporters of all kinds began experiencing significant financial strain.

The European Crisis and Germany

Intertwined with the financial crisis was the condition of the European Union. Crises necessitate action, and 2008 was the first true financial crisis the EU had faced. How the EU dealt with the crisis would affect how all of Europe would experience the crisis. And to understand how the EU reacted, the condition of the EU must be understood.

The crisis revealed both structural problems and fundamental imbalances in the European Union. First, the EU was not configured to deal with financial crises. The sort of formal and informal systems the United States developed in its post-war crises had never been developed in Europe. Part of this problem was a lack of structures and processes. But the deeper issue was political. The EU was supposed to be a transnational structure, but individual states maintained a great deal of sovereignty. The extent to which the EU had the responsibility or the authority to manage the 2008 crisis simply wasn't clear. If the EU didn't have the authority, then the states had to, but given that much of the EU shared a single currency, the nations didn't have control over the critical instrument—monetary policy. Therefore, they couldn't deal with the problem without some level of cooperation from the EU.

The solution was collaboration, but Europe had expanded to include nations at very different levels of development and, therefore, with very different interests. The policies that might help advanced industrial economies and substantially less developed economies were fundamentally different. A net creditor has one set of interests in this scenario while a net borrower has very different ones. It was possible to create a single coherent set of solutions in the United States that at least carried the country through the worst of the crisis. The United States had settled the principle of sovereignty in the Civil War. It had settled the principle of common management of a financial crisis in the 1930s. These worked imperfectly, but they created a framework for decision-making and policy implementation that a chaotic European Union lacks. There is no such

thing as a common European interest.

At the same time, the crisis highlighted how trade—one of Europe's building blocks—has contributed to deep imbalances. At its root, the EU is a free trade zone. At the center of this is Germany. The free trade zone, then, is built around a massive exporting machine—which is great for Germany... but makes it difficult for less developed countries (particularly in southern Europe) to develop. It must be remembered that, in the 1950s, Germany was allowed to protect its economy, controlling access to its market so that it could develop. Fearing Soviet influence in Europe during the Cold War, the United States supported Germany's economic growth. The United States had similarly protected its economy during the late 19th century, as had China and Japan to the benefit of their developing economies.

The European free trade zone stripped all member countries of the right to protect their economies in every sector with few exceptions. The Germans were massive exporters who also consistently ran substantial balance of trade surpluses, which meant that many European countries were swimming upstream in the process of development. In addition, prevailing sentiments said that exports were a sign of a growing and healthy economy. Consequently, the EU kept trying to apply Germany's model of success to countries like Greece.

Inevitably, the 2008 crisis revealed the underlying problem. As the recession took hold, one set of countries immediately began experiencing sovereign debt issues and other debt problems. That was inevitable. The question was how to address the problem. The creditors, led by Germany, wanted debtors to cut government budgets and carry the main burden of repayment. The debtor nations, lacking a single leader, dealt with the problem individually. The central focus was on the health of the banking systems, as isolated countries were pressured to reach agreements on repayment that were built on austerity packages.

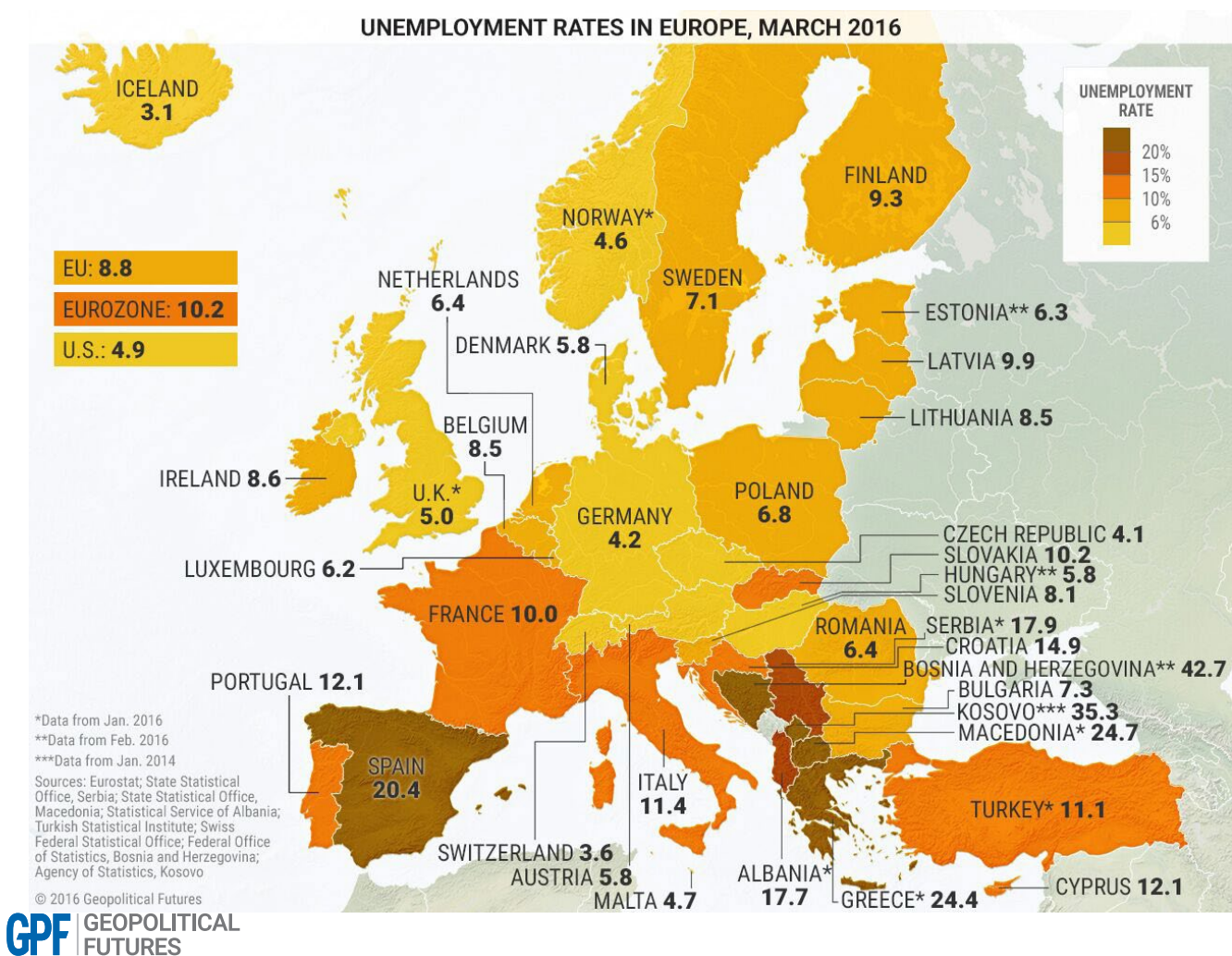
There was a contradiction built into Germany's insistence on austerity. Germany was and is a major creditor, holding paper from throughout Europe. When the southern European economies began to collapse, the Germans faced a dilemma. On the one hand, the European free trade zone absorbed much of Germany's exports, and therefore, it was in Germany's interest to stimulate Europe's economy. On the other hand, stimulus would mean that Germany would have to increase the amount of debt from countries near default, betting that the stimulus would turn these economies around. If the economies weren't stimulated, exports would decline. If they were stimulated, they faced a banking crisis.

All of this was compounded by the exporters' problem, particularly after the decline of oil prices.

GERMANY'S INVISIBLE CRISIS and How the World Should See It

Oil exporters reduced imports, and manufacturers in competition with Germany slashed prices. The Germans were trapped in an export-oriented market with limited appetite for their goods. It seemed the best the Germans could do was to slide into a significant depression while they restructured their economy in the hope that they would not slide into long-term depression. But Germany could not afford to do that and instead emphasized austerity throughout the European Union.

The purpose of austerity was to stabilize the financial system, but its byproduct was dramatically increased unemployment—particularly in the less developed eurozone countries. In much of Europe, the state is involved in health care, power utilities, transportation, and other sectors. Spending cuts, therefore, hit the professional middle class, which depends in part on state-financed sectors. The level of unemployment in many countries surged but did so most dramatically in the south where unemployment among the Mediterranean countries soared to over 20 percent... and in some cases to 25 percent. These were the same levels reached in the United States during the Great Depression. Countries outside the eurozone weathered the crisis better, but southern European members of the eurozone went into a recession, and as their economies suffered, demand for goods—including German exports—declined.



Germany staved off feeling the pain by increasing its exports to China, the United States, and to a lesser extent, the United Kingdom. Demand in China, however, has begun to fall. And there is a limit to how much and how long the US and the UK can fill the gap in demand for Germany's exports.

Germany's Inevitable Crisis

Germany poses the central problem in Europe. It was structured to be an exporter. Germany did not simply become an exporter after World War II; it was an exporter from the beginning. Like Japan, it was a latecomer to the industrial revolution. In order to catch up, it had to rely on exports while limiting its domestic consumption. After World War II, Germany merely returned to this model. In 1989, when the Berlin Wall fell and Germany reunified, it faced the problem of massively uneven development between East Germany and West Germany and the need to finance the integration. The solution was, once again, to increase exports, discourage domestic consumption, and increase savings rates. Once an economy is structured in this way, however, it can only be forced into another model by a significant crisis that makes its existing economic model untenable.

Germany's economic strategy was part of the German DNA. It was a strategy in which a highly educated and disciplined society would excel. Again, compare Germany and Japan. Both had vast human capital from the pre-war period and a devastated economy. Both used the highly trained workforce and management that had survived the war to rebuild and recapitalize their economies through exports. When 2008 struck, Germany was already caught in an exporter model, and it continued to emphasize exports while also maintaining its saving strategy.

The one option Germans didn't have was to accept lower exports, which would have required increased domestic consumption. Given German export dependence, the amount of increased domestic consumption that was needed was unattainable. Moreover, any increase in domestic consumption would slash into the German savings rate, and bring it down to zero. This would upend the German competitive advantage of high investment in advanced production methods.

Eurasia's interrelated crises—coupled with the ongoing crisis of exporters and Germany's fraught relationship with the European Union—have brought Germany's core economic vulnerability to the fore. There are three indications that the country is heading toward its own crisis. German trade patterns have shifted, return on capital has diminished, and some German companies have begun cutting prices in an attempt to maintain export levels. The tactics Germany has relied on to weather the storm are ineffective in the long term, and there are already signals that Germany's economy is slowing down as a result.

Germany needs to seek out large markets whose consumers have enough disposable income to buy high-value-added manufactured goods.

Although the US is an enormous market for the type of consumers Germany needs, dependency on this market for export growth is not a viable long-term strategy for Germany. First, the US is in a period of slow growth, with its own domestic savings rate rising. Moreover, Germany is a very large exporter, and it faces strong competition in the US for customers. Finally, it has been six years since the last recession in the US, and the country, generally speaking, tends to dip into recession roughly every seven years. So, if history is any indicator, the US is due for another recession in the near term. There is already the danger that the US market is saturated with German goods, but if a recession were to be added to the mix, it would limit Germany's exports even further.



Source: ITC calculations based on UN COMTRADE statistics

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The second indication that Germany's model is eroding is declining returns on capital invested. Some German exporters have experienced only slight declines, but several major companies have undergone significant shifts. Volkswagen, Bayer, and BASF all saw their rate of return on invested capital decline over the last two years. Volkswagen enjoyed a rate of return on invested capital of over 13 percent in late 2012. By late 2015, the rate was less than 3 percent. Daimler's rate of return on sales of its Mercedes-Benz cars in the first quarter of 2016 was 7 percent, compared to 9.4 percent the previous year.

The third indication of a coming crisis is that there are growing signals German businesses are sacrificing revenues in order to boost exports in the short term. According to the European Commission, producer prices in the eurozone are declining. Some German exporters publicly declared that they were cutting prices. BMW cut prices in 2016 for spare parts in China, while in 2015, Volkswagen introduced discounts and interest free loans in China to boost sales. One phenomenon that underscores the challenges facing Germany's exporters is a divergence between the growth in sales and growth in revenues. For example, Daimler's first quarter sales in 2016 increased by 7 percent compared to the first quarter of 2015, but revenues increased by merely 2 percent. BMW's automotive segment unit sales grew by 5.9 percent in the first quarter year over year, but revenue for car sales declined by 0.4 percent. While exchange rate effects did negatively impact revenues in the first quarter, a divergence is still noticeable when these figures are adjusted for shifts in exchange rates. German exporters, therefore, are facing a significant problem: they are boosting sales but not making much money. This tactic works in the short term but is financially unsustainable in the long run.

Germany is not yet in crisis, and many German companies are still sporting at least steady returns. But this report is as much a forecast as it is an analysis. We are looking for where the needle will just begin to waver, and the earnings reports of some large German companies produced some of the worrying observations we laid out above. The data, however, is not definitive in this case. We have constructed a model for how the German economy has functioned and is functioning today, and how Germany's economic situation is going to be affected by the economic, social, and political crises that span Eurasia. The proof of the suppositions made in this report will become evident this year when, we begin to look at the complete 2016 data which should be made public in coming days.

The Analogous Case and the Specter of Banks

The best analogy for the phenomenon we are now witnessing in Germany is Japan in the 1980s. Built on a debt-based economic model, also with a high savings rate, the Japanese economy needed substantial cash flow to service bank debts. They were relatively indifferent to rate of

return on capital so long as cash flow was maintained. The Japanese maintained their export surge by cutting profit margins to near zero and, on occasion, beyond that. Their exports and the economy grew, but underneath it all, the Japanese were hollowing out their economy. The warning came in 1990 when the Bank of International Settlements warned Japan that its banks would be suspended from international transactions because of low reserves.

The Germans went in a similar direction for somewhat different reasons. The Germans fear unemployment. There is a shared memory of the 1920s when the middle class was shattered, and there is a perennial fear of a repeat. In the 1990s, the integration of East Germany forced unemployment up, and that caused considerable dislocation. The Germans had to maintain employment rates, but since they could not consume more, they had to expand exports in the face of a global crisis of exporters.

The Germans adopted the Japanese solution, not as a national policy but as a strategy to assist major corporations. Daimler reported increasing sales and diminishing profit growth rates. That could have several meanings, but the most obvious is that the company was cutting prices and margins in order to increase sales. The Germans appear to be attempting to increase exports by decreasing return on capital.

This is something that can work, but only temporarily. The first signs of problems in Japan were in the banking system, where the decrease in margins became apparent in rising nonperforming loans and increasing stress as government policy and banking requirements clashed.

It is noteworthy that the German banking system is already under pressure even before the crisis we are predicting in Germany has begun to fully unfold. The problem German banks have is rooted in the crisis of 2008, which as we noted earlier was made worse in Europe because of the EU's inability to respond in a way that was conducive for all European economies. Germany was one of the net creditors in the system, and German banks are still exposed to many of the European countries that have not yet recovered in any meaningful way from 2008. Deutsche Bank currently has about \$47 trillion worth of derivatives on its books. The three major credit rating agencies all downgraded Deutsche Bank throughout 2016, with Moody's still having a stable outlook and Standard's & Poor and Fitch with a negative outlooks. German banks are grappling with serious problems, especially with interest rates remaining low and Eurasia's crises intensifying. Commerzbank's 2016 third quarter net profits fell by almost 21 percent (yoy), while Deutsche Bank saw revenue decline by 10 percent and a net loss of 1.4 billion euros in all of 2016.

Compounding this banking problem is Italy. [Our 2016 annual forecast](#) predicted a potential crisis in the Italian banking sector this year due to the high rate of nonperforming loans in Italian banks. Approximately 17 percent of outstanding loans (most from corporate borrowers) are nonperforming. [The Italian government, sometimes at odds with European Union regulations, is trying to cope with the country's banking challenges](#). This is relevant to German banks because Germany's exposure to Italian banks is roughly 120 billion euros (\$138 billion), which is over 3 percent of its GDP. Also, a failure of the banking system in an economy the size of Italy's (Europe's fourth largest) would lead to a crisis in Europe much more serious than that of Greece.

The problems in Italian banks are not the result of export decline but of lending practices. In Germany, however, it is the export crisis that has the potential to disrupt the banking sector. There is no definitive evidence that German banks have yet begun to feel the ill effects of the export problem. But eventually, as German companies lose profits and can't pay the banks, this will become a problem. As pressure builds on German banks, the challenges we are outlining in this report will be an added stressor, and the banking system, already under intense strain, will face a significant burden.

Conclusion

Germany, one of the world's largest exporters, is facing a global export crisis. The fact that it has not yet experienced an overall annual export decline is not a comforting thought. With Europe barely recovering from its economic stagnation and other markets similarly constrained, German exports should decline. The fact that they haven't, and that German banks are troubled in spite of cash flow, indicates that significant price adjustments are being made that affect the profit margins on these exports.

It appears that the problem of contracting exports is being postponed rather than solved. Germany's high dependence on exports causes the German state, bankers, and corporations to want to avoid export decline for as long as possible. Since exports are over 45 percent of Germany's GDP, a 5 percent drop would result in a decline in GDP of more than 2 percent, which would have a staggering impact.

Therefore, the Germans are postponing this decline for as long as possible. However, delaying it compounds the problems in the long run, particularly for already weak German banks that may be forced to deal with delayed or restructured debt repayments.

The Germans are facing a profound financial crisis that can be postponed but not avoided. The world's economy is stagnating, and exporters around the world are seeing declines. Germany has not so far. When it does, which is inevitable, the fourth-largest economy in the world will suddenly see massive export contractions, declines in GDP, and a significant financial crisis with global implications.

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