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German Power and Foreign Direct Investment in the Eurozone

Germany's large current account surpluses and its ability to shape European economic governance are widely taken as expressions of Germany's economic and political power. These formulations miss an increasingly crucial dimension of German power in Europe: the question of ownership. *Focussing on Foreign Direct Investment (FDI) within the Eurozone, we present new empirical data which trace the development of German FDI since the formation of the euro in the early 2000s. We make three central observations. First, after an initial period of restraint, German FDI flows significantly increased relative to other Eurozone states in the aftermath of the 2008 financial crisis. Second, by 2012, Germany had increased its outward FDI stock relative to other Eurozone states and its major Eurozone rival, France. Third, in the Central Eastern European (CEE) states, German FDI stock has consistently outstripped the FDI stock of other member states. Our findings open-up a new lens through which to interrogate the question of German power within European capitalism. FDI of course can underpin economic development, technology transfer and rising employment. But high levels of foreign ownership can also have negative effects for dependent economies. We advance a number of policy proposals to combat these tendencies at the EU level, including establishing an 'FDI imbalance procedure', an FDI 'rebalancing fund', increasing sources of domestic credit within dependent market economies and developing a Pan-European industrial policy attentive to unequal patterns of foreign ownership.*

Introduction

The question of German power has become a focal point in debates on the future of European capitalism (Dooley, 2017; Germann, 2018). Within the International Political Economy (IPE) literature, German power is characteristically seen to be expressed through two principal mechanisms. First, in the arena of *trade*, Germany has accumulated large current account surpluses since the formation of the euro. Germany's ability to maintain low unit labour costs under monetary union led to a large export-led boom throughout the 2000s which entrenched German competitiveness and economic power (Flassbeck and Lapavitsas, 2015). Second, in the arena of *politics,* Germany's overwhelming economic strength and geo-political power has allowed German officials to shape European integration in line with its own interests (Bulmer and Patterson, 2013; Thompson, 2013). Whilst these analyses point to important dimensions of German power in Europe, they overlook the question of *ownership.*

As argued by Susan Strange in the 1970s and 1980s, market actors can exert structural power in the global economy through acquiring private ownership of productive structures within foreign countries. One way to measure this power is to look at the flows and stocks of Foreign Direct Investment (FDI). In this paper, we trace how patterns of German FDI have evolved since the formation of the euro. Our objective is to present new empirical material which can act as a starting point for tracing how German power in the Eurozone is expressed through shifting patterns of ownership in other member states. The paper proceeds as follows. In the following section, we offer a primer on the data which we use in the

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analysis and our methodology. In the second section, we introduce our data on intra-EU FDI flows, with a particular focus on Germany relative to other Eurozone states and in particular France. In the third section, we focus on German FDI into four Central and Eastern European (CEE) states (Poland, Hungary, the Czech Republic and Slovakia). The fourth section concludes by advancing four concrete policy proposals.

FDI data and methodological considerations

FDI is commonly defined as an investment undertaken by Transnational Corporations (TNCs) of at least ten per cent in equity. The literature distinguishes between different types of FDI, such as efficiency-seeking, market-seeking, or resource- seeking investments. Based on Hymer's (1976) insights, the main incentive for firms to engage in FDI is to *control* the means of production. FDI therefore represents an effective measurement through which to gauge the control which German corporations exercise over the supply chains and economic resources of other member states.

In this paper, we trace how German FDI stocks and flows in Europe have developed since the formation of the euro. It should be noted that, although FDI may be used to measure corporations' ability to strategically affect economic development in other countries, this measure has several downsides. First, as FDI data include all investments of at least ten per cent in equity, the actual degree of foreign ownership, and with it the capacity to determine production, can vary widely between different countries with similar stocks and flows of direct investments. Secondly, the data usually do not distinguish between investments in productive capital, such as plants or machinery, between different industries, or between different types of FDI. Based on the literature on CEE integration, most of the FDI flows to CEE economies are associated with efficiency-seeking investments. Finally, the data can be distorted by companies using specific country hubs for their direct investments. For example, the tax havens in the Netherlands and Luxembourg have led many companies to establish Special Purpose Vehicles (SPVs) there, which they use for investing across Europe. Whilst Luxembourg and the Netherlands therefore have some of the largest outward FDI flows, it is not immediately clear which companies are behind these investments. The same applies to inward FDI, which can indicate that certain countries are the largest recipients of foreign (e.g. American) investment, whereas in fact, they merely serve as hub.

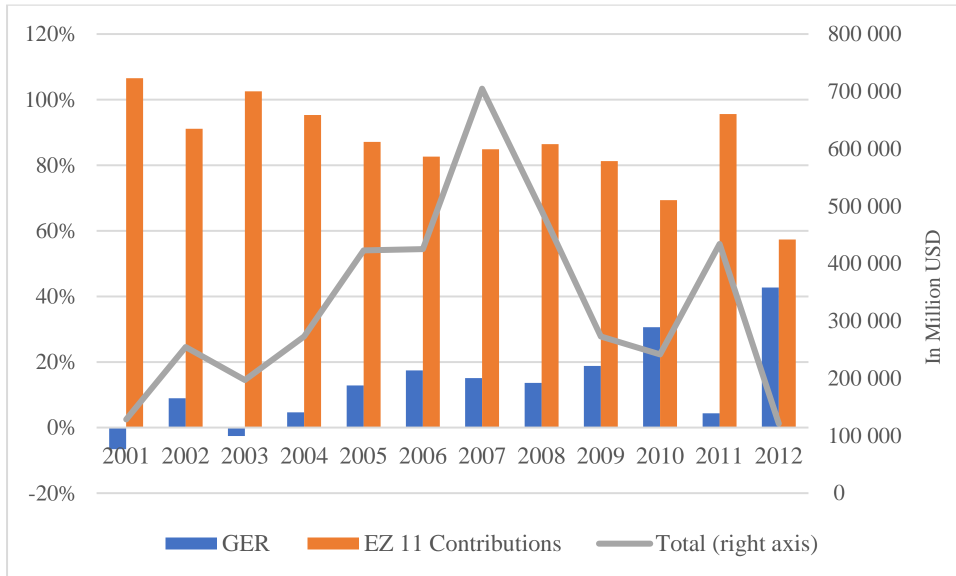
In order to capture developments of intra-EU German FDI, we analysed bilateral FDI data from UNCTAD for the first twelve years of the monetary union (2001-2012). We find that German contributions to intra-European FDI flows substantially increased from the mid-2000s on, and that Eastern European integration, which has been identified as a critical factor for establishing German industrial hegemony (Celi et al., 2017), played a critical role in that process. Moreover, throughout the whole period, German and French outward FDI stock accounted for roughly half of the Eurozone total – yet a comparative analysis between the two countries shows a gradual shift in ownership towards Germany.

Contributions to Intra-EU FDI Flows

Figure 1 shows the extent to which German capital outflows have developed relative to other Eurozone states since the emergence of the euro. The left scale indicates the percentage of total contribution, whereas the right scale illustrates the absolute value of these flows. The most interesting finding of this graph is that German FDI flows appear to run counter to general trends of intra-European FDI flows. Whilst the latter markedly picked up throughout the first years of our analysis, the German contribution to these flows was weak. After the outbreak of the global financial crisis (GFC) and the overall decline of FDI flows across Europe, Germany's contributions substantially increased relative to the Eurozone average, and were, in 2012, higher than 40 per cent of the total (even though there was little FDI activity in 2011). One explanation for this counter-cyclical behaviour of German contributions might be that German FDI flows are less volatile compared to direct investments of other Eurozone members. Deutsche Bank Research (2015) specifically outlines that most of German FDI is employed to support

its export industry. In contrast, French FDI was, to a much higher degree than German investment, focused on services and the financial sector (Banque de France, 2018). Since FDI flows of this form generally entail less investments into plants and machinery than manufacturing, they are naturally subject to more volatility.

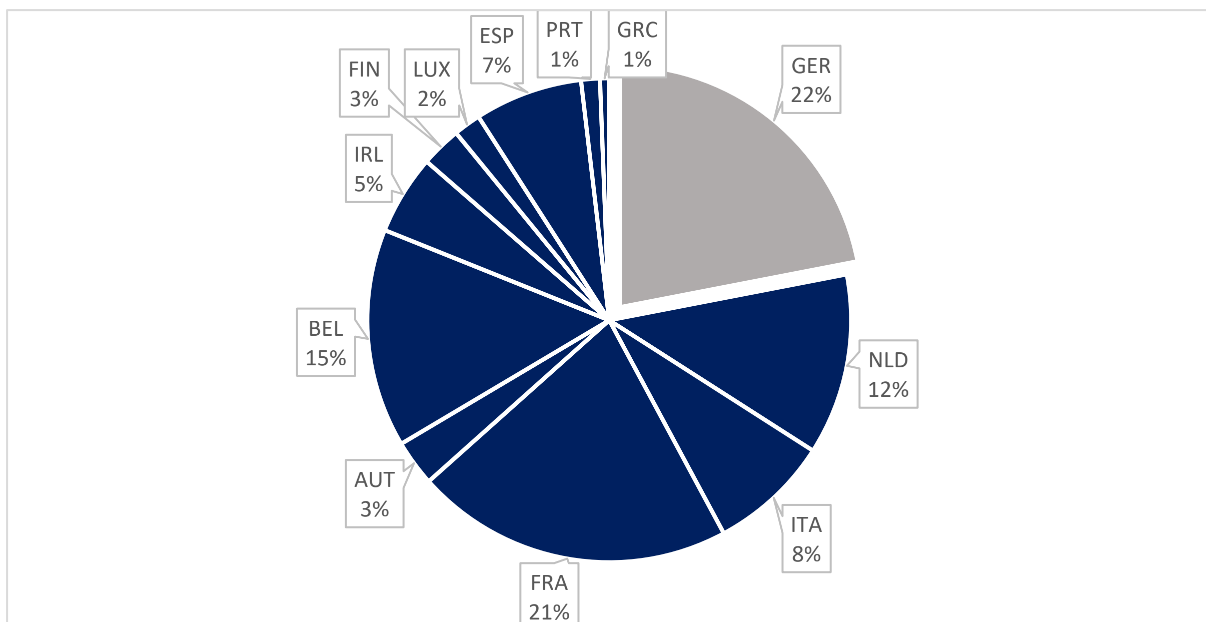
Figure 1 Contributions to intra-EU FDI Flows



Source: UNCTAD. Own Calculations.

Perhaps of more interest than FDI flows are FDI stocks, since they represent the actual amount of capital that is under control by a foreign entity. In this regard, German companies accounted for roughly one fifth of total Eurozone intra-EU FDI stock throughout the entire period – with France and the Benelux states (the Netherlands, Luxembourg and Belgium) enjoying similar shares. Figure 2 shows the latest pie chart from the data, highlighting the German share of total outward stock.

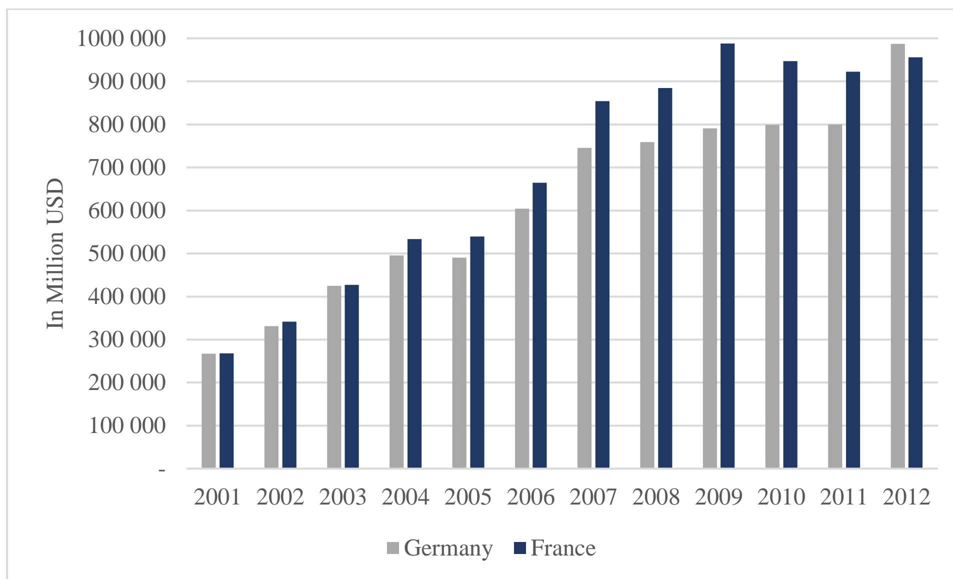
Figure 2 Share of Outward Intra-EU FDI Stock (2012)



Source: UNCTAD. Own Calculations.

The data do not include SPVs for Luxembourg, although some of the distortions that were described above most certainly explain the large shares of the Benelux states. As evident from the figure, outward FDI stock is, for the most part, dominated by German and French corporations. If we compare the trends of FDI stocks of Germany and France, however, we find that Germany had a higher growth in outward stock since the 2008 financial crisis. Due to data constraints, we could not find whether this trend continued beyond 2012, or whether it is imputable to normal fluctuations. In any case, it is notable that Germany has narrowed the large gap that existed between 2007 and 2010, and had, in 2012, a higher FDI outward stock compared to France.

Figure 3 Outward Stock Comparison of French and German intra-EU FDI

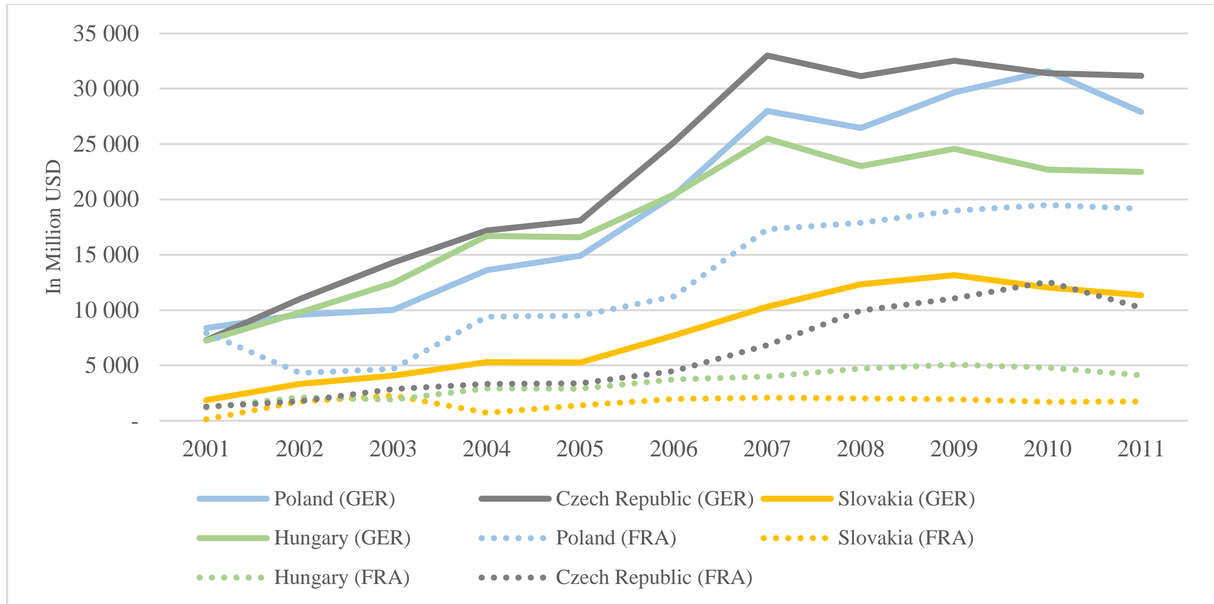


Source: UNCTAD. Own Calculations.

German FDI in Central and Eastern Europe

More critically for the establishment of German manufacturing dominance, however, were German direct investments in Central and Eastern Europe (CEE). Figure 4 below illustrates the significantly higher German FDI stocks in the Visegrad countries compared to France as the reference point for the next biggest player in intra-European direct investments. We focus on the Visegrad states since these countries have historically accounted for approximately two thirds of total FDI to CEE (Pavlínek, 2004, p. 63). Except for FDI outward stock in Poland, German stock exceeds that of France's by a factor of at least two.

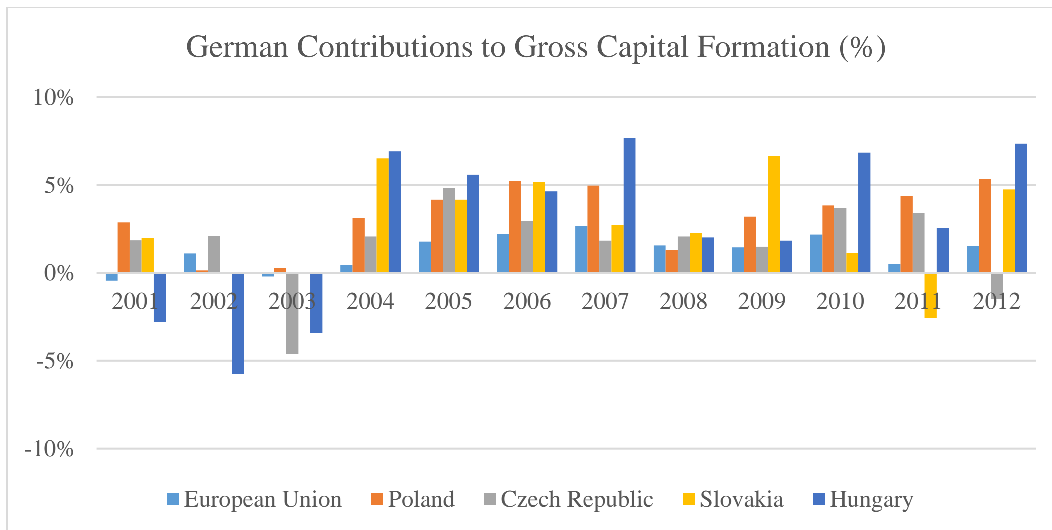
Figure 4 Outward Stock Comparison of German and French FDI in the Visegrad Countries

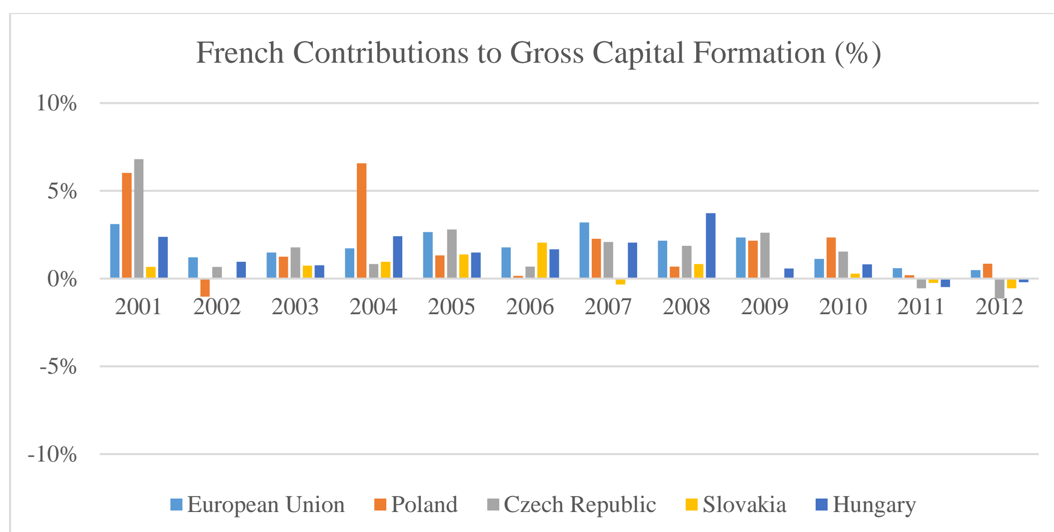


Source: UNCTAD. Own Calculations.

Moreover, if we look at contribution to gross capital formation, that is the increase in physical assets, we find that German investments contributed very significantly to this measure across all Visegrad states. By comparison, France's share is very small, and since the Eurozone crisis, French disinvestments in CEE are even more pronounced than its investments.

Figure 5 German and French Contributions to Gross Capital Formation in the Visegrad Countries and the European Union





Source: AMECO, OECD, and UNCTAD. Own Calculations.

More recent political economy research has recognised the role of Eastern European integration for the development of the European Union as a whole (Stehrer and Stöllinger, 2015, Celi et al., 2017, Garbellini, 2017). It is important to stress the wider political and economic implications of this process. Advocates of FDI of course argue that it offers a vital source of investment income to emerging economies within Eastern Europe. But it is important not to overlook the wider implications this process has for power relations within the single currency area.

The Downsides of FDI in Europe

FDI emerged as an important driver of economic transformation in CEE in the 1990s and 2000s (Drahokoupil, 2009). FDI brings capital, expertise and technological capacity to emerging economies. However, high levels of FDI, if not embedded in a coherent development strategy, can also have negative effects (Wade, 2010). We can identify a number of potential downsides to FDI. The first is that FDI flows can exacerbate *inequalities between regions* within the recipient state. FDI tends to flow to areas with lower labour costs and a skilled workforce capable of operating medium-level technologies (Nölke and Vliegenthart, 2009). However, the combination of these attributes tends to be found in more prosperous regions. Economies dependent on FDI can therefore experience intensified internal uneven development. For example, in the case of the Czech Republic, as of 2001 60 per cent of FDI flows were concentrated in Prague and the surrounding region. In Slovakia, Bratislava and its surrounding region accounted for close to 70 per cent of FDI flows in the early 2000s (Pavlínek, 2004, p. 51). FDI can therefore entrench regional disparities within member states.

The second downside of FDI is that it can lead to *dependence* on foreign corporations and a *dis-embedding* of productive structures from local supply chains. TNCs engaging in FDI tend to push through 'vertical' integration, whereby FDI recipients become a 'branch' of the wider corporate structure whilst higher-end R&D activity remains concentrated in the 'host' state (Wade, 2010). Furthermore, the recipients will remain dependent on the decisions made in Western TNC headquarters, limiting the scope for indigenous economic developmental capacity whilst tying the fortunes of the recipient state to the business model of the host corporation (Hymer, 1976). This can lead to a 'brain drain' from local companies to the TNC and can undermine potential multiplier effects of investment (Pavlínek, 2004, p. 52). The danger is that CEE economies become stuck in the 'middle income trap', specialising as assembly hubs in the supply chains of powerful TNCs, restricting their future potential to integrate at a higher level in the value chains of the world economy.

A third downside of FDI-dependence is that it can exert a *regional race to the bottom* within recipient states, as their respective governments seek to compete for inwards investment. In the early 2000s, the average wage of a Czech automotive worker was one tenth the wage of the average German automotive worker (Pavlínek, 2004, p. 57). Throughout the 2000s, CEE states engaged in a fierce competition seeking to secure FDI (Becker, 2016, p. 63). This involved restraining labour costs, weakening labour laws, offering tax incentives and cutting social entitlements (Bohle, 2018, p. 243). Whilst TNCs may have paid higher wages in selected sectors within CEE economies, this process has been accompanied by a range of negative effects. First, it leads to wage convergence at a lower level, as companies merely transfer highly productive technologies to lower wage production hubs, instead of investing in production techniques based on relative prices of labour and capital. This has the effect of constraining wage growth in equivalent non-CEE manufacturing sectors in other member states. Second, the intra-state competition to attract foreign capital limits the scope for wage increases within CEE economies which could mirror productivity gains within the individual firm. This in turn bolsters the competitiveness and profitability of corporations based in the German core, further entrenching their absolute advantage vis-a-vis other European exporters. Third, FDI dependence has had a particularly negative effect on lower skilled manufacturing workers and sectors within CEE economies oriented towards the domestic economy. This has compounded a continuing stagnation in real wages across the CEE countries since transition (Becker, 2016, p. 46).

Policy Recommendations

The Eurozone crisis exacerbated uneven development between the ‘core’ and ‘peripheral’ European economies (Parker and Tsarouhas, 2018). Following the crisis, projections suggest that the cluster of ‘core’ economies are likely to continue to outperform ‘peripheral’ European economies in the future. In this paper we have focussed on the question of FDI from Germany into other Eurozone states. The analysis suggests that German-based corporations continue to increase their ownership of supply-chains, particularly in the CEE economies. This process cannot be considered a mere ‘economic’ issue. Increased German FDI grants a level of political leverage and power to German corporations over the economies which host them. This has wider structural implications. Since the formation of the euro, German firms benefited both from wage restraint within Germany *and* from their geographical proximity to cheap labour in CEE. This has two implications. First, it has entrenched German industrial dominance over its competitors, in particular in Europe’s Southern periphery and in France. Second, notwithstanding the benefits that CEE economies obtained from foreign investments, German FDI-led integration has compromised their capacity for sovereign economic development and generated a dependence on German exports (Nölke and Vliegenthart, 2009). Our policy recommendations seek to address these challenges.

As we have seen, in the late 1990s and 2000s, FDI played a key role in the transformation of CEE economies. Uncoordinated inflows of FDI, that is inflows which are not embedded in a wider development strategy, often entail dependency for the recipient state. Since the bulk of R&D and technological capacity remains concentrated in the advanced European core, this threatens to undermine the economic sovereignty of FDI-dependent states in the medium-to-long term. Since the 2008 financial crisis, FDI has slumped across the Eurozone as a whole and in CEE economies in particular, which highlights the vulnerabilities of FDI dependence (ETUI, 2015). A reliance on foreign investment can exacerbate internal uneven development, undermine domestic productive structures and undermine local democratic control over the productive base. A key objective should therefore be to move CEE economies away from their dependence on foreign capital and German exports and to cultivate alternative domestically-rooted forms of economic growth. The four policy proposals below seek advance European-level proposals designed to meet this objective.

- ***Establish an ‘FDI imbalance procedure’ at the EU level***
  The EU has a newly-developed framework for assessing macroeconomic ‘imbalances’ through the macroeconomic imbalance procedure of the European Semester. However, FDI has been viewed by EU policymakers as an unqualified public good. As such, the idea of

FDI 'imbalance' has not been established in the mechanisms of European economic governance. As we have argued, excessive levels of FDI dependence can have negative effects both on recipient countries and on non-recipient countries who nonetheless see their industrial competitiveness undermined. We advocate the establishment of a Commission-level body charged with quantitatively and qualitatively assessing FDI imbalances. This body would monitor negative tendencies associated with FDI, for example where a 'race to the bottom' in wages or conditions takes place in order to attract inwards investment. The body would be able, in these cases, to attach progressive 'conditionality' clauses to FDI, ensuring that wages and conditions are not cut in order to induce FDI.

- ***Develop an FDI 'rebalancing fund'***
  As argued above, FDI can exacerbate regional inequalities within recipient states. This is socially and economically unsustainable in the long-term. FDI should spread the fruits of investment more equitably between regions within recipient states. As such, we propose that a levy is taken on each FDI of a value of up to 10 per cent, depending on the size of the overall investment. This would then be added to the available European structural funds of the recipient state and would be channelled to 'non-FDI' regions. This would ensure that corporations benefiting from foreign ownership do not selectively 'cherry pick' from the most economically advanced regions and sectors but also subsidise and contribute to the development of regions which are not direct beneficiaries of FDI.

- ***Coordinate a Pan-European investment framework which takes account of corporate power imbalances***
  The second pillar of the European Union – free capital mobility – needs to be challenged. All direct investments should be embedded within a new European-wide investment strategy that takes into account the negative effect which excessive foreign corporate ownership can have on domestic political economies. Regulations might entail a maximum share of 49 per cent in equity in foreign companies, with the remaining 51 per cent in hands of domestic investors or institutions, echoing some of the conditions which China has attached to its 'coordinated' approach to FDI. This of course could initially limit available investment for emerging European economies. In order to counteract this, it would be necessary to greatly enhance available public funds for investment at the EU level. One key element of such a strategic intervention would require a strengthening of the European Investment Bank, which could issue bonds that would be directly purchased by the ECB to finance productive investments. This would unleash a large quantity of investment funds, re-industrialising European supply chains whilst lessening dependence on foreign private ownership.

- ***Increase domestic sources of credit in CEE economies***
  The above forms of public funding should be complemented by developing domestic credit systems. In 2007, in the Visegrad 4, domestic credit to the private sector stood at 34.5 per cent of GDP. In contrast, Germany, Austria and the UK's figure stood at 112, 106 and 156 per cent respectively. In order to cultivate domestic sources of credit and to lessen foreign ownership, the V4 states and European Commission should aim to substantially increase domestic credit, issued in national currencies (except for Slovakia, which has adopted the Euro), to the private sector. This could be done by encouraging the development of national investment banks charged with directing revenues towards productive activities in strategically significant sectors, in particular those with high R&D potential.

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