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The Eurozone's Self-harming Quest for Trade Surpluses

PhD thesis

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'If we are victorious in one more battle with the Romans, we shall be utterly ruined.'

Plutarch: The Life of Pyrrhus

1

INTRODUCTION

1.1 The Eurozone's self-harming quest for trade surpluses

International trade is often thought of as a competition between nations, and the name of the game is selling more to partners than what is bought from them. An economy running trade surpluses (exports exceeding imports in a given period) conjures up images of a strong industrial base, thriftiness, or quite simply: winning. While the lure of trade surpluses spanned several centuries and holds strong to this day, John Maynard Keynes, father of modern macroeconomics, had a markedly different view. He stressed how surpluses can be rooted in underconsumption, underinvestment and social inequality. After all, the trade balance (a difference) improves not only by exporting more, but also by importing less. Writing his 'General Theory' in the wake of the Great Depression, he explained how nations spending less than what they produce end up harming themselves, as well as their neighbors. They undermine domestic employment, while also limiting others' room to recover from the fall, inciting political conflict between nations. International trade becomes a vessel to transmit the effects of self-harming policies onto trading partners, and also a last resort channel to make up for weak home demand by relying on the same partners (Pettis 2013, Klein and Pettis 2020). Keynes called out these strategies as '*a desperate expedient to maintain employment at home by forcing sales on foreign markets ... which, if successful, will merely shift the problem of unemployment to the neighbour which is worsted in the struggle*' (1936, Ch. 24/IV).

The starting proposition of this thesis is that the case of the present-day Eurozone is remarkably similar to what Keynes described above. In the onset and aftermath of its crippling debt

crisis, Europe's currency union exemplified a destructive and therefore quite puzzling policy strategy: a self-harming pursuit of trade surpluses through suppressing domestic spending, that is not only beggar-thy-neighbor, but also beggar-thyself.

The rationale was that members could 'export themselves out of trouble' by implementing fiscal austerity and cutting wage costs to push down the domestic price level and make exports more competitive (i.e. cheaper). This was often justified by pointing at the perceived success cases of austerity: 'export world champion' Germany tightened budget strings in the middle of the Eurozone recession, but experienced stellar job growth. On the periphery, Ireland emerged as a poster child, committing to the internal devaluation strategy and rebounding faster than crisis-hit peers.¹ The dissertation aims to show the contradictions of this policy strategy by problematizing the apparent success of these two cases.

By 2013, the Eurozone as a whole overtook China as the global region with the biggest current account (CA) surpluses. As Keynes predicted, suppressing spending and forcing up saving in a recession came with devastating economic and social costs. A large body of scholarship documented the pain inflicted by Europe's austerity-bias: collapsing labor markets, declining incomes and social protection, especially in the most severely hit Southern periphery (Gutiérrez 2014, Pérez and Matsaganis 2017, 2019, Picot and Tassinari 2017, Afonso 2019, Walter *et al.* 2020), and an abysmal growth performance throughout the continent (Mody 2018, p. 392). Economic output sharply diverged from pre-crisis trends and never returned; and Europe lagged far behind the United States, the biggest deficit country, who chose to counteract the slump more forcefully with fiscal stimulus. The immediate target of Europe's extreme fiscal stringency was the reduction of debt burdens, but the debt problem, too, was exacerbated by the widening depression (De Grauwe and Ji 2013).

¹ In 2010, at the depth of the crisis, Bundesbank President Jens Weidmann stressed that 'Germany's experience should provide some reassurance to those countries faced with the need to restore their competitiveness.' European Central Bank chief Jean-Claude Trichet famously proclaimed that 'Greece has a role model and that role model is Ireland.'

Beyond staggering domestic costs, the Eurozone's strategy sparked international tensions too. In an environment of globally weak demand and near-zero interest rates (which Keynes called a liquidity trap), CA surpluses and a reliance on external demand to grow has harsh zero sum effects. It is equivalent to capturing some of trading partners' scarce demand, limiting their room to produce as much as they want, in other words, exporting unemployment to them (Blanchard and Milesi-Ferretti 2012). Also on this front, Keynes' warnings materialized: critics ranging from consecutive US administrations to the International Monetary Fund denounced Europe's parasitic demand management and refusal to help the global recovery by spending more at home. The Obama administration was first to float the idea of corrective tariffs (Geithner 2010), and the Trump administration threatened to escalate the conflict to an all-out trade war (Polyak 2019).

Reaching record-high current account surpluses was a Pyrrhic victory for the Eurozone. Both for surplus and (former) deficit countries, higher domestic consumption and investment could have remedied a host of domestic economic problems, while also easing international tensions. Why, then, did the Eurozone stick to policies suppressing spending?

The analysis below argues that the Eurozone's rationale for sticking to the 'export yourself out of trouble' strategy was based on *three fallacies*, that are the main theoretical contributions emerging from this work. These fallacies are rooted in the empirical problem of *observational equivalence*, which inherently obscures costs and benefits attached to CA surpluses.

1. The first fallacy is mistaking external enablers for domestic competitiveness— interpreting successful export performances in the Eurozone to be the results of domestic reforms ('the success cases of austerity'), while they were largely explained by better links to faster growing trading partners like the United States and China.
2. The second fallacy is mistaking weak imports for strong exports— interpreting surpluses as 'winning,' even when they are not driven by superior export performance, but sluggish import growth, and are rooted in domestic distortions like inequality and underinvestment.

3. The third fallacy is mismeasuring multinational firms' contributions to national exports— interpreting profit shifting and assets stashed in low tax jurisdictions as export performance.

The core argument lays out how these fallacies inflate the net gains of surpluses (overstating their benefits, understating their costs) and serve as the political incentive structure keeping self-harming macroeconomic policies in place, providing political rationality for choices that are irrational in terms of economic self-interest.

The argument advanced here is twofold. The first part, establishing the empirical puzzle, is that Eurozone economies' pursuit of surpluses is self-harming, and hurts trading partners as well. It is a '*beggar thyself, and thy neighbor*' strategy and it adds up to a global *negative sum game*. The policy configurations generating these surpluses hurt domestic residents. The boldest part of the argument is that not even export-sector producer groups – the domestic stakeholders who are generally assumed to be 'winning' from sustained CA surpluses – are truly benefiting. These thoroughly puzzling, negative sum distributional impacts beg the question: why are these surplus-generating policies kept in place? The second part of the argument answers this puzzle by pointing to three fallacies that obscure the cost-benefit calculus attached to surpluses, and create political incentives to pursue these policies.

1.2 The argument in brief: three fallacies

Attaching national-level costs and benefits to CA surpluses is marred by the observational equivalence problem: surpluses can emerge from both virtuous and harmful policy choices, and it is difficult to distinguish between the two. The three fallacies that arise from surpluses' cost-benefit calculus give the structure of the thesis. The three analytical chapters deal with each of them, in turn.

1.2.1 Mistaking 'external enablers' for competitiveness: imbalances across the Eurozone

The first (and most important) fallacy is mistaking the effect of 'external enablers' for competitiveness-enhancing domestic reforms. The strategic rationale behind austerity policies was that the currency area's crippling debt crisis was diagnosed as being rooted in overspending and a loss of

competitiveness in Europe's periphery (Wyplosz 2013, Jones 2016). Cutting wage costs and 'profligate' fiscal spending aimed to depress the domestic price level, making exports cheaper and more attractive (a policy strategy called internal devaluation). Cutting Unit Labor Costs (ULC) and improving fiscal discipline were the two key themes of extensive EU-level reform efforts like the Six-Pack, Two-Pack or Fiscal Compact (Gabrisch and Staehr 2015). The model to emulate was Germany, whose remarkable transformation from the 'sick man of Europe' in the early 2000s to an export-fueled economic powerhouse was understood to be a product of successful wage restraint and fiscal austerity. Beside the reigning export world champion, a poster child emerged on the periphery too (Brazys and Regan 2017, Roche *et al.* 2017). Ireland, although hit hard by the crisis and forced to undertake painful internal devaluation, managed to rebound in 2012, and grow significantly faster than the Southern European crisis countries. A widely held narrative saw the German and Irish experience as model examples for the 'no pain, no gain' advice: those who endure painful but necessary reforms will be rewarded by export-driven employment and growth. The chapter takes issue with these competitiveness-based success stories – and argues that the key to explain both of these success cases was foreign demand, not domestic austerity.

The analysis departs from the question why some euro members coped with austerity easier than others, in terms of employment outcomes, in the onset and aftermath of the Eurozone crisis. It aims to show that compared to their respective surplus and deficit country peers, these alleged success cases of austerity were not aided by improved competitiveness but favorable external demand shocks. The fallacy stems from the fact that these two are observationally equivalent: a rising CA balance and rising employment can emerge from austerity-driven competitiveness gains as well as trading partners' increased spending. The analysis finds that in both the German and Irish cases, export growth was not a product of austerity, but the other way around: existing export ties enabled austerity. The missing variable is external demand: these two countries had stronger ties to faster growing trading partners like the United States and China, the 'enablers' of Eurozone austerity, who were willing to spend and borrow (running bilateral deficits mirroring their surpluses), masking the otherwise painful effects of suppressed domestic spending.

Without the US acting as a consumer market of last resort, featuring automotive manufacturing, pharmaceuticals and business sector services heavily in their import mix (fitting sectoral specializations of these two countries), and without China cutting its CA surplus from 10 percent to 2 percent of its GDP through an investment-heavy fiscal stimulus (a boon for high tech machinery ‘Made in Germany’) – suppressing home markets would have been much costlier. Judging from this perspective, some of these ‘painful but necessary’ policies were indeed very painful, but also unnecessary.

The theoretical proposition is tested on the whole universe of country cases – those Eurozone members, who ran excessive surpluses before the crisis and members who corrected excessive deficits, turning them into surpluses. The direction of the spending suppression (an upward movement in the CA balance) is the same in both groups, allowing us to analyze them in a single, coherent framework. This comparative exercise substantiates the case selection: from ‘most similar’ comparisons within surplus and deficit country groups, a parallel emerges between two ‘most different’ cases. Germany and Ireland both managed to cope better with demand suppressing policies– an outcome widely interpreted to be rooted in austerity and structural reforms. Instead, the chapter introduces the external enablers channel, a mechanism to show that the both countries’ success occurred in spite of austerity, not because of it, by relying on foreign demand.

The external demand channel introduced in the chapter explains part of the compensation effect through real effective exchange rate (REER) competitiveness. It has immense theoretical significance. Since the positive effects of demand suppression are assumed to be competitiveness gains, if this channel is weaker than previously thought, then the gains from these policies are also inflated.

1.2.2 Mistaking weak imports for strong exports: the case of Germany

The ‘external enablers’ chapter establishes how strong existing ties to the right partners allowed Germany to suppress domestic demand without corresponding costs in employment. While this was plausibly an important incentive structure for German policymakers to forgo rebalancing (they were not forced to do so by rising unemployment), several question marks remain. Beyond job numbers,

there are plenty of harmful side-effects of suppressed spending. A large low wage sector undermines domestic living standards, chronic underinvestment in physical and digital infrastructure harms long-term competitiveness. For an economy as open and export-dependent as Germany, international criticism in and of itself should be an important incentive to change course. Why was there no rebalancing, then?

This ‘residual’ puzzle in the German case is rooted in the second fallacy: mistaking weak imports for strong exports. A CA surplus can be interpreted as an ‘import deficit’ or an ‘export surplus,’ the two are two sides of the same coin, and observationally equivalent. The chapter aims to show that Germany’s large and persistent CA surpluses are, in fact, rooted in domestic policy distortions suppressing spending: rising inequality (shifting income from people who consume a larger share of it, to people who save a larger share) and excessively tight fiscal policy starving the state of public investment. This does not negate the fact that Germany has a strong and successful export sector, with products and services desired throughout the world – but the *surplus*, i.e. the large and growing *difference* between exports and imports was not driven up by improved export performance (these indicators remained more or less unchanged), temporal patterns show that changes on the import side were the dominant factor. From the early 2000s, German wages grew slower than productivity so income shifted from workers to firm-owners, and since workers and ordinary households have a higher marginal propensity to consume (MPC), a larger share of the overall income will be saved (Pettis 2013). This drove up the CA surplus, which is by definition an excess of savings, i.e. residents of a country spending (consuming or domestically investing) less than what they produce in a given period. Interestingly, both the competitiveness and excess savings narratives share the same starting point: wage suppression. Suppressed wage growth can not only be filtered through cost-competitiveness gains causing an increase in goods or services exports – it also exerts a negative impact on domestic demand, as income is shifted away from wage earners who have a higher Marginal Propensity to Consume (MPC), meaning they are more likely to consume this income rather than save it. The difference between the two causal chains, and the observationally equivalent starting and end points can be summarized as follows –

COST COMPETITIVENESS SHOCK

suppressed wages → decreasing production costs → increasing CA balance

EXCESS SAVING SHOCK

suppressed wages → shifting income from high MPC to low MPC → increasing CA balance

Disregarding the import deficit or excess saving aspect distorts the politics of German imbalances. If Germany's predicament was an export surplus rooted in supreme competitiveness, the only potential losers would be trading partners. In case of an import deficit, however, it becomes visible that low wage workers – and ultimately, all citizens deprived of a sufficient level of public goods lose out from the pursuit of trade surpluses. A qualitative content analysis of media discourse and parliamentary debates finds narrative evidence that this fallacy is indeed present in the debates surrounding Germany's excessive surpluses. The chapter goes on to argue that as a consequence of the fallacy, domestic losers of German imbalances are systematically underrepresented in the public discourse. The second fallacy feeds into the political incentives working against rebalancing: the German surplus debate, narrated as a noisy competition *between* nations, drowns out dissatisfied voices *within* Germany. Paraphrasing the powerful title of Michael Pettis and Matthew C. Klein's book (2020): *trade wars* drown out *class wars*.

1.2.3 Mistaking multinationals' accounting tricks for exports: the case of Ireland

The 'external enablers' chapter explains Ireland's divergent recovery from the Eurozone crisis by pointing at the island's starkly different integration into global trade, compared to other members. Ireland is home to the world's fastest growing multinational giants and has a unique economic relationship with the United States – while much of the rest of Europe has trade links that are concentrated within the continent. Sturdy export performance from US-owned multinational enterprises (MNEs) in the information and communication technologies and pharmaceutical industries (the famous 'big tech' and 'big pharma') explained much of the Irish rebound, casting doubt on the rival narrative stressing austerity-induced competitiveness gains.

The ‘residual’ puzzle, the question that remains unexplained by the first fallacy in the Irish case is quite profound – was this export performance actually there? As a growing number of observers warn: much of Ireland’s economic and export growth only exists on paper (Frank and Setser 2018, Damgaard *et al.* 2019, Klein and Pettis 2020, Brazys and Regan 2021). MNEs use accounting tricks to shift wealth and income to low-tax jurisdictions, often without moving actual production there. Export activity occurring elsewhere in the value chain thus becomes observationally equivalent to Irish export activity. To identify fictitious activity and assess the magnitude of the third fallacy, the chapter uses a novel empirical approach to contrast traditional, value-added based measures to economic performance to employment and earnings by sector. The simple insight leveraged here: if jobs and earnings grow, it is evidence for economic activity beyond accounting fiction.

The analysis concludes that distortions are substantial, and overwhelmingly cluster in the ‘big tech’ and ‘big pharma’ industries. These distortions have an impact on the national level cost-benefit calculus attached to CA surpluses: they look more beneficial on paper than they actually are. However, these sectors still saw substantial expansion, also when measured by job-sustaining economic activity (employment headcounts, wages). Robust growth in jobs and earnings show that beyond distortions, Ireland can justifiably be viewed as an export-oriented economy – the magnitude of export gains should be adjusted, however. The third fallacy introduces another layer of complexity to national level costs and benefits attached to economic activity that is increasingly global and spatially fluid.

1.3 Links to existing explanations

The existing literature offers rich and complex answers to the central puzzle: why Eurozone economies insisted on policy configurations suppressing spending and forcing up saving, notwithstanding their severe distributional costs. The following section reviews how the core argument links to these existing explanations, and the gaps it aims to fill.

1.3.1 Institutional complementarities, growth models

The Comparative Political Economy (CPE) literature offers a coherent explanation to the puzzle of suppressed spending and growing CA surpluses, even in the face of severe recessionary shocks. Scholars in the Varieties of Capitalism (VoC) tradition would point to sectoral vested interests in export-oriented economies, and a set of complementary institutions upholding low spending (Hall and Soskice 2001, Iversen and Soskice 2012, Hall 2014, Iversen *et al.* 2016, Hall 2017). In Coordinated Market Economies, centralized wage bargaining institutions are coupled with macroeconomic policies to deliver wage restraint and suppress the domestic price level to boost export competitiveness, a priority for policymakers attuned to the interests of high value-added exporting industries (that, in turn, are the main source of economic growth and investment). Central banks prioritize low inflation, and fiscal policy contributes by keeping public-sector unions at bay and refraining from demand stimulus to prevent real appreciation hurting export sales.

The argument presented here offers a different perspective. The main line of disagreement is that CPE works usually assume that domestic demand suppression directly contributes to export growth through a strong REER competitiveness channel. As Hall (2017, p. 4) explains: *‘the successful operation of ... export-led growth models also depends on a complementary set of macroeconomic policies ... [including] restrained fiscal policy, which is especially important in such contexts because it limits public-sector wage increases that might otherwise raise the real exchange rate and damage competitiveness.’* While marking an important step away from the supply-side orientation of VoC works and offering a more dynamic perspective (better fitting cases like Ireland, ‘oscillating’ between ideal types), the growth models paradigm of Baccaro and Pontusson (2016) also posits that export-led growth crucially depends on suppressing domestic spending to limit real appreciation.

This investigation finds that export-oriented economies, and export sector firms, too, are hurt by policies suppressing domestic spending. The main argument put forward by the first, ‘external enablers’ fallacy is that part of the export growth attributed to competitiveness gains, stem from favorable external demand shocks, that are observationally equivalent to REER shocks. The external

demand channel does not aim to debunk the competitiveness channel (both of these are at play in parallel), but introduces a mechanism relatively unexplored by CPE works that does explain away some of the variance attributed to REER, and thereby weakens the extent to which domestic export sectors ‘win’ from demand suppressing policies. Beyond this finding, there are other aspects shaping the preferences of export sectors— such as their vested interest in fiscal spending on public investment (their productivity directly suffers from faulty physical or digital infrastructure), or their risks and uncertainty from the international trade conflicts generated by excessive surpluses. These combined effects cast doubt on the pivotal role of exporters’ gains keeping these policies in place.

Although there are overlaps between the focus on export-led growth and the pursuit of CA surpluses, the second fallacy also shows that there are differences. The study of export-led growth regimes concentrates on CA surpluses achieved by growing exports (understandably, since this is the channel generating growth), and pays less attention to those achieved by weak imports, and the role of growing inequality that shifts income to agents with a lower propensity to consume. CPE works that find a correlation between wage setting institutions (delivering wage restraint) and CA surpluses often automatically assume that competitiveness drives the effect, disregarding the role of imports and the excess savings channel. Similarly, the third fallacy, the role of global value chains inflating export performance is somewhat of a blind spot in CPE works.

It is possible that policymakers in export oriented economies buy into the competitiveness narrative themselves, fearing that policies stimulating domestic demand would cost them market share – but this causal argument stretches beyond the incentive structure of the growth model and confers explanatory power to *narratives or beliefs* about how these growth models work. It is not exporters’ objective interests that propel their behavior, but a perception of their interests that may be discursively constructed. This leads us to the second strand of the literature providing convincing alternative explanations for the central puzzle – that of ideational political economy.

1.3.2 Ideational biases

Ideational scholars, stressing the separate causal role of narratives (Matthijs and McNamara 2015), discourse (Schmidt 2014), or more broadly, the power of austerity as an economic idea (Blyth 2013, Farrell and Quiggin 2017) covered a lot of ground in explaining why Europe firmly rejected stimulus and stuck to internal devaluation so persistently, arguably against its own self-interest. As they explain, part of the appeal of the competitiveness narrative is that there is a fundamental moral intuitiveness to the story about an economy ‘saving its way out of a crisis,’ especially if it pertains to a debt crisis. This influences how voters see austerity: they may support it even if it hurts them, while they are hostile against stimulus programs which are often considered to be gifts to them (Bremer and McDaniel 2020, Bansak *et al.* 2021). It is similarly intuitive (therefore, politically well received) to frame exports as a superior form of generating national income, while consumption is scolded as profligate.

The causal role of ideas – the moral intuitiveness of austerity and surplus-generating competitiveness – provides a strong explanation why governments and voters opt for them even against their own self interest, but does not explain why the pursuit of competitiveness through internal devaluation was (seemingly) successful, even politically well-received in some countries like Ireland, while unsuccessful and contested in others. Such voter preferences and ideational resources are supposed to be stable over time, yet we see considerable within-case variation in policy outcomes. Germany, the archetype of stability culture, enacted sizable fiscal stimulus packages after the 2008 crash (Schelkle 2012) as well as the 2020 COVID-shock (Sandbu 2020). Ireland switched from a paradigm based on a credit-fuelled asset price bubble to stringent internal devaluation and fiscal austerity.

The ‘external enablers’ argument advanced in Chapter 2 proposes that ideational factors also interact with allowing outside conditions provided by global aggregate demand dynamics. It is convincingly demonstrated by the literature that Germany and the Eurozone as a whole have an ideational bias towards austerity, but it is less plausible that an ideational bias alone can uphold any macroeconomic policy mix if unemployment spikes up because of a global demand collapse (as was the case in Germany in 2008 and 2020, duly prompting policymakers to enact large stimulus programs). It

is unlikely that these narratives could have stayed in place without economic success providing ex-post legitimacy to reforms and the enabling incentive structure created by external demand – putting in doubt the primary causal significance of austerity as an idea. In other words, there was an ideational bias against Keynesianism (among others underpinned by Germany’s famous stability culture), but it was *enabled* by an outside causal factor. The competitiveness narrative was thereby ‘saved’ by a masking effect of external demand.

The role of ideas has more explanatory leverage in the question tackled in Chapter 3 – the ‘residual puzzle’ in the German case. This chapter goes beyond the previous one in arguing that suppressed spending is not only not helping German residents, including exporters, as much as previously assumed (through competitiveness effects), it is hurting them. It is thoroughly puzzling why these policies are kept in place, in light of the staggering number of domestic losers they produce. For instance, workers in Germany’s large low-wage sectors are disproportionately hit, but all domestic residents are hurt by the inadequate level of public goods. Interests or incentives alone cannot offer a full explanation. The chapter taps into the literature on the discursive construction of interests (e.g. Hay and Rosamond 2002) to argue that narrating the surplus debate as a noisy political rivalry *between* nations, while disregarding distributive tensions *within* Germany, creates political obstacles for rebalancing. This perspective treats ideas not as constraining structures stemming from cultural or historical determinism, but rather as political resources that can be utilized by agents in a strategic way.

1.3.3 Distributional politics

In order to explain the central puzzle, the theoretical perspective needs to take into account distributional political conflict on the international (both global and European) and domestic levels, with due attention to interaction effects. Existing works in International Political Economy have engaged with this multilevel nature of political conflicts engendered by CA surpluses. In their analysis of the Eurozone crisis, Frieden and Walter (2017) lay out a framework highlighting the double layer of distributional politics in cases of current account adjustments: tensions arising within countries (as the adjustment burden is shared between societal groups) and between countries (creditors and debtors)

(see also Walter 2013, Walter *et al.* 2020). Macroeconomic policy choices emerge from these dynamic political struggles to distribute crisis adjustment costs, and not constraining structures (either institutional complementarities or ideational biases). My argument builds on these insights – but goes further than them in three ways.

Firstly, it introduces a third, global level of analysis beyond the domestic and Eurozone-level focus of these accounts, highlighting that spending and saving choices in member countries are affected by choices of their trading partners outside the Eurozone, i.e. demand shocks originating from the United States or China. Thus, outcomes cannot be fully understood without taking into account the effect of ‘external enablers’ and global aggregate demand dynamics (first fallacy). This way, the focus turns away from intra-Eurozone imbalances, to the growing surpluses of the Eurozone as a whole, vis-a-vis the rest of the world. Secondly, it concentrates on how distributional tensions on the domestic and international levels *interact* and argues that domestic political conflict can be drowned out by the noisy political tensions with trading partners (second fallacy). Finally, the study of distributional tensions could also be enriched by a focus on global value chains, and the measurement problems arising in global trade, that is increasingly decoupled from nations (third fallacy).

Introducing a global level of analysis shows how countries, interest groups and ultimately voters are all vulnerable to other countries’ policy choices as well as their own. For example, the German export sector was highly vulnerable to periphery countries’ internal devaluation, since it resulted in a demand collapse on their export markets, and Germany had a large bilateral trade surplus vis-a-vis the five periphery countries before the crisis (see also: Bibow 2013). The key variable in this case was extra-EU demand, and the regional nature of the Eurozone crisis: more spending from China (and Asia) and the United States substituted the collapsing periphery’s demand. In a hypothetical counterfactual scenario, without an upsurge in extra-EU demand, the German export sector would have likely been much more invested in policies boosting domestic demand. And indeed, similar historical counterfactuals presented themselves in both 2008-09 and 2020, when export market collapse was more widespread – duly triggering large stimulus packages in Germany.

External demand (Y^*) would thus become another ‘external adjustment’ option in the framework set up by Frieden and Walter (2017, Table 1). Exchange rate revaluation is not the only lever to rebalance CA surpluses – if a crucial trading partner economy like the United States suppressed domestic spending through fiscal austerity, it would do the trick too. Note that the deficit country / surplus country matrix by Frieden and Walter opens the door to the Y^* argument: the symmetry they draw up between the external adjustment of a surplus country and the internal adjustment of the deficit country implies that one’s internal adjustment (stimulus or austerity policies) constitute the Y^* for one’s trading partners. As it follows from the paradox of thrift: someone’s spending is another one’s income. The same applies for borrowing and lending – which is mirrored in the authors’ focus on financing policies, the third adjustment channel beyond external and internal policies (although financing is not a lever to resolve imbalances, but a means to sustain them). Sustaining CA surpluses and excess savings is only possible if there are deficit countries willing to borrow, i.e. supply financial assets for savers. This leads us to financial markets based explanations in the Eurozone-focused political economy literature.

1.3.4 Financial enablers

As an accounting necessity, the financial account (FA) is always a mirror image of the current account (CA), reflecting the financial flows underscoring real economic developments as captured by the CA. The argument presented here focuses on real economic processes and variables. It does put saving propensities and ‘excesses’ of savings front and center – but understands saving to be a real economic, not a financial phenomenon (in contrast to the everyday use of the term). Saving, in a macroeconomic sense, means income not consumed, a real economic concept, while excess saving (a CA surplus) is income neither consumed, nor domestically invested ($CA = S - I$). As the other side of this coin, net financial claims are acquired on foreigners, constituting the ‘capital outflows’ recorded in the FA.

The real economic nature of savings is also emphasized by the ‘endogenous money’ literature in the context of international capital flows (Kumhof *et al.* 2020). However, Kumhof’s approach also warns against interpreting the savings glut of Eurozone surplus countries as ‘flowing’ abroad, and

financing or ‘enabling’ deficits elsewhere (a widespread reading of the Eurozone crisis is that German savings flew into periphery assets, thereby creating the imbalances). As he explains: ‘[Surplus] countries are not sending savings to America to give it ‘funds’ to finance their imports. (...) Their net exports *are* the saving, by definition’ (The Economist 2020, emphasis added). How these cross-border real transactions are financed is a different question, captured in the financial account. In modern finance, existing real economic savings are not prerequisites of financial flows, but can rather be the consequence of them. Banks can create funds out of thin air through the act of lending, without needing any pre-existing real savings to do so. This can finance the import spending of CA deficit countries domestically, which then generates the export revenues surplus countries can decide not to spend (i.e. to save).²

This also means that financial market shocks can indeed be important drivers of imbalances in their own right, decoupled from real economic behavior. Works on the origins of the Eurozone crisis, also taking issue with the wage divergence and competitiveness accounts outlined above, point to ‘search for the yield’ in financial markets as a causal story – and how it was exacerbated by distinct features of the Eurozone (increased cross-border lending, elimination of currency risks) (Jones 2016, Tooze 2018, pp. 105–106, Pérez 2019). Chapter 2 will briefly explore how the United States’ role as an ‘external enabler’ is also driven by the fact that they possess the world’s most developed and deepest financial market (as well as being the issuer of the global reserve currency) (Klein and Pettis 2020).

The above approach highlights that real economic dynamics and excess savings are not necessarily the originating cause of global imbalances – imbalances can also have financial roots. However, even in this framework, excessive saving behavior does contribute to *maintaining* the imbalance by pushing down imports in surplus countries. The aim of this analysis is not to show whether the root of Eurozone imbalances was a real economic excess saving shock, a financial shock (or both), but it is assumed that change in spending and saving propensities interact with financial

² In this case, the Financial Account just contains an entry recording the cross-border change in ownership of an already existing financial asset, without any need from the side of the surplus country to engage in lending or financing.

markets. This work attempts to move beyond the question whether it was the CA dominating the FA or the other way around, and whether certain shocks originated on the real economy or financial side. Rather, it focuses on real economic phenomena such as favorable foreign demand shocks on Eurozone export markets, or the inequality-driven rise of saving desire, which contributed to sustaining the imbalances.

1.4 A primer into imbalances: the Swan diagram

The central theoretical argument laid out in this thesis is that policies driving the Eurozone's persistent current account surpluses are self-harming, but kept in place because of the fallacious cost-benefit calculus attached to them. Surpluses' net gains are inflated: in terms of domestic economic outcomes, their benefits are overstated and their costs are understated. The following theoretical section fits the three fallacies in a stylized model.

The classic framework to overview policy levers and their impacts on both the internal balance (full employment) and the external balance (a balanced current account) is the Swan (or Meade-Swan) diagram. It was named after Trevor Swan (1963)³ who distilled the insights about the external-internal nexus in Keynes' *General Theory* (1936) and James Meade's *The Balance of Payments* (1951) in a simple model. It is a useful, stylized way to outline how pulling different policy levers affects both domestic employment and the current account balance. It addresses the focal question of this thesis – the interdependence of external and internal balances, and the costs and benefits of external imbalances in terms of domestic economic outcomes.

³ The diagram was first circulated in 1955, then published in 1963.

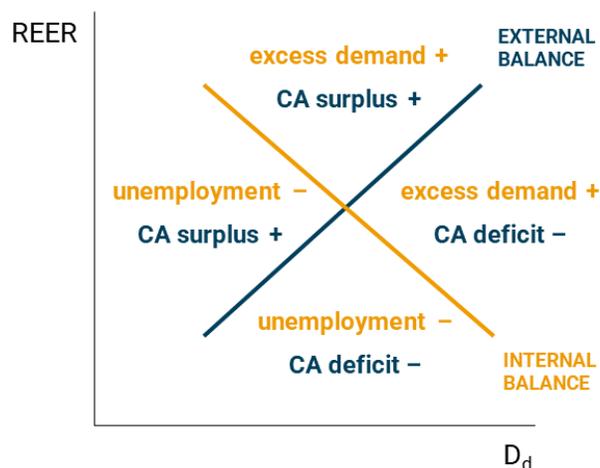


Figure 1.1. Swan diagram. Based on Swan (1963), Krugman and Obstfeld (2009, p. 519), Temin and Vines (2013, p. 257)

The two lines on the diagram show two outcomes policymakers are striving towards: the internal balance (IB) where the economy is at full employment (output is at its potential), and the external balance (EB) meaning a balanced current account. An economy can achieve balance both internally and externally: this is where the two lines cross. Policymakers target combinations of domestic demand (D_d) and the real effective exchange rate (REER) to keep the economy on these two lines, because slipping off either one would find it in one of the ‘four zones of economic discomfort’ (Krugman and Obstfeld 2009, p. 520). In an economy internally off-balance, demand is either deficient, resulting in unemployment (IB -), or in excess, resulting in inflation and overheating (IB +). In an economy externally off-balance, the current account either shows an excess deficit (EB -) or an excess surplus (EB +).

The two axes of the Swan diagram plot two variables, and *adjusting* these two variables can move the economy towards balanced positions – or push it away from said balanced positions.

The variable plotted on the horizontal axis is domestic demand (D_d). The adjustment of D_d is called *expenditure changing*: a change in the overall level of spending in the economy. Increasing spending from an equilibrium position (where IB and EB cross), all else held constant, means the economy will shift towards internal overheating and excess demand, while the external position will

shift towards a CA deficit through the increase of imports (IB +, EB -). On the flipside, decreasing spending (through fiscal austerity, for instance) would move the economy from the equilibrium towards unemployment and CA surpluses by reducing imports (IB -, EB +).

The variable on the vertical axis is the real effective exchange rate (**REER**). It is defined as the nominal effective exchange rate (NEER) times the ratio of foreign and domestic price levels (P^*/P) – and in simple terms, shows how ‘cost-competitive’ (cheap) a country’s products are relative to a trading partner. The adjustment of REER is called *expenditure switching*: a change in relative prices directs (or switches) demand away from foreign goods and services towards domestically produced goods and services, or the other way around. REER devaluation, a shift towards a more competitive exchange rate is a move up on the axis – towards more demand for domestic goods. Starting from the equilibrium position, all else held constant, this move would result in excess demand internally and CA surpluses externally (IB +, EB +). REER revaluation, a shift towards a less competitive exchange rate is a move down on the axis – towards more demand for foreign goods and consequently, unemployment internally, CA deficits externally (IB -, EB -). Since REER consists of the nominal exchange rate and relative price levels, it can be changed by devaluing or revaluing the nominal exchange rate. This policy was not available for individual euro members, as it would have implied the breakup of the common currency (Walter *et al.* 2020). Moreover, currency devaluation is a policy that is frowned upon in the post-Bretton Woods system of flexible exchange rates – if done deliberately to engineer a trade advantage (Blanchard and Milesi-Ferretti 2012).

What is quite consequential from the point of view of this discussion: *expenditure switching* can be achieved not only through the exchange rate lever, but also through domestic policies targeting the domestic price level. This is commonly known as internal devaluation (and revaluation) or real devaluation (and revaluation). Importantly, policies depressing D_d along the previous, expenditure changing channel have an *opposite* effect. Cutting back spending depresses the domestic price level, making REER more competitive (a move up) and driving up exports. Note that this is a simultaneous, compensation effect to that of the expenditure changing channel: the jobs lost by a decreased overall

level of spending can be gained back through rising exports, making austerity a more attractive policy choice.

When the European Commission talks about ‘structural reforms to improve competitiveness,’ a key policy agenda set for Eurozone economies, it mostly refers to fiscal and wage policy interventions and the expenditure switching channel. The limits of these dynamics can be illustrated through the case of the Eurozone’s Southern periphery after the crisis: achieving external surpluses while missing the internal balance (Figure 1.2). Real devaluation was the policy strategy to correct the Eurozone periphery’s excessive CA deficits (EB -) and excess domestic spending (IB +): countries were prescribed cuts in public expenditure and wages. In the Swan diagram, these policy interventions signify a move from starting position 1 to 2 – depressing the overall level of domestic spending, on both domestic and foreign goods and services, along the expenditure changing (horizontal) axis. As imports collapsed, periphery countries rebalanced their current accounts, and most swung into surplus positions – but at the painful cost of slipping off the internal balance curve and suffering soaring unemployment levels (IB -). Policymakers’ intent was for the expenditure switching channel to get them back to internal balance: as austerity and wage cuts would improve REER competitiveness and exports would soar, causing the economies to move up from 2 to 3 to full employment by gaining export sector jobs.⁴

Sadly, this is not what happened. The analysis chapters will show that the best performer, Ireland, needed ten years to reach pre-crisis job numbers in 2017. In Portugal, and especially Spain and Greece, unemployment remained painfully high, even with substantial demand squeezes and corresponding rebalancing efforts (Perez and Matsiganis 2019). Recovery from the Euro crisis had not been completed throughout the period leading up to the COVID-19 shock, another severe blow to internal balance.

⁴ Note that the sequential steps are only for the sake of clarity – usually we see simultaneous effects, i.e. 1 to 2 and 2 to 3 happening at the same time.

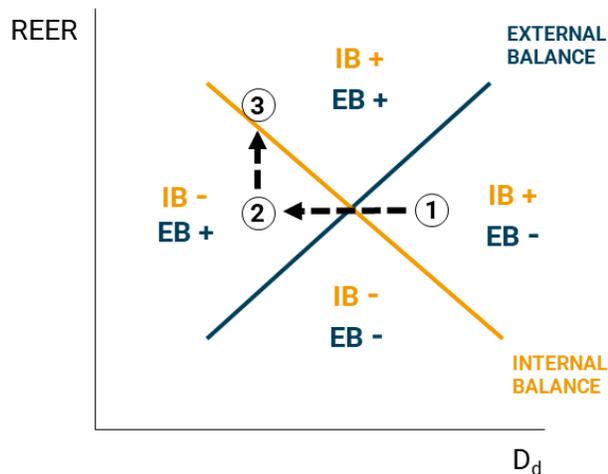


Figure 1.2. *Planned adjustment strategy for periphery countries. Own conception.*

A plausible explanation is that the expenditure switching channel, based on the positive compensation effect of relative prices on exports, is not as strong as policymakers thought. Expenditure switching is based on the assumption that exports are price elastic, i.e. sensitive to movements in REER, a more competitive exchange rate translates to higher export sales. If price elasticity is lower, the slopes of the IB and EB curves will be steeper (at a zero elasticity, they would be vertical). As shown by Figure 1.3, with lower REER elasticities, the expenditure changing channel depresses imports and pushes the external balance towards a surplus (EB +). But the expenditure changing channel does not increase exports enough to reach full employment and the IB curve, the economy stays below it and unemployment remains high (IB -).

The price elasticity problem demonstrates that the extent to which adjustment in either domestic demand or real exchange rates translates to the desired effect in the internal and external balance is not straightforward, there are other factors at play. The sensitivity issue triggers intense policy debates when it comes to the fiscal lever – but sensitivity to relative price movement is perhaps less widely discussed, and often taken for granted.

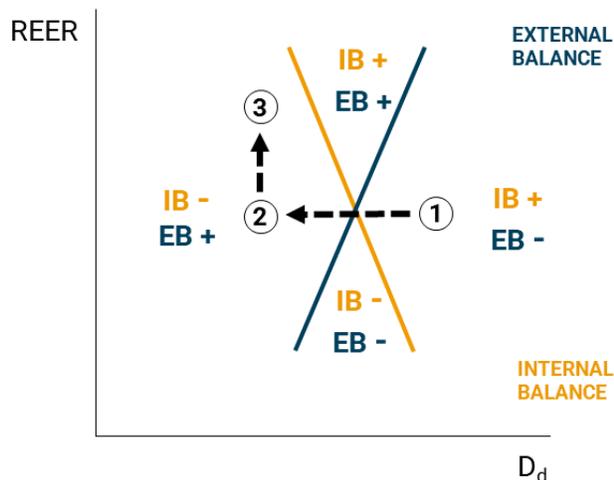


Figure 1.3. Adjustment for Eurozone periphery countries – with low REER elasticities. Own conception

The so-called ‘fiscal multiplier’ (or Keynesian multiplier) is the parameter determining the size of the employment and CA effect in case of fiscal adjustments along the expenditure changing channel. The idea behind the multiplier is that government spending raises incomes, which in turn, will be spent and invested, contributing to even more activity. In the 70s, the ‘rational expectations’ school offered a critique to this. The concept of ‘Ricardian equivalence’ assumes that households are forward-looking, and will react to a windfall of government money by saving it, since they expect an equal contraction in the future. ‘Ricardian’ households’ low marginal propensity to consume therefore decreases the multiplier. Estimates of multipliers are scattered in a wide range. The controversial ‘expansionary austerity’ thesis even claimed they were negative (smaller than 1), because austerity and fiscal discipline increase investor confidence (e.g. Alesina and Ardagna 1998, for a discussion, see: Dellepiane-Avellaneda 2015). After the financial crisis, macroeconomists gravitated towards the consensus that multipliers were large and positive (Spilimbergo *et al.* 2008). With economies operating under full capacity, extra spending was expected to boost activity without crowding out private investment. Fiscal contraction in a period like that has the same multiplying effect in the negative direction. The multiplier discussion also highlights how distributional effects of different fiscal policy interventions matter. In both directions, the effect on employment and the CA is larger, if the policy impacts high MPC (lower income) households.

Adjustment channel	Core driver of the employment/CA effect
Expenditure changing	Fiscal multipliers, Marginal Propensity to Consume
Expenditure switching	REER elasticity

Table 1.1. *What drives the effect of adjustment options?*

The combination of large fiscal multipliers (in part, because of policies hitting lower income, high MPC households), and smaller REER elasticity would imply that Eurozone austerity policies would be followed by a devastating collapse in employment and imports and paired with smaller compensation effects in competitiveness-led export gains – a pattern supported by the analysis below.

However, if the REER channel is less relevant, then what explains the cases where internal devaluation was followed by an improvement of the CA balance and good employment performance? This is where the ‘external enablers’ channel comes into play.

1.4.1 Swan diagram with external enablers

The Swan diagram omits an important factor– that is the effect of *other countries’* expenditure changing policies. If the overall level of demand increases or decreases in a trading partner economy, because *their* government implements any of the interventions in public expenditure (stimulus or retrenchment), it will yield the same effects on the internal and external balance as a REER depreciation (move up) or appreciation (move down) would.

As shown below in the modified Swan diagram with external demand Y^* (Figure 1.4), changes in Y^* coincide with changes in REER, plotted on the original model. The model remains the same, the only difference is the labeling of the vertical axis. In terms of observable implications, a movement in Y^* (an external demand shock) coincides with a movement in REER (a competitiveness shock). This implies that we should be cautious to interpret upward movements in CA balances as competitiveness improvements. The first chapter assesses this fallacy in the case of Eurozone economies. As mentioned above, the Eurozone’s demonstrative cases for competitiveness-driven success are Germany and Ireland.

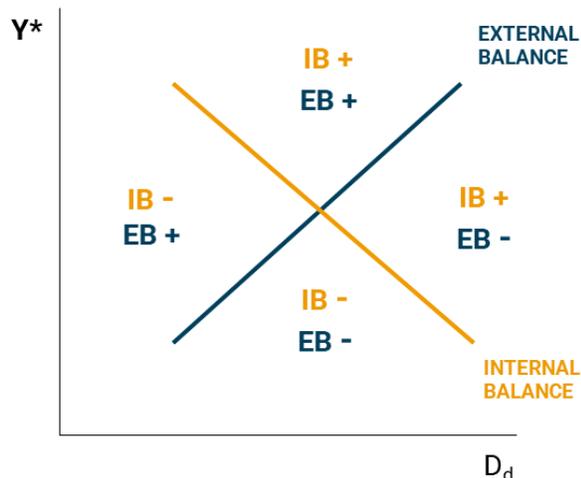


Figure 1.4. *Modified Swan diagram with external demand (Y^*). Own conception.*

The German economy started out as the sick man of Europe with low growth and high unemployment in the late 1990s, early 2000s (IB-, EB-). Then, in the mid-2000s, a set of painful structural reforms known as the ‘Hartz reforms’ (wage restraint, fiscal consolidation, social security adjustments) suppressed the overall level of spending and corrected CA deficits by momentarily throwing the economy even further off the IB (a move from 1 to 2). However, Germany engineered an export-led boom and reached almost zero unemployment and large CA surpluses by the 2010s – which was consequently interpreted as a REER-driven compensation effect.

Ireland emerged as a poster child in the recovery phase. Before the crisis, Ireland experienced credit-fueled, domestic demand led growth and an overheating economy with high inflation and a CA deficit (IB+, EB-). They implemented harsh austerity (a move from 1 to 2), suppressing domestic spending and closing the CA deficit, then reached pre-crisis employment levels through strong exports (reaching the IB, a move from 2 to 3) a lot faster than the ailing Southern periphery. Similarly to Germany, the Irish economy stood out both in its success to implement and uphold wage restraint (one marker of suppressed domestic demand) and also a more successful and export-driven recovery from the crisis, lending further support to the ‘austerity works’ argument.

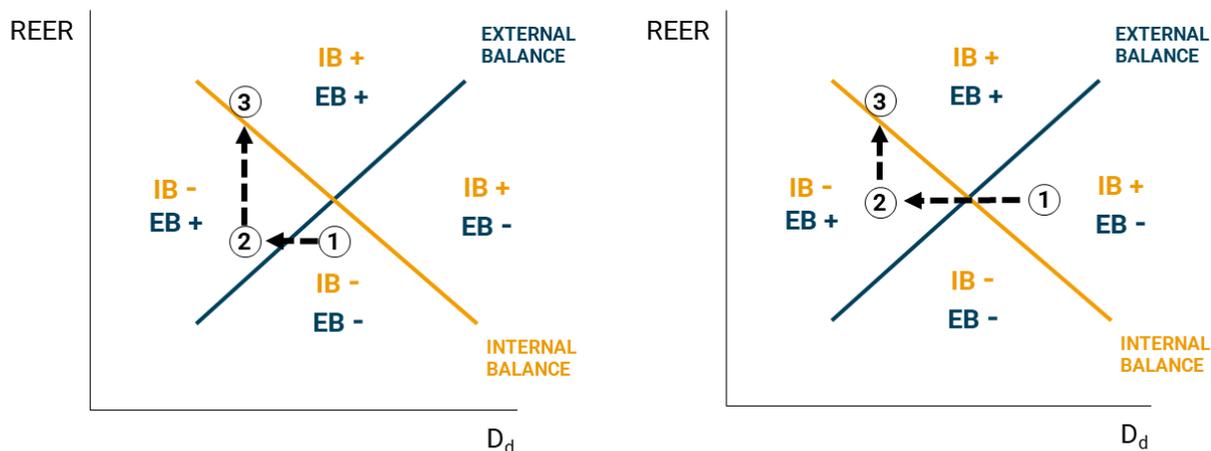


Figure 1.5. Germany's (L) and Ireland's (R) experience in the cost-competitiveness (REER) narrative

The next chapter will argue that neither Germany's rebounding growth in the early 2000s, nor Ireland's superior recovery from 2012 onwards were primarily a product of suppressed spending and the ensuing REER improvement. Rather, the observationally equivalent Y^* shock played a significant role: stronger ties to fast-growing trading partners like the United States and China, and export product mixes to satisfy their pent-up demand explained a substantive part of the variance. Again, the REER-based narrative rests on the assumption that the two countries' exports are price-elastic, and several scholars question that assumption in both cases (e.g. Danninger and Joutz 2007 in the German case, Brazys and Regan 2017 in the Irish case), which would imply steeper IB and EB curves in a REER-based chart (see Figure 1.3).

Now consider the same two sets of charts, with Y^* on the vertical axis. The external demand channel gives an alternative, coherent story to describe the German economy's path from unemployment and CA deficits (IB -, EB -), through internal devaluation depressing domestic employment but driving up the CA surplus (IB -, EB +); back to the internal balance curve with a large CA surplus but almost no unemployment.

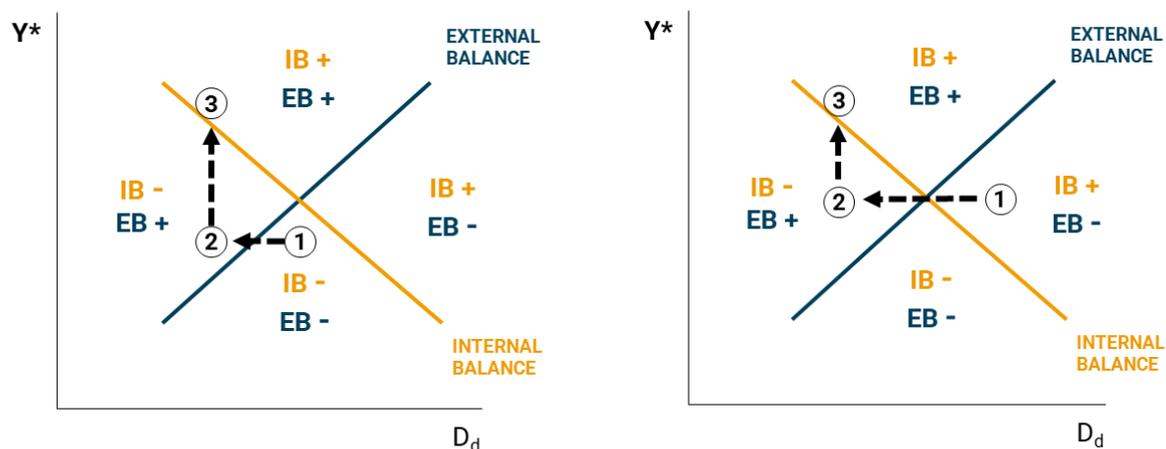


Figure 1.6. Germany's (L) and Ireland's (R) experience: the foreign demand-led story

Similarly, the external enablers channel has the power to explain the Irish economy's trajectory: starting from the pre-crisis quadrant of excess demand and CA deficits (IB +, EB -), moving to unemployment and surpluses through suppressing domestic spending (IB -, EB +), but more successfully getting back to the internal balance curve, with a more robust employment recovery than other periphery countries. The external demand-led channel argues that in both cases, although internal devaluation pushed the country off the internal balance curve towards unemployment and weak domestic demand – reforms coincided with favorable external demand shocks that cushioned the fallout from these policies. Since the two interventions are observationally equivalent, the fallacy emerges.

To sum up, augmenting the Swan diagram with external demand demonstrated that a favorable external demand shock has the same observational implications as a cost-competitiveness shock, feeding into the fallacy of automatically assuming CA surpluses to be rooted in supreme competitiveness. In case of the 'success stories' of austerity, the external enablers channel would imply that the two countries' performed better in spite of austerity, not because of it.

1.4.2 Expenditure switching and expenditure changing

The Swan diagram also demonstrates that the same policy levers improving the external balance through rising exports (with clear benefits for the surplus countries) can also improve them by falling imports. In fact, even if the external balance is improved by superior export performance, enhanced competitiveness cannot be achieved without suppressing domestic spending (a rightward movement on the horizontal axis). A growing current account surplus will therefore involve the decrease of imports, at least in part – and if export prices are inelastic and there are no favorable Y^* shock to rely on, most of the CA surplus will be driven by weak imports, not strong exports; implying very different domestic costs and benefits. To show that, an overview of policy levers and their effects on the respective balances are in order.

What are the policy tools to build up and correct imbalances in the Swan diagram? Let us start by the horizontal (D_d) axis and expenditure changing.

The most straightforward lever is **fiscal policy**: stimulus is a move to the right, austerity is a move to the left. If a government decides to increase spending in a given year from an equilibrium position (where IB and EB cross), all else held constant, the economy will shift towards internal overheating and excess demand, while the external position will shift towards a CA deficit through the increase of imports (IB +, EB -). On the flipside, austerity policies decreasing fiscal expenditure would move the economy from the equilibrium towards unemployment and CA surpluses by reducing imports (IB -, EB +).

Another important lever is **wage policy**: increasing wages, for instance through minimum wage legislation, stimulates output and shifts the economy towards a CA deficit through the increase of imports (a move to the right), while cutting wages, for instance through reforms reducing collective bargaining coverage, depresses demand and reduces imports, driving up the CA surplus (a move to the left).

An expenditure changing intervention that is less widely discussed with regards to imbalances is **social redistribution**. Its effect on the internal and external balances is connected to Keynes' Marginal Propensity to Consume (MPC) concept: rich households have a lower MPC than poor ones, meaning they consume a smaller share of their income and save a larger share. If income is redistributed to higher MPC agents (income inequality rises), the overall level of spending in the economy will decrease, and we move to the left on the D_d axis, towards CA surpluses and unemployment (IB -, EB +). Redistributive policies from the rich to the poor and a decrease in income inequality would trigger a move to the right (IB +, EB -).

Also on the horizontal, REER or expenditure switching axis, the policy levers used for adjustments are the following: fiscal policy, income policy and redistribution.

Fiscal austerity achieves internal devaluation by depressing the domestic price level, making REER more competitive (a move up) and driving up exports. As mentioned above, this is a compensation effect, offsetting the expenditure changing channel: the jobs lost by decreased overall spending can be gained back through rising exports, making austerity a more attractive policy choice. Fiscal stimulus achieves the opposite effect, making REER less competitive (a move down), driving down exports.

Wage cuts are an even more straightforward tool of internal devaluation: labor costs are an important component of relative prices, and cutting them would also make REER more competitive, increasing exports. Again, the negative effects exerted through the expenditure changing channel have a compensation effect here: employment is hurt by a lower overall level of spending, but export competitiveness may compensate for that. Wage inflation, on the other hand, makes exports less competitive.

Social redistribution also has an effect on the REER: if income is redistributed to higher MPC agents who spend a larger share, it amounts to a demand stimulus with real appreciation effects (a move down). Redistribution in the opposite direction has the opposite effect (real devaluation, a move up).

Adjustment channel	Direction of policy change	Internal Balance	External Balance
Expenditure changing	Restriction: $D_d \leftarrow$	-	+
	Stimulus: $D_d \rightarrow$	+	-
Expenditure switching	Restriction: REER \uparrow	+	+
	Stimulus: REER \downarrow	-	-

Table 1.2. *Overview of policy changes' effect on the internal and external balance*

Table 1.2 gives an overview of the policy levers and the direction of movement in D_d and REER triggered by the two different adjustment channels. An important insight is that all policies exert an impact through both channels, so by looking at one observable implication, it is often difficult to disentangle which channel is at play. In case of fiscal austerity or wage cuts, for instance, a consequent improvement in the trade balance can imply depressed imports (the expenditure changing channel), increased exports through competitiveness gains (the expenditure switching channel), or both.

The internal balance offers a clue: if the EB moves towards a surplus but unemployment rises (IB -), it suggests that the expenditure changing channel (depressed imports) dominates the other. As shown here, the positive effects of real devaluation on the internal balance are based entirely on the expenditure changing channel. If this channel is weaker, the true costs of these policies will be higher than expected.

The framework demonstrates that the same policy levers intended to achieve CA surpluses through strong exports may end up achieving them by weak imports, giving rise to the second fallacy. Increasing REER competitiveness cannot be achieved 'immaculately,' a degree of domestic demand suppression and 'import deficits' are necessary. But while in the case of CA surpluses through export growth, the surplus comes with obvious benefits of export-sector employment, in the latter (surpluses through depressed imports), the surplus is paired with high unemployment. Real devaluation policies (cutting wages or public expenditure) are meant to stimulate exports by making the real exchange rate more cost-competitive, but they simultaneously suppress the *overall* level of domestic spending.

Chapter 3 argues that the fallacy of disregarding the import deficit portion of CA surpluses is prevalent in self-proclaimed ‘export world champion’ Germany. The analysis aims to show that excessive German surpluses are rooted in domestic inequality, a large low-wage sector and a substantial investment shortage (both public and private). Yet political and public discourse automatically assumes that surpluses mirror supreme competitiveness and Germany’s strong export sector. This fundamentally confounds winner-loser relations attached to surpluses, and creates a political obstacle to the correction of imbalances.

1.4.3 National imbalances and global value chains

But how do these dynamics play out with trade increasingly decoupled from nation states, organized in a spatially dispersed network of global value chains? The final theoretical section, linked to the third fallacy, overviews the theoretical complications introduced by GVCs, further obscuring national-level costs and benefits of global imbalances.

Based on the OECD’s estimates, trade in final products only captures about 30% of today’s total trade in goods and services, the rest involves transactions within GVCs, where most export products are intermediate inputs, often crossing borders multiple times. The complexity of within-GVC linkages weakens the relationship between variables that can be moved by domestic reform, and export volumes. Price elasticity is a case in point: some trade economists argue that a general decline in exports’ sensitivity to price changes is driven by the rise of GVCs (De Soyres et al. 2018). As elastic export prices are crucial for the REER-driven competitiveness channel to work (as discussed above), this severely undermines the Eurozone’s strategy of competitiveness-enhancing reforms (fiscal austerity or wage cuts), in hope of a consequent improvement in the trade balance through the expenditure switching channel. This insight is particularly relevant in the case of Ireland, an economy deeply integrated in Transatlantic value chains. As Brazys and Regan (2017) argue, Ireland’s FDI-fueled, export-oriented growth regime had little to do with a suppressed (more competitive) domestic price level through wage cuts and fiscal austerity. At the heart of this model are US multinational enterprises (MNEs) domiciled in Ireland and exporting goods and services within

their value chain. These firms mostly operate in the high-tech and high-wage IT sector, trading in services and products with low price elasticities.

The Irish economy, relying on foreign MNEs as export engines, exemplifies a deeper problem of assessing CA imbalances in the world of GVCs. The fundamental question popping up more and more often with regards to Irish export performance: is it actually there? As a growing number of scholars and commentators highlight (Seabrooke and Wigan 2014, Lane 2017, Frank and Setser 2018, Damgaard *et al.* 2019, Klein and Pettis 2020, Brazys and Regan 2021), statistical measures often mistake multinationals' profit shifting and accounting tricks for Irish export activity.

MNEs are known for distorting trade statistics through their aggressive tax optimization strategies, such as moving high-yielding intellectual property (IP) assets to a low-tax jurisdiction like Ireland. Even when no Irish factors of production are employed in the creation of a product or service, if an Irish subsidiary owns the IP rights, on paper, the sale will show up as an export transaction from Ireland. A similar tax-optimizing trick is 'factoryless manufacturing' (Coyle and Nguyen 2020). A firm uses a subcontractor to produce on their behalf, in a setup where legal ownership never changes hands. On paper, the export transaction will take place between the Irish-registered MNE and the buyer, not the subcontractor and the buyer, erasing (taxable) economic activity from where it actually happens, and creating the illusion of economic activity in Ireland. Finally, MNEs like to move (invert) their group headquarters to low-tax countries, without moving along productive facilities (jobs or investment), contributing to what Damgaard and coauthors (2019) called 'phantom FDI.'

Chapter 4 will show that the sectors where such fictitious activity is the most prevalent are the pharmaceutical and information and communication technology industries. Both involve large-scale research and development activities, conducive to generating intangible assets; and both are dominated by US-owned MNEs. In 2015, when Irish GDP surged by a highly implausible 26% (prompting Paul Krugman to coin the famous term 'leprechaun economics'), researchers identified two mergers between two pairs of pharmaceutical giants as the source of the distortion. In big tech, the case of Apple Inc. is well publicized: the firm 'onshored' its IP assets to Ireland after a regulatory change,

basically converting iPhones to Irish export products overnight – on paper. For our framework, this implies a fundamental uncertainty about the measurement of the external balance, as well as any cost-benefit calculus attached to it. In an extreme case, this can mean that a CA surplus in the official statistics is actually a deficit. This gives rise to the third fallacy, addressing the disconnect between truly global and spatially evermore fluid economic activity and national economic performance (Seabrooke and Wigan 2014, Linsi and Mügge 2019).

1.5 Research design

1.5.1 Methodology and empirical strategy

The thesis uses a two-pronged methodological approach. Firstly, it builds on the ‘analytic narrative’ approach of Bates *et al.* (1998), and lays out theoretical propositions (wherever possible, through simple models), and assesses their empirical implications across a wide range of macroeconomic indicators, policy, and political data, as well as secondary sources. Then, these *data-driven narratives* are nested in a case comparison framework.

Data-driven narrative building as a method has limitations. It is an inherently descriptive technique, and does not allow for formal hypothesis-testing or causal identification the way inferential statistics do. The reason for choosing it is rooted in the small number of observations – the main research question focuses on a country-level policy outcome (the pursuit of CA surpluses in the onset and aftermath of the euro crisis), and there is a limited number of Eurozone countries. On the other hand, the main strength of the approach is that it allows for a closer reading of each case, also delving into temporal patterns through process tracing.

Informed by the theoretical starting point – that is the observational equivalence problem of certain macroeconomic aggregates – the empirical chapters aim for a high level of statistical detail:

- Variables of interest are disaggregated by industries, institutional sectors and trading partners;
- For many concepts under scrutiny, there are multiple measures considered – e.g. traditional value added-based measures of exports are contrasted to export-sector employment;

- The analysis, especially the Irish case chapter, pays close attention to global value chains and spatially dispersed networks of production, and the biases they introduce to country-level statistics – e.g. tracking the source of *final* demand (as opposed to trade in intermediate inputs) using the input-output matrices of the OECD’s Trade in Value Added database.

The analysis of political frames in the German case chapter relies on an original database of public statements, compiled from media reports and Parliamentary debates. Beyond that, empirical results from secondary sources are also used to fill in gaps.

1.5.2 Case selection

As discussed above, the basis for selecting the German and Irish cases was their status as paradigmatic ‘success cases’ of the austerity-driven competitiveness narrative, the main alternative explanation. The two are politically important cases, and the dissertation seeks to problematize their apparent success. The piece of evidence often invoked to support the competitiveness narrative was Nominal Unit Labor Cost (NULC) trends. And indeed, the parallel position of Germany and Ireland visible in Figure 1.7. Both were able to cut labor costs more efficiently than their peers on the core and periphery, and experienced sturdy employment growth. This made them model examples of the ‘no pain, no gain’ advice, and provided justification to pursue export-reliance as a Eurozone-wide strategy.

The case studies are nested in a theory-driven small-N comparative framework. The Germany-Ireland pair constitutes a ‘most different systems design’ (Przeworski and Teune 1970, Meckstroth 1975), as the two exhibit maximum heterogeneity in relevant causal factors:

- Germany is the seminal case of a CME, Ireland is an LME characterized by wage inflation and financial dominance in the prelude of the crisis;
- in ideational resources, Germany’s ‘ordoliberalism’ stands in contrast to Ireland’s pre-crisis ‘profligacy’ and high indebtedness;
- in the distributional political divide between creditors and debtors, the two countries were on opposite sides;

- context was also highly dissimilar in the two cases: German wage and fiscal restraint started in the early- to mid-2000s, while Ireland squeezed demand in the post-crisis period; the recessionary shock was also substantially more severe for Ireland.

The common thread is the pursuit of export-oriented strategies: both countries engineered successful export-led recoveries while curtailing domestic spending.

The ‘external enablers’ narrative developed in Chapter 2 will argue that Germany and Ireland stood out in what the analysis calls an external option: the two were better positioned to capitalize on the positive external demand shock originating from outside of the Eurozone, mainly from the United States and China.

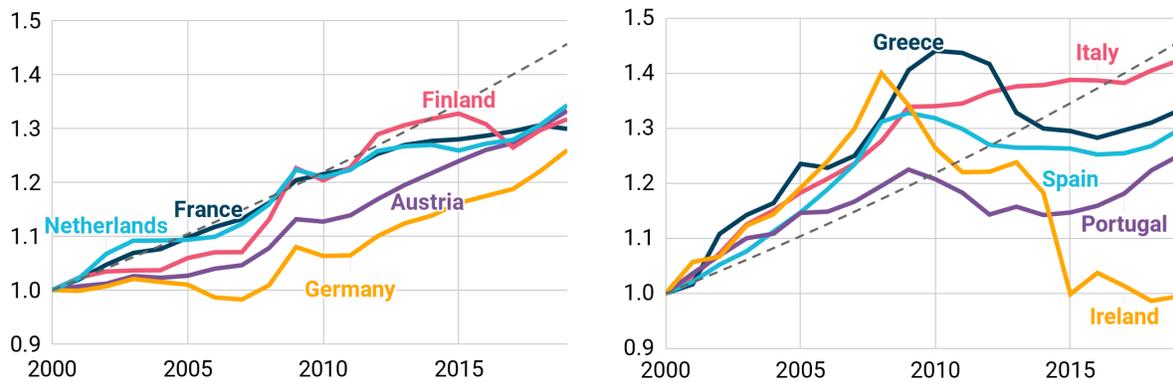


Figure 1.7. Nominal Unit Labor Cost trends, 2000=1 (Data: ECB); Dashed line: inflation target

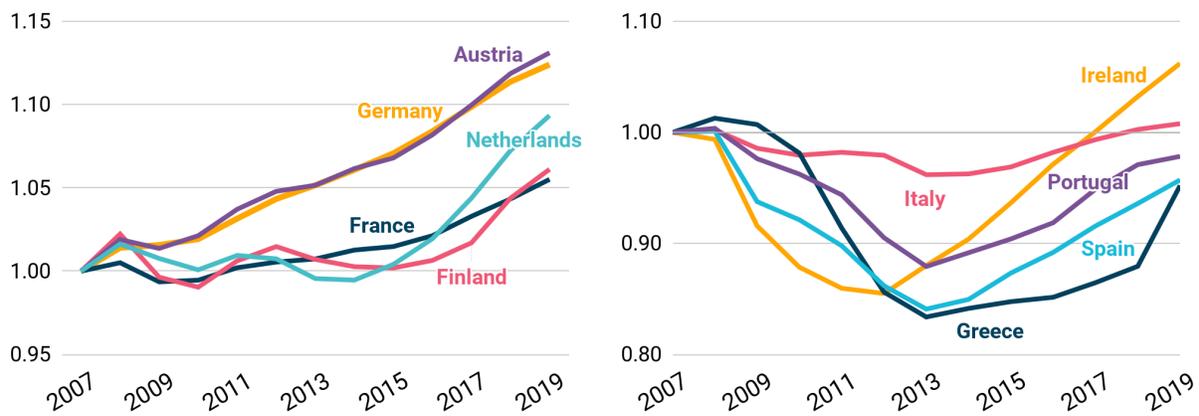


Figure 1.8. Employment trends, 2007=1 (Data: Eurostat)

	External option	No external option
Surplus country	DE, NL	AT, FI
Deficit country	IE	PR, ES, GR

Table 1.3. *Country cases based on surplus or deficit position and external option*

The analysis finds that it was not NULC-based competitiveness that made a difference in their performance, but strong existing trade ties to these faster-growing partners and favorable product mixes to satisfy their pent-up demand. These factors allowed the two to reap the benefits in the form of additional jobs sustained by extra-Eurozone final demand.

Analyzing cases as dissimilar as Germany and Ireland also has obvious limitations. Therefore, as a complementary exercise, the two are also compared to a respective group of ‘most similar’ cases. Combining the ‘method of agreement’ with the ‘method of difference’ in J. S. Mill’s classic formulation (e.g. della Porta and Keating 2008, p. 29) allows for more robust conclusions.

Because of a case-based nature of the design which relies on in-depth analyses as opposed to a large-N variable-based approach, the number of cases had to be restricted to be manageable (keeping in mind that each round of case selection introduces a level of arbitrariness from the researcher). Three additional cases in each group yielded a sample of eight Eurozone members.

To choose the three ‘most similar’ candidates for each of the two groups, again, the starting point was the competitiveness narrative. The crisis divided the currency union into a ‘creditor’ and ‘debtor’ group, roughly corresponding to countries with excessive current account surpluses and deficits in the pre-crisis period. The widespread reading of the origins of balance-of-payments problems was inflationary spending and a ‘loss of competitiveness’ in debtors, from 2000 onwards, after the introduction of the euro in 1999 (e.g. Johnston *et al.* 2014). Since these wage inflation dynamics, linked to the common currency itself play a central role in the competitiveness narrative, countries who adopted the euro more recently are excluded, to control for this variation (Slovenia 2007, Cyprus and

Malta 2008, Slovakia 2009, Estonia 2011, Latvia 2014 and Lithuania 2015). Outlier case Luxembourg is also dropped, because of frequent data availability problems, as well as the distorted picture emerging from the small size of its economy. Dropping these cases does not mean that they are beyond the scope of the external enablers argument, only that there is too much variation to account for when identifying a possible effect.

This leaves us with 11 cases. To construct the two ‘most similar’ groups, the investigation uses CA positions in the pre-crisis period (average between 2005 and 2009) (Table 1.3). Somewhat conservatively, a 3% threshold is used to indicate an imbalance in both directions– a decision informed by the theoretical starting point to problematize surpluses as well as deficits. The European Commission uses an asymmetric threshold (3% for deficits, 6% for surpluses); the US Treasury usually uses a 4% numerical target as a cap for both deficits and surpluses; the IMF prepares more sophisticated measures taking into account fundamentals as well. (For an overview of the monitoring regimes, see: Moschella (2014))

	Pre-crisis (2005-2009)		Crisis onset (2010-2014)		Recovery (2015-2016)	
GR	-12.60	Excess deficit	-7.18	Excess deficit	-1.81	Balance
PR	-10.32	Excess deficit	-5.29	Excess deficit	1.15	Balance
ES	-7.83	Excess deficit	-1.87	Balance	2.93	Balance
IE*	-5.26	Excess deficit	-1.87	Balance	-1.85	Balance
IT	-1.68	Balance	-1.42	Balance	2.63	Balance
FR	-0.20	Balance	-0.70	Balance	-0.60	Balance
BE	0.78	Balance	-0.16	Balance	0.90	Balance
AT	3.29	Surplus	2.10	Balance	2.14	Balance
FI	3.11	Surplus	-0.36	Balance	-1.39	Balance
DE	5.77	Excess surplus	6.30	Excess surplus	8.27	Excess surplus
NL	6.70	Excess surplus	8.19	Excess surplus	9.43	Excess surplus

Table 1.4. Average CA balances before, during and after the euro crisis % of GDP (Data: OECD, *CSO)

Through this mapping of imbalances, four members are identified with pre-crisis deficits: Greece, Portugal, Spain and Ireland, and all four reduced their deficits dramatically. Note that the fifth member of ‘GIIPS’ or program countries, Italy, had consistently modest deficits, suggesting that the economy’s frequent designation as a competitiveness laggard should be reconsidered. France and Belgium also had balanced positions. Since the present investigation is set out to explain patterns of excess saving and excess spending, these country cases will not feature in the rest of the analysis; the universe of cases are Eurozone countries with excessive deficits or surpluses. Again, dropping balanced countries does not mean that they are outside of the scope for the external enablers argument – it is only a way to construct similar groups in terms of the main explanatory factors.

Sustained, large surpluses were recorded also in four members: the most excessive surpluses in Germany and the Netherlands edged upwards as well, contributing to the overall growth of the Eurozone’s surplus vis-a-vis the rest of the world. Austria and Finland took a different path: rebalanced their economies from a surplus of around 5% towards more domestic spending. This variation already foreshadows an interesting puzzle that is addressed by Chapter 2, that will argue that the two countries (without external options) were forced to rebalance and rely more on domestic spending to escape unemployment. Figure 1.9 gives a summary of the case comparison framework, with the eight cases situated in the ‘most similar’ and ‘most different’ setups.

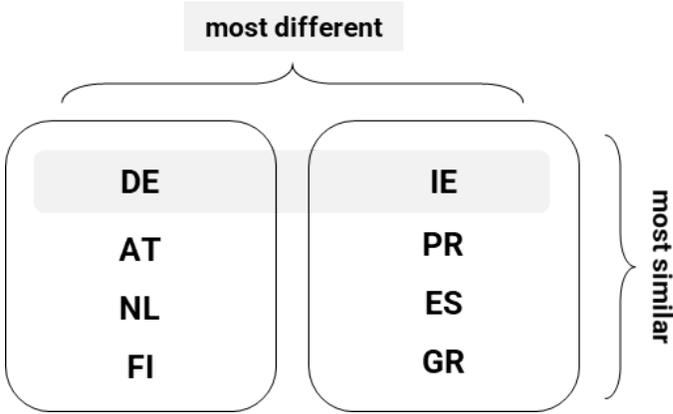


Figure 1.9. Case comparison framework

1.5.3 Structure of the empirical chapters

Chapter 2 and the first, *external enablers* fallacy stands out as the ‘base’ argument and the most important theoretical contribution. It rests on the comparative analysis of the eight selected Eurozone members. The analysis of the surplus and deficit country groups are symmetric – the trajectories of Germany and Ireland and their respective ‘most similar’ peers are assessed along largely the same variables, and the parallel position of the two cases emerges from the analysis. While both were understood as success stories of reform-driven competitiveness gains, they were aided by their more favorable ties to trading partners.

But the two highly different cases also imply that the analysis leaves different ‘residual puzzles.’

Chapter 3 assesses the German residual puzzle. While Germany’s external option provides an explanation for the blunted employment costs of suppressed domestic spending (a *necessary* condition to keep these policies in place), there are a number of other important domestic costs of excessive surpluses – such as social inequality, underinvestment or the uncertainties triggered by international trade tensions. Why did all these factors fail to ignite a political pushback? The chapter argues that disregarding domestic costs of surpluses leads to a distorted political debate where the noisy conflict with trading partners prevails over domestic tensions. The methods fitting this discursive proposition is qualitative content analysis, based on news media narratives and parliamentary protocols. The investigation builds an original database of stakeholders’ public statements.

Chapter 4 then tackles the substantial statistical distortions that constitute a case-specific problem in the Irish economy, dominated by foreign multinationals known for artificially inflating trade statistics through what the OECD calls ‘Base Erosion and Profit Shifting.’ The Irish residual puzzle is therefore: was there any real economic activity behind output growth in the pharmaceutical manufacturing and ICT sectors? A way to distinguish fictitious and real activity is to contrast employment-based measures with output or exports, leveraging the insight that in the case of accounting fiction, we should not see growth in employment headcounts or earnings.

FIRST FALLACY: MISTAKING EXTERNAL ENABLERS FOR COMPETITIVENESS

The case of Eurozone imbalances

The aim of this chapter is to introduce the fallacy of mistaking the effect of external enablers for the effect of competitiveness-enhancing austerity policies. As explored in the theoretical section above, external demand (Y^*) shocks are observationally equivalent to real effective exchange rate (REER) shocks. The argument is assessed through the cases of Eurozone economies with excessive surpluses and deficits. The starting question is why economies of the currency area stuck to policies suppressing domestic spending and forcing up saving (i.e. driving up CA imbalances) in the onset and aftermath of the euro crisis, and why some countries upheld these policies more easily than others. The analysis finds that individual Eurozone members' ease of suppressing spending were linked to the policy choices of their trading partners. Europe's austerity bias was bolstered by a convenient external option: positive external demand (Y^*) shocks from China and the United States alleviated the employment costs of weakened home markets. The external option (mistaken for a REER shock) impaired an important feedback channel, contributing to these policies staying in place.

The analysis of balance-of-payments and employment statistics is nested in a case comparison framework to increase explanatory leverage: it draws a parallel between Germany and Ireland and finds that, compared to their surplus and deficit country groups, these perceived 'success cases' of austerity were aided by their better position to benefit from foreign demand boosts through favorable export product mixes and established ties to faster-growing partners. Because external demand shocks are observationally equivalent to REER shocks, Eurozone imbalances are in a fallacious way, mistaken as the products of virtuous competitiveness gains.

2.1 Explaining the ease of suppressing spending with trading partners' demand

For about a decade, the Eurozone stubbornly clung to policies suppressing domestic spending even in the face of the deep recessionary shocks of the early 2010s. The consequence was a momentous increase in the currency area's current account (CA) surpluses, marking a growing difference between what is produced and what is consumed or invested at home. Excessive CA deficits were eliminated, excessive surpluses edged upwards, turning the region into the main source of global imbalances – while hurting domestic economies too (Tooze 2018, Klein and Pettis 2020). During a recession, forcing up savings devastates growth; a fact underscored by deficit countries' dramatic employment collapses (Pérez and Matsaganis 2017). Surplus countries are hurt too, for in the face of a downturn, forgoing stimulus and refusing to rebalance undermine jobs as well as public goods like infrastructure (Redeker and Walter 2020).

The case for rejecting Keynesian wisdom (i.e. the need to counteract a recession by more government spending) was supported by the 'success cases' of austerity: countries who managed to export themselves out of trouble without extensive stimulus. Germany *tightened* fiscal policy in the depths of the Eurozone recession, not reducing but swelling its record-large imbalances – and yet, the country enjoyed sturdy job growth. In contrast, Austria or Finland (also entering the crisis with CA surpluses) ran budget deficits and rebalanced towards domestic sources of growth to avoid a recession. In the group of deficit countries, Ireland emerged as a poster child: although hit hard by the crisis and forced to undertake painful austerity to close CA deficits, the Irish economy managed to rebound and see faster job growth than Portugal, Spain or Greece. European Central Bank chief Jean-Claude Trichet famously proclaimed that 'Greece has a role model and that role model is Ireland.'

This variation raises a question – why do some countries cope with austerity easier than others, in terms of employment outcomes? When is it less painful to suppress spending? Taking the trade-off between austerity and employment performance as a dependent variable allows us to analyze Eurozone economies in both the 'surplus' and 'deficit' country groups in a single, coherent framework. The investigation looks at the period between 2010 and 2016 (the onset and recovery phases of the

Eurozone crisis) and finds divergent employment performances associated with the across-the-board swings towards surpluses. In case of surplus countries (with space to run down savings), this question points to a puzzling divergence of policy choices: employment costs can help explain why some members chose domestic stimulus and rebalancing, but not others. In case of deficit countries, where austerity was not a choice but an outside constraint, what remains to be explained is the divergence of growth performances accompanying similar demand squeezes.

The chapter argues that the perceived ‘success cases’ of Eurozone austerity had external enablers: their greater ease of suppressing spending was allowed by the policy choices of their trading partners. While the existing body of research on Eurozone adjustment and policy choices is mainly focused on domestic factors, this analysis explores how positive demand shocks from China, the United States and (to a lesser extent) the United Kingdom blunted unemployment costs of weakened home markets, cushioning the fallout from austerity policies. This channel, however, could only be used by highly open economies with established trade ties to these booming partners and favorable export product mixes to satisfy their pent-up demand – putting these two members, Germany and Ireland (and to a lesser extent, the Netherlands), in particularly advantageous positions. Those without such favorable trade ties either needed to switch to higher spending (if their private and public sectors had space to run down savings) or endure a painful adjustment path with high unemployment. The analysis finds that Germany and Ireland stood out in their ability to benefit from these booming markets, compared to their surplus and deficit country peers. The US import upsurge was concentrated in the automotive and pharmaceutical industries Germany specializes in. China’s massive fiscal stimulus was biased towards infrastructure investment, a boon for advanced engineering products ‘Made in Germany’. Ireland, a small, extremely open economy capitalized on the favorable geographical composition of its exports: final demand from the US and UK sustain 35% of Irish export sector jobs, so upswings in these countries present a larger boost for Irish labor markets than for Portuguese, Spanish or Greek ones. Ireland’s main exports, within-value chain business sector services also factored heavily in the United States’ import mix.

The existing political economy literature usually addresses the link between austerity and employment trajectories through the lens of cost-competitiveness, the causal link at heart of most Comparative Political Economy works (Iversen and Soskice 2012 e.g. Hall 2014, Iversen *et al.* 2016). The competitiveness channel assumes that restrained spending is an attractive policy choice, because real devaluation makes the REER more competitive relative to trading partners, which, in turn, stimulates exports and generates employment. Based on this, Germany and Ireland enjoyed stronger export-led employment growth relative to their peers *because* they devalued more successfully. The external enablers channel introduces a lesser explored mechanism that works in reverse: instead of (or beyond) austerity driving exports, export ties can *enable* austerity. Countries with stronger existing ties to faster growing trading partners were well positioned to exploit favorable demand shocks, making otherwise painful choices more palatable for policymakers.

As an empirical strategy, the chapter nests data analysis in a case comparison framework. It relies on ‘most similar’ comparisons within the Eurozone’s deficit and surplus country groups, and draws a parallel between Germany and Ireland, constructing a ‘most different’ setup across these groups. The analysis uses balance-of-payments statistics disaggregated by sectors and geographic detail from the OECD trade in value-added (TiVA) database; and complements this with an analysis of *export-sector employment* from the OECD’s trade in employment (TiM) database to control for global value chain linkages that may artificially inflate CA figures— a known problem in the Irish case (Lane 2017, Setser 2019). The employment-based analysis leverages a simple insight: if jobs grow, it is evidence for economic activity beyond accounting fiction. Germany and Ireland are politically important cases: they are often cited to prove the success of the ‘no pain, no gain’ strategy of reform-induced export gains.

2.1.1 Empirical puzzle: the divergent costs of rising savings in the Eurozone

Current account dynamics are important markers of Eurozone economies’ decline of domestic spending and surge in saving. The CA shows the net saving of an economy; the difference between a country’s gross disposable income and the part that is consumed or invested at home. If a country runs

surpluses, it means that its residents spend less than what they earn. Excess savings are exported abroad in the form of capital outflows (i.e. lending). On the flip side, running deficits mean residents consume and domestically invest more than their income and the excess spending is financed through capital imports (i.e. borrowing). CA balances reflect the millions of choices governments, firms and households make every day about spending or saving their income – and these choices are globally interdependent. While overspending is an often-discussed source of vulnerability in this interdependent system, over-saving less so. Although it may sound counterintuitive because of the moral frames attached to saving as opposed to spending and borrowing – there is such a thing as too much saving. Since someone's spending is someone else's income, if all want to save at the same time, in the end, no one will have an income to save from, a phenomenon John Maynard Keynes called the *paradox of thrift*. In the same vein – for someone to be able to save an extra dollar, euro or yuan, someone else must borrow the same amount (Blyth 2013, Pettis 2013, Fuller 2018).

A glance at euro members' imbalances before and after the crisis reveals the swing towards surpluses. All excessive deficits (Greece, Portugal, Spain and Ireland) were eliminated (mostly through collapsing imports, Petroulakis (2017)), while excessive surpluses increased in Germany and the Netherlands. Only Austria and Finland rebalanced from a surplus of around 5 per cent towards more domestic spending. (A 3 per cent threshold is used to indicate excessive imbalances.)

Italy, France and Belgium had balanced positions throughout the period – with deficits and surpluses consistently remaining in the +/- 3 per cent range. Since this investigation is set out to explain patterns of excessive saving and spending, these cases will not feature in the rest of the analysis; the universe of cases are Eurozone countries with excessive imbalances. This choice underlines the argument raised by multiple scholars: the case of Italy is often mischaracterized as an economy with an overspending problem (Moschella 2017, Notermans and Piattoni 2019, Heimberger and Krowall 2020).

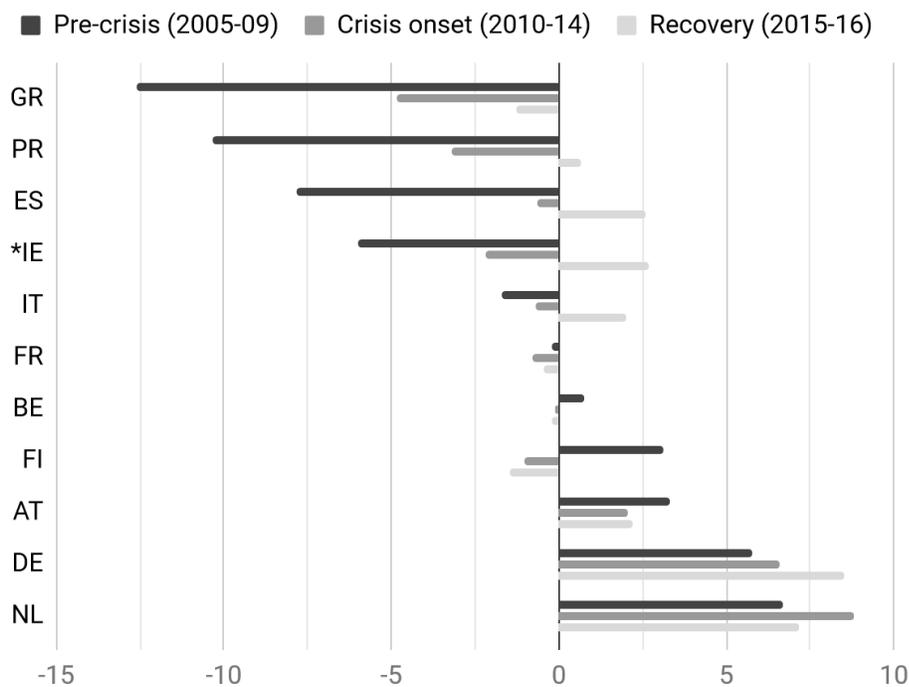


Figure 2.1. Average CA balances (percent of GDP) before, during and after the crisis (Data: OECD).

IE: CA (per cent of GNI*), CSO)

Jobs recoveries indicate varying costs of forcing up domestic savings. Ireland, although showing a steep rebalancing trend and a deep employment collapse, engineered a faster rebound than other deficit countries. German surpluses soared to record heights, while Austria rebalanced – yet the two countries’ job numbers grew in an almost identical lockstep (in unemployment rates, Germany performed even better). Dutch and Finnish employment trends were also similar, while their CA balances shot in opposite directions.

In their respective country groups, Germany and Ireland stood out as frontrunners in suppressing spending yet performing better in employment.

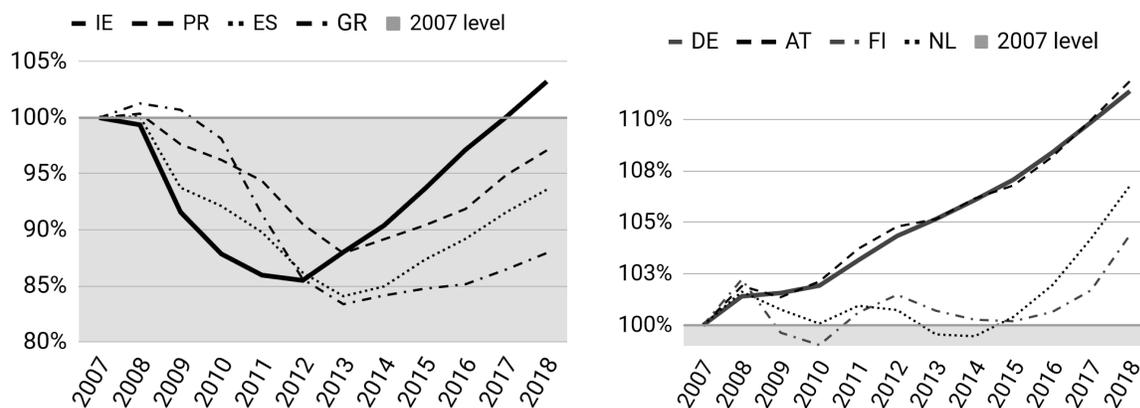


Figure 2.2. *Employment growth in deficit (L) surplus countries (R), 2007=100 percent (Data: Eurostat)*

Taking the trade-off between suppressed spending and employment performance as a dependent variable allows us to analyze deficit and surplus countries in a single, coherent framework. In case of deficit countries, the puzzling question is not why they chose to force up savings (it was an outside constraint) – but why costs of adjustment differed, in other words, why they faced dissimilar trade-offs attached to similar adjustment paths. In case of surplus countries, who did have a choice between policy options, the focus on trade-offs illuminates variation in incentive structures behind these choices.

2.1.2 Explaining the austerity bias

Ideational scholarship covered a lot of ground explaining the Eurozone’s austerity-bias (Matthijs and McNamara 2015, Farrell and Quiggin 2017) – yet divergent employment trajectories associated with austerity rarely feature in these accounts. Germany, the country commonly associated with a normative bias among elites (Vail 2014), parties (Bremer and McDaniel 2020) and voters (Howarth and Rommerskirchen 2013), saw Angela Merkel’s governments rejecting stimulus during the Eurozone crisis, but enacting large packages in 2008-09, responding to the global financial crisis (Schelkle 2012) and in 2020, responding to the COVID-19 shock (Sandbu 2020). This temporal variation signals that an ideational bias alone cannot uphold the policy mix if unemployment spikes up because of a more widespread, global collapse of export markets. Ideas’ explanatory power also weakens in a case like

Ireland – a model student of austerity after 2010 but experiencing credit-fuelled growth beforehand.

Varieties of Capitalism scholarship provides an answer to the employment portion of the puzzle: sectoral interest groups have vested interest in reforms enhancing cost-competitiveness, including cutting inflationary public expenditure, which, in turn, generates employment (Iversen and Soskice 2012, Hall 2014, Iversen *et al.* 2016). Ireland is a notoriously difficult case for VoC – relying on a financialized, liberal model before the crisis, while also having a strong internationally oriented sector. But there are question marks left in the ‘Coordinated Market Economy’ (CME) group too. According to VoC works, CMEs like Germany have centralized wage bargaining, interacting with the macroeconomic policy mix to deliver wage restraint, a preference for the export sector. Beyond central banks doing their part, fiscal discipline contributes to the lack of inflationary pressures by keeping public-sector unions and other demand stimulating measures at bay, preventing REER appreciation. This is a deeply moored incentive structure stabilising demand suppressing policies in these economies. While marking a shift from VoC’s supply-side orientation to demand drivers of growth, the ‘growth model’ framework pioneered by Baccaro and Pontusson (2016) continues to rely on cost-competitiveness as the core causal link. In their seminal 2016 paper, the authors describe a direct trade-off between domestic consumption and export growth, describing German growth as ‘depend[ing] critically on keeping domestic costs down and hence on repressing domestic consumption’ (Baccaro and Pontusson 2016, p. 191).

Whether export industries blocked (inflationary) fiscal accommodation in surplus countries to safeguard their cost-competitiveness is less clear in light of recent works on the distributional politics of Eurozone adjustment options by Walter, Ray and Redeker (2020). Their survey data shows that employers’ organizations in the export sector were open to fiscal stimulus and fiscal rebalancing was overwhelmingly preferred among interest groups compared to other adjustment levers. This is supported by public statements from representatives of exporter firms – influential lobby organization BDI has been openly and repeatedly calling for the government to reconsider its stringent fiscal rules.⁵

⁵ E.g. ‘German business calls for end to new borrowing ban.’ Financial Times, Sep 24, 2019

Walter and her co-authors argue that the obstacle to German rebalancing was not a structural bias against stimulus, but a distributional political gridlock: disagreement over the specific interventions to stimulate. However, the temporal variation mentioned above remains unexplained. The German government tends to override the gridlock when facing widespread collapses of export markets.

The argument advanced here highlights an explanatory factor that has been somewhat neglected— the enabling role of external demand shocks originating from outside the Eurozone, and countries' different positions to capitalize on it. The next section details the theoretical links between foreign demand and the employment costs of suppressed spending.

2.2 The 'external enablers' channel

The mechanism behind the external enablers channel is most straightforward when laid out in parallel to cost-competitiveness. The stylized model is derived from the original Swan diagram with REER (see Figure 1.1). To translate the model to the variables of interest, the model uses exports (Exp) instead of the external balance (EB) – so that CA improvements through import decreases are controlled for. The internal balance (IB) is proxied by employment (Empl).

Both channels assume a negative relationship between suppressed domestic demand ($\downarrow D_d$) and employment growth ($\uparrow \text{Empl}$): a weakened home market undermines jobs. While the competitiveness channel assumes a compensation effect through a more competitive REER stimulating exports ($\downarrow D_d \rightarrow \uparrow \text{Exp}$), the external enablers channel introduces a missing variable, external demand ($\uparrow Y^*$). In the face of weak home markets, relying on foreign economic activity (trading partners' faster GDP and import growth), allows suppressed spending without corresponding employment costs. Trading partners thereby *enable* demand suppression ($\uparrow \text{Exp} \rightarrow \downarrow D_d$), the arrow between the two variables is reversed.

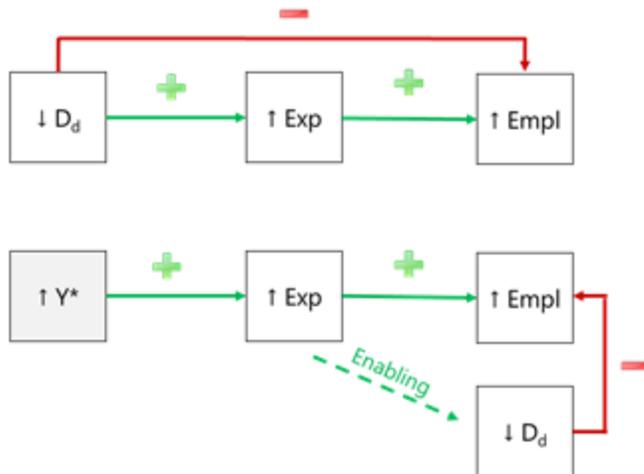


Figure 2.3. Mechanisms behind the competitiveness channel (above) and the external enablers channel (below). (The sequential pattern is for the sake of clarity, the relationships are mostly simultaneous.)

Note that the observable markers of the two proposed mechanisms almost coincide: declining domestic spending, export growth and employment growth. To distinguish between the channels, the focus needs to turn to the links between the variables. The empirical implication of the competitiveness mechanism would be a strong link between suppressed spending and export growth ($\downarrow D_d \rightarrow \uparrow \text{Exp}$), measured by the price elasticity of exports, i.e. how sensitive export performance is to relative price movements. The external demand-led mechanism implies that export products have low price elasticity and high foreign income elasticity, i.e. sensitivity to foreign demand movements ($\uparrow Y^* \rightarrow \uparrow \text{Exp}$).

Export price elasticity estimates are intensely debated in the empirical literature. The seminal case is Germany, whose transformation from the ‘sick man of Europe’ in the 1990s to a growth engine is often attributed to competitiveness-enhancing reforms (wage restraint, fiscal consolidation, social security adjustments). Many empirical works take issue with this perspective and argue that Germany’s rebounding exports were not (at least not *only*) a product of suppressed spending, but ties to fast-growing trading partners. Danninger and Joutz (2007) show that between 1993 and 2005, relative price improvements explain less than 2% of Germany’s superior export performance vis-a-vis industrialized countries (REER vis-a-vis extra-Eurozone partners remained flat, because of nominal

appreciation). Ties to fast-growing trading partners and regional value chain integration explain over 60% of the variance. Storm and Naastepad (2015) also find that German exports' sensitivity to price differentials is low, partly because of the significant share of high-tech, high-value-added sectors (results are robust across different measures of relative prices, different time periods and modelling strategies). The debate is not settled: other studies produce substantial positive estimates for German export price elasticities (e.g. Baccaro and Tober 2021). But what neither of the debating sides put in doubt is that foreign demand explains a significant portion of the variance in export performance, and foreign income elasticity is strong (Neumann 2019). Given the widespread consensus that German exports are sensitive to foreign demand, it is puzzling why this perspective is rarely featured in discussions around export-oriented economies.

Ireland's recovery is also often interpreted as a success case of improved competitiveness; the economy saw the Eurozone's steepest decline of unit labor costs (ULC) after 2010. However, McDonnell and O'Farrell (2016) show that this ULC decline was driven by a composition effect: the relatively low-productivity construction sector collapsed during the recession. Brazys and Regan (2017) argue that not cost-competitiveness, but a state-led effort of attracting foreign (mainly US) export-platform FDI explains Ireland's divergent recovery. At the heart of this model are US multinationals, mostly operating in high-tech, high-wage, not price-elastic sectors who export within their Global Value Chains (GVCs). A decline in exports' sensitivity to price changes is a wider phenomenon in GVCs (de Soyres *et al.* 2018). Trade in final products only captures about 30% of today's total trade (OECD TiVA), the rest involves transactions within GVCs, where most products are intermediate inputs, often crossing borders multiple times. The complexity of within-GVC linkages, the upstream and downstream interconnections weaken the relationship between domestic price levels and exports.

Settling the debate on price elasticities and the competitiveness channel is not the core focus of this work. The two channels exist in parallel; the debate outlined above addresses their relative strength. The aim of this chapter is to gather evidence for the external enablers channel, a perspective largely

missing from the literature on macroeconomic policies underpinning export-oriented growth. The following sections delve into the indicators showing these dynamics, starting with the ‘enablers.’

2.3 Chinese rebalancing and the United States as a ‘spender of last resort’

The Eurozone’s recovery had an external push. By the time the currency area plunged back into recession in 2011, main trading partners’ recovery was already underway, partly fuelled by more fiscal and monetary stimulus. Compared to growth trends in the three biggest export markets – the United States, the United Kingdom and China (with respective 17%, 12% and 7% shares of Eurozone exports), the Eurozone’s divergent path from 2011 onwards is striking.

Meanwhile, in the spending and saving propensities of global regions, a tectonic shift was underway. The unsustainable complementarity between China and the United States – Chinese excess saving offset by US borrowing and spending – was a well-understood cause of the GFC and after 2008, the call for surplus countries to do their share of rebalancing grew louder (Jones 2009, Blanchard *et al.* 2010, Frieden *et al.* 2012). Notoriously high-saving China heeded the advice and slashed its surplus, from around 10% to 0.2%. Rebalancing was driven by a formidable fiscal impulse, dwarfing EU, or US stimulus efforts (Fardoust *et al.* 2012).



Figure 2.4. GDP growth (% left) and CA balances (% of GDP, right) – Eurozone, China, United States, United Kingdom (Data: OECD)

The Chinese stimulus was heavily biased towards infrastructure investments, providing a buoyant market for world-leading advanced engineering products ‘Made in Germany’. Decomposing Chinese import growth by sectors, the contributions of electrical and transport equipment stands out.⁶ Pharmaceuticals, another traditional strength of Germany, are also significant. As Ashoka Mody (2018, p. 229) put it, China ‘went on a global spending spree’ and Germany was the biggest beneficiary. Through rebalancing, Chinese factories did not need to rely so much on capturing the (scarce) demand of foreign consumers anymore – instead, Chinese investment and consumption contributed more to stimulating global aggregate demand. Meanwhile, the US and UK continued to run deficits: an average of -4.2% and -2.5% of GDP, respectively.⁷ These dynamics allowed the Eurozone to keep increasing its CA surplus. In terms of CA balances, the Eurozone and China traded places.

The role of the US, the world’s consumer market of last resort, was even more pronounced. The robust US recovery was accompanied by dynamic import growth: real imports showed a 21% increase between 2010 and 2015. The sectoral decomposition of US import growth reveals the paramount role of manufacturing (automotive and pharmaceutical) industries– again, Germany’s export engines. ‘Business sector services’ also saw robust growth. It is a good proxy for the within-value chain service trade Ireland specializes in; through multinational tech giants in Dublin’s famous ‘Silicon Docks’ (for a more nuanced analysis based on employment-corrected export data, see the Irish case section).

On the financial side of the imbalances, many observers correctly point out that persistent CA/FA deficits of the United States are also a result of its special position in the global financial system (Pettis 2013, Caballero *et al.* 2017, Fuller 2018, Klein and Pettis 2020, Mian *et al.* forthcoming). With the most developed, deepest financial markets on the globe, the US’s ability to issue safe assets and act as a spender/borrower of last resort is of paramount importance. Assuming a hypothetical counterfactual, rebalancing within Eurozone surplus countries would have been necessary if excess

⁶ Source of import data throughout the section: OECD TiVA.

⁷ An average between 2010 and 2016. (Data: OECD)

savings did not have an alternative destination, (mostly) US financial markets. After the intra-Eurozone dynamic of capital flows broke down as the Eurozone periphery was no longer able to supply lucrative assets for core countries' savers, they could fall back on US asset supply, thereby forgoing adjustment at home. So the United States' willingness to continue borrowing and supplying assets – in other words: acting as a 'spender of last resort' – was a necessary condition to carry on running surpluses. London's City is a significant financial center as well, and although not on the scale of the US, the UK is also a reliable provider of safe assets to the Eurozone's savers. What also allowed Europe to forgo rebalancing was China's decision to rebalance. On the one hand, China stepped in to absorb part of Europeans' surplus, as discussed above. On the other hand, by exporting less capital to the US, China effectively ensured that Europe had less competition for the scarce supply of US assets.

2.4 External options across the Eurozone

Eurozone members' different positions to benefit from the external demand shock (i.e. different 'external options' to fall back on) interacted with their initial levels of domestic spending (a surplus or deficit position in the pre-crisis period t_0). Their combined impact on the domestic reception of adjustment options are plotted by the matrix below (resembling a 'mapping' of adjustment options by Frieden and Walter (2017)).

Country cases (all four members running excessive pre-crisis surpluses versus all four running excessive deficits) are placed based on their CA and employment outcomes. Surplus countries have a choice: whether or not to switch to high spending (domestic stimulus), i.e. rebalance. For those with favorable external options, unemployment can be avoided both ways; for those without, only through rebalancing. Deficit countries are in a more difficult situation. A recessionary shock is a sudden stop of capital flows for them, so they face market pressures to correct imbalances in a way surplus countries do not.

	External option	No external option
Low domestic spending in t_0	DE, NL switch to high spending + low unemployment in t_1 OR <u>continue low spending + low unemployment in t_1</u>	AT, FI <u>switch to high spending + low unemployment in t_1</u> OR continue low spending + high unemployment in t_1
High domestic spending in t_0	IE switch to low spending + low(er) unemployment in t_1	PR, ES, GR switch to low spending + high unemployment in t_1

***Table 2.1.** Trade-offs between domestic employment and adjustment options based on initial spending levels and external options*

With enablers, a deficit country can rely on foreign demand to compensate for market-induced spending cuts, and therefore avoid the large job losses normally associated with austerity. But in the bottom right corner, countries need to endure a painful, high-unemployment adjustment path. Therefore, in the subsequent analysis of the external options, we expect Germany and the Netherlands (the countries opting not to rebalance yet maintaining employment growth; top left corner) to show stronger pre-crisis ties to the enabling foreign demand shocks than Austria and Finland (top right corner); and Ireland (bottom left corner) to show stronger pre-crisis ties than Portugal, Spain, and Greece (bottom right corner).

2.4.1 Germany and surplus countries

The diverging geographical concentration of exports can be proxied by initial partner shares at the start of the crisis, i.e. the share of countries' value-added sustained by the final demand of each partner.

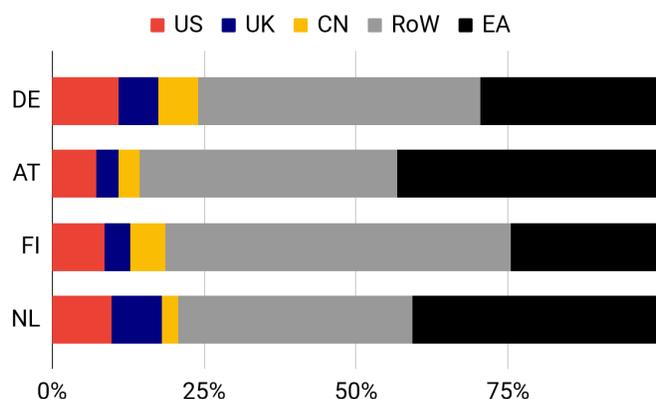


Figure 2.5. Value-added exports by partner, surplus countries (2010) (Data: OECD TiVA)

Among the four surplus countries, Germany relied less on Eurozone demand and had a larger exposure to the US, UK, and especially, China at the start of the crisis. (The pattern is mirrored by employment-corrected measures.)

Tracking demand components' contributions to growth shows Germany's large exposure to foreign demand – net exports accounted for a whopping one-third of German growth. This number is indeed excessive; domestic demand makes up a much larger portion of overall GDP than net exports (even Germany's excessive surplus 'only' accounts for 8% of GDP, the remaining 92% is consequently domestic demand), so for its contribution to be this large, it had to change by a large margin. The case of the Netherlands (a 50% contribution) is even more striking. In contrast, Austria relied on foreign demand only to a limited extent. Finland's external balance had a sizable negative contribution, but it was offset by a larger push from domestic sources. There is an interesting variation in the main empirical markers of their external options and the trade-off that is worth exploring case by case.

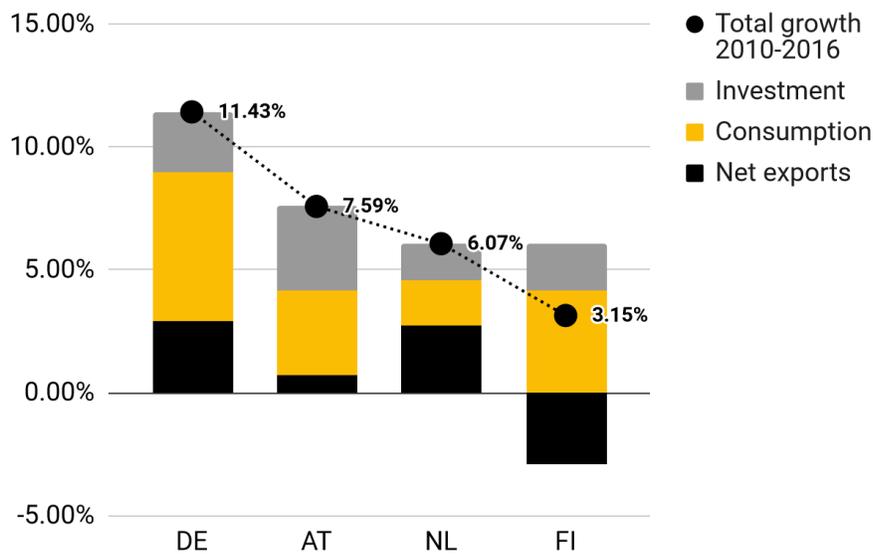


Figure 2.6. Demand components' contributions to GDP growth, 2010-2016, per cent (Data: Eurostat)

Finland is an especially interesting contrasting case to Germany. Running large surpluses before 2008 with an export mix geared towards extra-Eurozone partners, the Nordic country sharply rebalanced. Why? Finland gradually lost its ability to penetrate extra-Eurozone markets through two constraining channels – sanctions against Russia, a key trading partner, and the decline of export champion Nokia. Deprived of its enablers, Finland could only have sustained its surplus with severe employment costs. Rebalancing was a necessity. The share of Russian final demand in Finnish exports was 7.95% in 2010, much larger than Germany (3.04%) Austria (2.81%) or the Netherlands (2.2%). The Russian market had already been weakened by plummeting oil prices, when in March and July 2014, the European Union introduced punitive trade restrictions after Russian troops' illegal annexation of Crimea (Council of the European Union n.d.). Based on OECD TiM estimates, Finland lost 33.000 export-sector jobs between 2010 and 2015, trade with Russia accounting for over 60%. The steepest decline occurred between 2014 and 2015. The other factor was the decline of Nokia prompted by market-disrupting competitors like Apple (Wessman 2015). The process can be captured by the dramatic fall in jobs sustained by foreign demand in the industry labeled 'Computers, electronic and electrical equipment'. The almost 50% decline in the decade between 2005 and 2015 is especially

striking considering this is a sector which saw an *increase* of the same magnitude throughout OECD countries (suggesting it was not offshoring to China or India driving Finland's performance). In Finland's case, the external option was lost due to exogenous shocks, forcing the country to reorient its economic activity towards the domestic sector. And accordingly, as Germany's surplus soared, Finland moved from an 8% surplus to a 2% deficit, a highly atypical path.

The Netherlands, similarly to Germany, did not rebalance. Dutch export-sector employment relies strongly on Eurozone final demand (limiting export options), but ties to the US, UK and China are also strong. However, employment performance was far below the trends of Germany and Austria, and more aligned with that of Finland, which points to a harsher trade-off than Germany's. The explanation to this variance can be found in the extent to which the Netherlands squeezed domestic spending – the fact that the Dutch surplus still surged even above the levels of Germany (exceeding 10% of the GDP in 2012) is therefore not due to larger export success, but to even more austere domestic spending policies. The case remains partly unexplained – with the space to run down savings, the Netherlands could have used more stimulus and alleviated the domestic costs of weak spending. But without enablers, the result of the anaemic home market would not have been a stagnant labor market, but a collapsing one. This plausibly helped policymakers get away with a lack of stimulus.

Austria, an economy highly synchronized with the German business cycle had less opportunities to capture extra-Eurozone demand: Austria overwhelmingly relies on the Eurozone market (a 43% share of value-added exports, as opposed to Germany's 30%). So to sustain employment growth, Austria turned to more accommodative policies (including a more extensive use of fiscal stimulus) and rebalanced its CA. Its excess surplus disappeared and remained modest. The breakdown of CA balances by domestic sectors (government, households, firms) confirms this narrative. The Austrian government kept on running deficits (an average of -2.3% between 2010 and 2016) as the German government switched to balanced budgets and ran growing surpluses from 2011 onwards. Corporate savings, which were the most important factor driving up Germany's CA surplus (Redeker 2019), remained small in Austria. Yet, employment grew at an almost identical rate. The explanation is

Germany's external option. Without booming export markets in the US and East Asia, German policymakers' refusal to stimulate the ailing domestic market would have resulted in a spike in unemployment – an outcome Austria avoided by spending more at home.

As discussed above, the growth of Germany's surplus is mainly a product of domestic weakness – in simple terms, it is not an *export surplus* but an *import deficit*. German wage growth lagging behind productivity growth is equivalent to a redistribution of income from workers (who have a larger propensity to consume) to firm-owners (who are likely to save a larger share), driving up savings. Wage suppression lowered German households' disposable income by 6% of the GDP between 2005 and 2017. The adverse impacts are suffered by wage-earners, mainly in the lower end of the income distribution. Consequently, there is a remarkably strong relationship between the CA balance and income inequality (Dao 2020, p. 4). The rise in the top decile's income share in the early- to mid-2000s surged in close lockstep with the surplus. The two variables – the top 10 per cent's share of post-tax disposable income and the CA balance – have a correlation coefficient of 0.94. Again, a comparison to Austria is insightful. CA balances of the two countries started diverging in the mid-2000s (in 2004, to be precise), in sync with the disconnect between top income shares. Germany's top 10% income share skyrocketed, along with the CA surplus, while Austria kept inequality, as well as CA imbalances more in check.

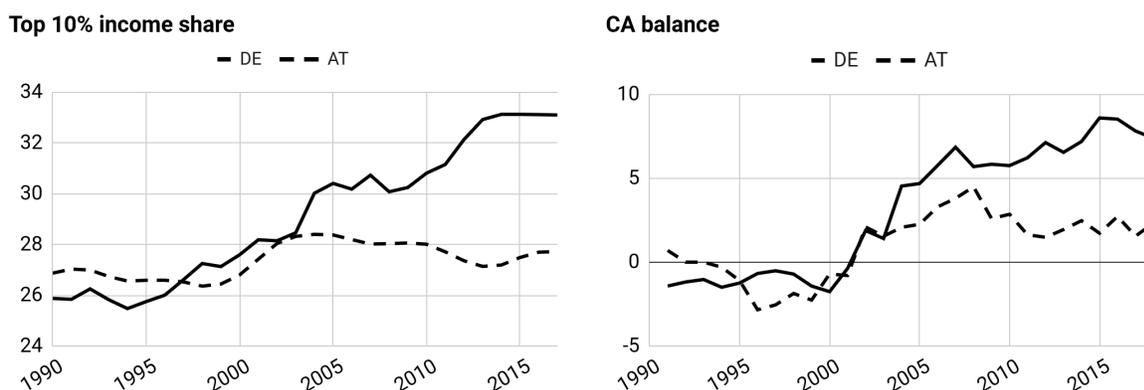


Figure 2.7. Top 10% share of post-tax disposable income (L) and CA balance (% of GDP) (R) in Germany and Austria (Data: World Inequality Database, OECD)

German income inequality (explored in depth by Fratzscher (2016)) has been steadily increasing. Poverty levels in Germany rose in parallel with a decrease in unemployment, as employee share in low-wage sectors grew. Recent contributions trace wage restraint back to the mid-1990s, stressing that changes were not brought about by the famous ‘Hartz reforms’ of the mid-2000s, they were already underway by then, as Germany’s industrial relations changed in response to globalization (Dustmann *et al.* 2014). Decreasing real wages, especially in lower income brackets, could have triggered a political backlash from unions and left-wing parties; but plausibly, Germany’s fallback option to rely on enablers weakens domestic resistance. Although there were some rebalancing measures taken (the introduction of the statutory minimum wage, a small increase in public investments) – the surplus remained excessive. Even before COVID-19 hit, this strategy was strained by skyrocketing trade uncertainties – precisely in China, the US and the UK. After 2016, China and the United States locked horns in a bitter trade war and President Donald Trump also directed tariff threats towards Germany. The UK sunk into unprecedented instability induced by the Brexit vote. As prospects of German exporters turned bleak, the policy discussion became more open towards criticisms. The head of Germany’s export lobby came out to criticize the government’s too stringent fiscal policies (Polyak 2019). Similarly to 2008-2009, the global nature of the COVID shock made the costs of Germany’s anaemic domestic market impossible to ignore, providing important incentives for the government’s historic decision to introduce a large stimulus package (Sandbu 2020) and possibly, for Germany’s change of heart towards transfers to the Eurozone periphery.

2.4.2 Ireland and deficit countries

Turning to deficit countries, export partner shares make Ireland’s singular position visible. Irish trade is dominated by two partners: the US and the UK, who together soak up around 35% of Irish export value-added, putting Ireland in a unique position to benefit from their faster growth. Irish links to enablers stands in stark contrast to Southern European peers, whose export destination is predominantly the Eurozone market. Constrained spending in the Eurozone limited export-led growth for those more integrated in that trade area as opposed to Transatlantic or other extra-Eurozone links.

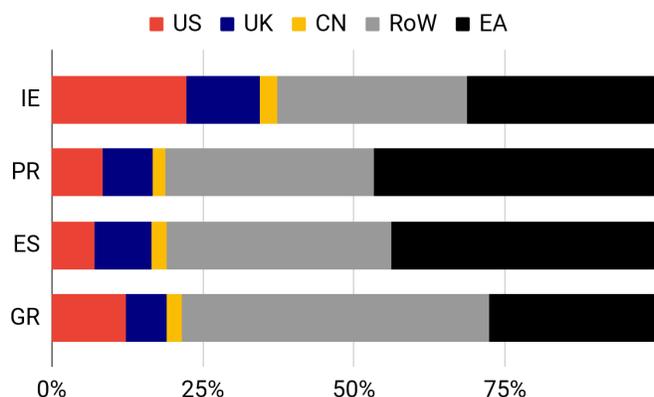


Figure 2.8. Value-added exports by partner, deficit countries (2010) (Data: OECD TiVA)

Can the divergent jobs recoveries in Ireland vis-a-vis Southern European deficit countries be explained by the smaller size of the demand squeeze (i.e. less harsh austerity)? A comparison of CA balances disaggregated by sectors signals otherwise. Ireland produced faster employment recovery, although both the fiscal squeeze and households' deleveraging (signaled by the improving net lending positions of the government and households) were just as steep or even steeper. The cyclically adjusted primary budget balance – that is a good proxy for the government's fiscal stance because it excludes interest payments or effects of the business cycle – was steeply tightened, following a similar trend in all four countries. Ireland's fiscal squeeze was less extreme than that of Greece, but similar to that of Portugal and stricter than that of Spain (while Spanish labor market performance, shown in Figure 2. was far below the Irish). The careful comparative investigation of Teague (2016) reaches a similar conclusion: it shows that all four countries implemented cuts to public sector wages and pensions, reduced civil service staff, reduced unemployment benefits and implemented cuts to welfare and education spending.

So Ireland suffered a shock to the domestic market in a similar magnitude to the rest of GIPS, but the external enablers partially offset the consequences of this in terms of employment. The employment expansion can plausibly explain some of the variation between contentious politics against austerity in Ireland vis-a-vis other program countries (Pappas and O'Malley 2014).

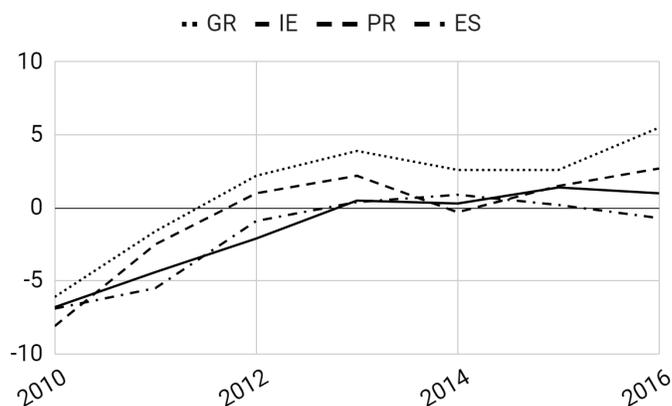


Figure 2.9. General government cyclically adjusted primary budget balance (as % of potential GDP), 2010-2016. Source of data: IMF Fiscal Monitor

One frequent doubt raised against Ireland’s export-based recovery is statistical: Irish export figures are distorted by multinational companies’ profit shifting for tax avoidance purposes (the particularly skewed 2015 GDP growth figure of 26% was famously dubbed ‘leprechaun economics’ by Paul Krugman). Accounting tricks often show up as large swings in Irish exports or imports, albeit not generating any economic activity in Ireland (Lane 2017, Setser 2019). So was Ireland’s recovery at all export-led? The analysis uses export sector employment statistics instead of national accounts to grasp job-sustaining activity. It leverages a simple insight: if jobs grow, it is a sign of actual economic activity beyond accounting fiction. Results of the analysis suggest that beyond distortions, foreign demand did play a decisive role in Irish recovery.

The OECD compiles a database estimating employment effects of foreign final demand. It is derived from the input-output matrices of the Trade in Value Added (TiVA) database, tracking cross-border flows of goods and services from a value-added perspective, in sectoral and geographical breakdown. For the Trade in Employment (TiM) statistics, TiVA data are projected onto employment data, creating a measure of ‘Employment sustained by foreign final demand’ (Horvát *et al.* 2020). If 50% of a firm’s production goes to satisfy foreign final demand, it is assumed that 50% of their

employment is sustained by foreign final demand (FFD).⁸

The approach using employment-corrected export measures helps identify job-sustaining economic activity: if exports are fictitious and inflated, they will be deflated when projected onto jobs data. So how do Ireland and other deficit countries fare in terms of jobs sustained by FFD and which trading partners contribute most? As expected, Ireland has a larger share of employment sustained by FFD (46%) than Portugal (23%), Spain (20%) and Greece (17%), another measure of the economy's openness. Also in employment-corrected data, the US and UK stand out. In 2010, almost 15% of Ireland's total employment was sustained by FFD from these two countries, putting the island in a unique position to benefit from their faster growth. In the other three, this ratio was around 3%. (These ratios remain stable, 10-year averages produce the same patterns.)

Decomposing the change in employment numbers into foreign and domestic sources of demand (an employment-corrected equivalent of decomposing GDP growth to demand components) shows that the superior employment performance of Ireland was driven by a relatively smaller decline in jobs sustained by domestic demand, and a bigger increase in jobs sustained by foreign demand.

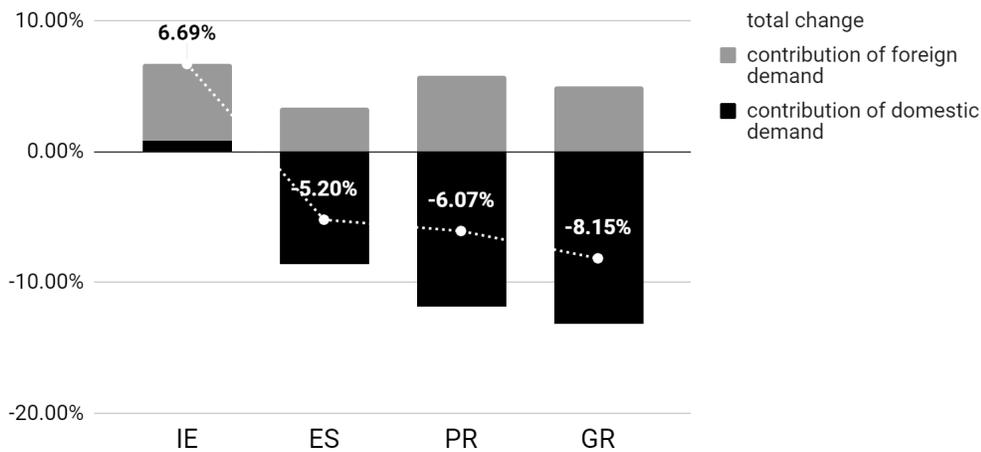


Figure 2.10. *Decomposition of employment growth by sources of demand, percent change, 2010-2016*
(Data: OECD TiM)

⁸ It is important to stress that TiM data are approximations, assumptions of homogenous productivity can produce biases.

This is an important piece of supporting evidence for our narrative. Suppressing domestic spending is not so costly for an economy that is less reliant on domestic spending in the first place and can also benefit from an external option provided by currently booming trading partners. (The Irish domestic sector shows a small expansion— because 92% of Irish job losses were suffered before the Troika arrived, between 2007 and 2010. However, the pattern is robust using different base years.) Zooming in on Ireland's period of rapid employment growth (after 2012) and the industries and trading partners driving it, the contribution of the US and the UK stand out.

Ireland's recovery does not, however, mean that the model could have been emulated by other program countries (Pérez and Matsaganis 2019). When ECB's then-President Jean Claude Trichet famously proposed Ireland as a role model for Greece, what Greece was asked to copy was Ireland's favorable trade links, in part simply due to its geographic location. From the four countries, Greece stands out as the negative outlier: with only 17% of its employment sustained by foreign final demand (compared to Ireland's 46%), its external options were the most limited. This was combined with the steepest fiscal adjustment of the four, and resulted in a dramatic labor market collapse, with employment far below pre-crisis levels even a decade after the fall.

As part of the Irish strategy is submitting to multinational companies' tax optimization, its long-term sustainability is also questionable (setting aside normative concerns). These companies are highly mobile, and a shift in tax regimes could convince them to cease or downsize their Irish operations. As both US governments and EU officials are increasingly committed to curb multinationals' tax tricks, the Irish model does not seem like a safe bet (although criticisms are yet to be followed up by actions). Regan and Brazys (2017) add an important insight to the domestic politics of the Irish model. MNCs employ a large share of non-Irish nationals, which weakens the compensation effects of export-led growth, thereby also weakening its domestic political sustainability.

2.5 Summary discussion

While the case-based analysis conducted above gives room for a deeper engagement, a significant

drawback of the approach is that it makes it more difficult to systematically evaluate the argument. Therefore, a more structured overview of the evidence is in order (Table 2.2).

The puzzle this chapter aimed to explain was that Eurozone members saw different costs attached to demand suppressing policies, i.e. trade-offs between austerity and employment diverged. Proxies of the dependent variable (DV) are plotted in the top two blocks of Table 2.2. The squeeze in both public and private spending is proxied by fiscal balances, the change in households' net lending/borrowing position and deleveraging efforts after the crisis, as well as all sectors' overall dynamics shown by the CA. Economic performance is measured by employment and GDP. Among **surplus countries**, *Germany* saw a big increase in its CA balance and a steep tightening of fiscal policy, yet employment and GDP growth remained strong. *Austria* could only reach comparable growth through more domestic spending. Similarly, *the Netherlands* and *Finland* also reached similar growth paired with wildly different demand management paths – dramatic fiscal adjustment and private deleveraging in the Netherlands, and a big shift towards domestic demand in Finland. In the **deficit country** group, *Ireland's* employment and growth stood out. Although part of it may be explained by the harsher austerity in other program countries (Greece especially), Ireland's fiscal adjustment was on par with *Spain*, while the squeeze in private demand shown by households' deleveraging was the most sizable of the four (the crisis was a housing market credit crash in Ireland and Spain). Table 2.2 also reveals that *Portugal* and *Greece* had similarly drastic cutbacks in spending, yet Portugal performed better relative to Greece.

The independent variable (IV) is the availability of 'external enablers' – existing trade ties and sectoral specializations to exploit external demand shocks from faster growing trading partners. Section 2.3 above identified the three biggest trading partners of the Eurozone, namely the United States and China, and to a lesser extent, the United Kingdom, as the source of significant favorable demand shocks. Data shows that among **surplus countries**, *Germany* had the strongest initial ties to these partners at the starting point (2010), evidenced by the highest share of these partners in their exports. *The Netherlands* similarly fared well, especially in the growth of exports to partners outside the EU.

	SURPLUS COUNTRIES				DEFICIT COUNTRIES			
	DE	NL	AT	FI	IE	PR	ES	GR
DV: SQUEEZE IN PUBLIC AND PRIVATE DEMAND								
Change in Current Account balance	2.73%	1.07%	-0.13%	-3.52%	6.08%	11.35%	7.13%	8.29%
Change in primary fiscal balance	3.10%	4.20%	1.90%	1.10%	7.80%	10.80%	6.20%	11.60%
Change in households' net lending (deleveraging)	-0.23%	6.42%	-3.36%	0.24%	11.30%	2.08%	7.56%	2.64%
DV: EMPLOYMENT AND OUTPUT								
Employment compared to pre-crisis level	108.4%	101.9%	108.1%	100.6%	97.14%	91.87%	89.20%	85.15%
Real GDP growth (*IE: real GNI*)	11.43%	6.07%	7.59%	3.15%	5.5%*	-2.19%	2.89%	-18.79%
IV: TRADE TIES TO 'ENABLERS'								
Share of US, UK, CN final demand in exports	24.00%	20.67%	14.36%	18.59%	37.28%	18.80%	18.98%	21.44%
Share of US, UK, CN final demand in employment	6.06%	5.98%	4.33%	4.63%	16.33%	4.12%	3.74%	3.22%
Growth of exports to partners outside the EU	40.14%	41.17%	25.30%	-2.88%	160.7%	42.56%	39.69%	-10.58%
IV: SECTORAL SPECIALIZATIONS								
Share of chemical manufacturing in exports	9.89%	6.84%	6.01%	8.08%	18.14%	6.66%	7.65%	6.33%
Share of electronic manufacturing in exports	6.69%	2.28%	5.41%	10.42%	3.77%	2.58%	1.84%	0.98%
Share of automotive manufacturing in exports	9.29%	1.07%	3.94%	1.31%	0.24%	4.24%	4.74%	0.44%
Share of wholesale and retail trade in exports	12.29%	17.55%	16.32%	11.56%	12.79%	17.53%	17.51%	14.54%
Share of business sector services in exports	12.72%	18.92%	9.80%	9.87%	11.84%	9.85%	10.20%	7.56%

Table 2.2. Overview of the evidence: proxies of the dependent (DV) and independent variables (IV). (In each group, the shaded cell indicates the highest figure)

Looking at the sectoral composition of global import demand, the analysis identified chemical, automotive and electronic manufacturing, wholesale and retail trade and business sector services as the industries which saw the most significant growth in the period. So another empirical marker of having an ‘enabler’ is a sectoral specialization in these areas. The share of these sectors in each country’s total exports is used as a proxy for specialization. Germany’s famous car industry and chemical manufacturing stands out as focal areas, as well as the Netherland’s business services sector. The analysis also explores how *Finland* was actually quite well-positioned to benefit from surging demand in electronic manufacturing, but this ‘external option’ was lost due to the decline of Finnish export champion Nokia (while EU sanctions against Russia, a major extra-Eurozone partner also hit Finnish trade). This latter insight also demonstrates the added value of case-based analysis and process tracing.

In the **deficit country** group, *Ireland* is a class of its own.⁹ The Irish economy is extremely open, very differently integrated to global trade than the rest of the Eurozone (the US and UK alone account for 35% of Irish exports) and heavily specialized in chemical manufacturing and business sector services – and these factors were key to a divergent recovery path. Note, however, that *Portugal* saw a stronger growth in extra-EU exports than any of the surplus countries, and *Spain* also fared well in this measure. Reliance on Latin American partners explains the bulk of this. It was, however, a smaller demand boost than what the US or China could provide, while the hit to the domestic market was much larger. So Portugal (and even Spain) could also dampen the fall from austerity by relying on existing trade ties and shifting to extra-EU markets, although to a far lesser extent than Ireland. This plausibly explains part of the variance they have shown vis-a-vis *Greece*, a country that had none of these ameliorating conditions, and saw a dramatic, 10.6% export *collapse* to partners outside the EU.

To sum up, the evidence above provides ample support for the ‘external enablers’ argument – a channel which has been relatively unexplored by the literature. It is not a direct ‘debunking’ of the cost-competitiveness hypothesis, but it does weaken it by providing a coherent alternative explanation that accounts for the variance often automatically attributed to competitiveness gains.

⁹ Although, as Chapter 4 will show, the 160.7% growth in exports is highly inflated.

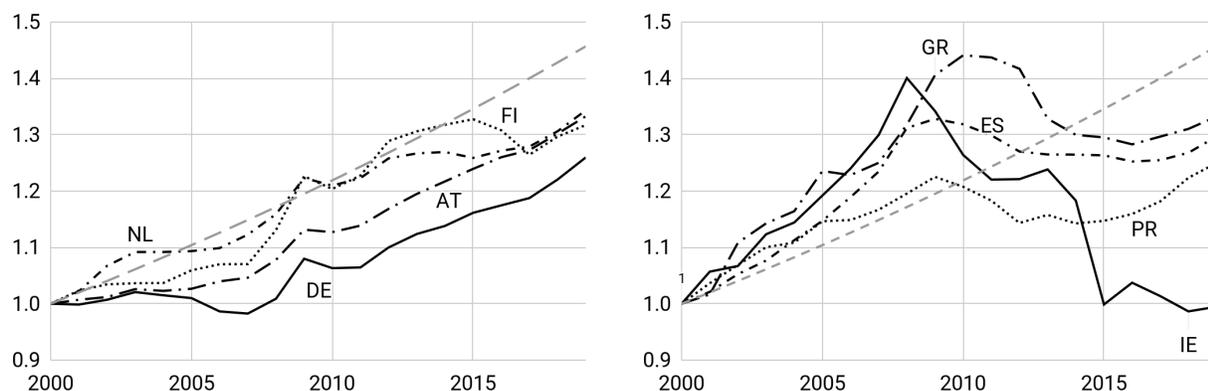


Figure 2.11. *Nominal Unit Labor Cost trends in surplus (L) and deficit (R) countries, 2000=1 (Data: ECB); Dashed line: inflation target*

That said, the analysis also reveals the implausibility of ULC-based competitiveness as the decisive factor behind export gains. Again, the process tracing method is an important aid here. Firstly, it is highly improbable that external demand shocks, such as an infrastructure-heavy fiscal stimulus in China after the GFC happened because of wage cost dynamics in Germany or elsewhere. It was an exogenous factor with respect to Eurozone policy choices. Secondly, ULC patterns in the period cannot account for variation in members' ability to capitalize on this external boost (e.g. Germany's ULC inflation trend in the 2010-2016 period is similar to the other three).

Similarly, the role of ULC devaluation in the US-Irish trade nexus is questionable. While Irish ULC does indeed show the starkest drop, careful analysis of McDonnell and O'Farrell (2016) shows that it was based on a composition effect, driven almost entirely by the collapse of the construction sector (where jobs had a higher labor intensity) after Ireland's credit-fueled real estate bubble burst (Dellepiane-Avellaneda et al. 2021). Brazys and Regan (2017) add that Ireland's within-value-chain exports cluster in high-tech, high-value added industries that are not sensitive to relative prices, so it is implausible that Ireland's divergent recovery was driven by suppressed spending.

Taken together, these dynamics lend support to the claim that it was not austerity driving up exports, but the other way around: exports enabled austerity.

Change in Current Account balance (*IE: modified CA)	2010-2016 change, %	OECD: Balance of Payments (BOP6); CSO: modified Current account as a percentage of GNI*
Change in cyclically adjusted primary fiscal balance	2010-2016 change, %	IMF Fiscal Monitor: Advanced Economies: General Government Cyclically Adjusted Primary Balance
Change in households' net lending (deleveraging)	2007-2016 change, %	Eurostat: National Accounts, Non-financial transactions [nasa_10_nf_tr], Net lending (+) /net borrowing (-), Households, constant (2015) prices
Employment compared to pre-crisis level	2007-2016, 2007=100%	Eurostat: National Accounts, Total employment domestic concept [nama_10_a64_e]
Real GDP growth (*IE: real GNI* growth)	2007-2016, 2007=100%	Eurostat: National Accounts, GDP and main components, chain linked (2015) (output, expenditure and income) [nama_10_gdp]; CSO: Modified Gross National Income at constant prices
Initial share of select trading partners' demand in exports	2010, %	OECD TiVA: FFD_DVA, domestic value added embodied in foreign final demand by trading partners
Initial share of US, UK, CN final demand in employment	2010, %	OECD TiM: FFD_DEM, domestic employment embodied in foreign final demand by trading partners
Growth of exports to partners outside the EU	2010-2016 change, %	Eurostat: National Accounts, GDP and main components (output, expenditure and income) [nama_10_gdp], Exports of goods and services to third countries and international organisations, constant (2010) prices
Initial share of select sectors in total exports	2010, %	OECD TiVA: FFD_DVA, domestic value added embodied in foreign final demand by industries (sector / total)
Foreign and domestic final demand's contribution to employment growth	2010-2016, contribution to total growth, %	OECD TiM: FFD_DEM, domestic employment embodied in foreign final demand

Table 2.3. Operationalization of variables and data sources

2.6 Conclusion

The analysis of diverging employment performances accompanying suppressed spending and rising current account balances in the Eurozone revealed a significant impact of China and the United States, whose import growth masked some of the domestic costs of austerity. Reaping the benefits were countries with strong existing ties to these partners, Germany and Ireland in particular (and the Netherlands to a lesser extent). In contrast, members who are more integrated in the Eurozone trade

area, had limited room for export-led growth. The effect of external enablers, masking employment costs of suppressed domestic spending, is spelled out through comparisons within the Eurozone's surplus and deficit countries. Surplus countries without the external option were forced to rebalance and run down savings (like Austria and Finland did). Deficit countries without the external option needed to endure austerity with painful collapses in jobs (like Portugal, Spain and Greece did). The analysis contributes to the literature in three ways.

Firstly, it introduces a global perspective to the mainly domestically focused Comparative Political Economy research on macroeconomic policies underpinning export-oriented economies. It shows that observable boosts in export performance attributed to domestic policy configurations can also be affected by other countries' policy choices. The external enablers channel highlights that correlations between suppressed spending (declining fiscal expenditure or wages) and CA surpluses are often automatically assumed to be competitiveness effects, even though the relationship could also work in reverse: instead of (or beyond) austerity driving up exports, existing export ties can *enable* austerity. If a country has trading partners willing to spend, favorable external demand shocks will result in employment growth, compensating for the jobs lost due to weakened home markets, and making otherwise painful policies easier to implement and uphold. This suggests that the study of export-led growth regimes should integrate differences in geographic and sectoral trade orientation, marking different positions to benefit from external demand shocks (e.g. De Ville and Vermeiren 2016).

Secondly, the findings contribute to our understanding why austerity policies are chosen and upheld in the first place. Since external demand masks the negative effects of austerity, it also disrupts an important feedback channel. This lack of a negative feedback effect (in the form of unemployment) is an incentive to uphold these policies – that in turn interacts with other factors. While scholarship on normative ideational factors (e.g. Matthijs and McNamara 2015) or distributional political conflict (Walter *et al.* 2020) cover a lot of ground in explaining policy choices in the onset and aftermath of the Eurozone crisis, external demand as an enabling condition is somewhat of a blind spot, even though

global demand dynamics do interact with them. More widespread collapses in export markets, like the global financial crisis of 2008-09, as well as the COVID-19 shock of 2020 did trigger large stimulus packages in the Eurozone, overriding both normative biases and political gridlocks. The Eurozone crisis was different because of the regional nature of the shock.

Finally, a crucial takeaway from this analysis is the global interdependence of spending and saving choices. Europe's anaemic home market, weakened by growing inequality and years of austerity has global repercussions, putting Europe's export champions on a collision course with their partners: in an environment of globally weak demand and near-zero interest rates (which Keynes called a liquidity trap), relying on external demand to grow is equivalent to 'capturing' some of trading partners' scarce demand, in other words, exporting unemployment to them. From both domestic and international perspectives, strengthening ordinary people's purchasing power and boosting investments in public goods would be a favorable strategy for Europe.

SECOND FALLACY: MISTAKING WEAK IMPORTS FOR STRONG EXPORTS

The case of Germany

Germany's excessive current account surpluses mirror domestic problems. They are rooted in inequality and a weak home market, creating an overdependence on exports. Why, then, are policymakers so reluctant to reduce them? The chapter argues that the answer is rooted in the second fallacy: mistaking weak imports for strong exports. Surpluses can be achieved through two channels that are observationally equivalent. The first is the expenditure switching channel, improving relative prices, making exports more competitive. The second is the expenditure changing channel, which means a change in the overall level of spending, depressing imports. Simply put, a surplus achieved through the first channel can be called an export surplus, a surplus achieved through the second is an import deficit. The empirical starting point of the paper is that Germany's problem is an import deficit. This obscures winner-loser relations: an export surplus or superior competitiveness would be a problem for trading partners. An import deficit however, while also hurting trading partners, has significant negative consequences for domestic residents. It is a '*beggar-thyself, and thy neighbor*' policy.

The analysis shows how this fallacy is mirrored in the public misrepresentation of surpluses' domestic costs. Imbalances are narrated as distributional conflicts between countries, not within them; and bilateral trade is framed as a competition, where surplus countries win. The analysis reconstructs stakeholders' positions and discursive strategies through media narratives and Bundestag debates, using an original dataset of public statements. It finds evidence for a systematic bias disregarding the domestic losers of surpluses. Whenever imbalances are discussed, the triggering event is external criticism, mainly from the European Commission and the United States. The ensuing debate follows

an ‘us versus them’ logic, where foreign critics clash with domestic defenders – mainly the government and export-sector organizations. The success narrative and identitarian discourse about an ‘export nation’ limits left-wing actors’ room to move beyond incremental criticism. The analysis finds an effect of European integration exacerbating imbalances. Germans fend off critics by an arena-shifting strategy: pointing out that exchange rates and trade are European-level prerogatives, disregarding internal policy levers for rebalancing.

3.1 The silent losers of German export surpluses

Compared to noisy foreign critics of Germany’s record-large current account surpluses, domestic losers of the country’s longstanding export-reliant model are less frequently heard – even though consistently spending less than what is produced has negative effects for Germany as well (Jacoby 2020, Klein and Pettis 2020). As closer empirical investigations reveal, ballooning trade imbalances (a growing difference between exports and imports) were not driven by superior export performance, but chronically weak domestic spending (Tilford 2015, Behringer *et al.* 2020, Dao 2020). Simply speaking, Germany’s problem is not an *export surplus* but an *import deficit*. Imbalances mirror rampant inequality, anemic household consumption and a large public and private investment gap – distortions that are expected to trigger domestic pushback. Foreign critics have limited means to force German policy change, but domestic voters hold the ultimate, electoral leverage. So why don’t these grievances translate to rebalancing?

An established answer of the political economy literature focuses on special interests and the lobbying prowess of Germany’s high value-added export sector, blocking rebalancing even in the face of high aggregate costs (Hall 2012, Iversen and Soskice 2012). But even if exporters are ‘winning’ from suppressed spending through real depreciation (an assumption that is not a given), there are plenty of harmful side-effects, even for them. Chronic underinvestment in physical or digital infrastructure harms long-term (non-price) competitiveness. International pressure should also be an incentive to course-correct, as trade uncertainties damage business prospects. Tellingly, representatives of the export

lobby have issued multiple public calls for more fiscal spending.¹⁰ Entrenched export interests alone do not offer a full explanation. Tapping into the literature on the discursive construction of interests (e.g. Hay and Rosamond 2002), this paper argues that the fallacy of mistaking weak imports for strong exports distorts the domestic politics of imbalances. Narrating the debate as a noisy rivalry *between* nations obscures the costs of surpluses *within* Germany.

Another factor is the role of external enablers – the argument laid out in the previous chapter. From the 2000s onwards, positive demand shocks from China and the United States masked employment costs of weak domestic spending, blunting domestic pushback. The enabling effect of low unemployment may have been a *necessary* condition to keep these policies in place – but it does not *sufficiently* explain the lack of political contestation against German surpluses, considering severe economic and social costs beyond employment numbers. To answer this ‘residual puzzle,’ this chapter turns to the domestic costs of imbalances and their misrepresentation in the public discourse. Current account (CA) imbalances are framed as a conflict between countries, not within them, distorting public perceptions about their domestic costs.

Using an original database of stakeholders’ public statements, the investigation finds evidence for a systematic underrepresentation of domestic losers of German surpluses. This may help explain why domestic costs of imbalances do not translate to a political program towards correcting them, not even by left-wing actors (Bremer and McDaniel 2019, Bremer 2020). The analysis of news media narratives and Bundestag debates finds that the triggering event for discussing the issue is almost exclusively outside criticism, creating an ‘us versus them’ dynamic where pressure ‘on Germany’ comes from abroad, activating domestic defenders. Surpluses are narrated in an identitarian discourse, where ‘we are an export nation’ or ‘export world champions’ are recurring tropes. Criticizing the surplus amounts to criticizing a source of national pride, also limiting left-wing actors’ room to move beyond incremental criticism. The final section turns to the international level and asks how Germany gets away with reliance on trading partners’ spending. As a further contribution, building on theoretical

¹⁰ “German business calls for end to new borrowing ban” Sep 24, 2019, Financial Times; “BDI-Chef Kempf hinterfragt deutschen Handelsüberschuss” Sep 14, 2017, Reuters

insights of Johnston and Regan (2018), it points to the impact of European integration exacerbating imbalances – by enabling an arena-shifting strategy for Germany as trade policy and monetary policy are delegated to the European-level.

3.1.1 Distributional conflicts generated by German CA surpluses

To establish the starting claim – excessive surpluses are bad for Germany – this section gives a short review of the empirical literature and some macroeconomic insights.

CA surpluses emerge through two main channels, expenditure switching and expenditure changing. The first one implies a change in relative prices– boosting exports by making them more competitive (i.e. cheaper). The second one implies a change in the overall level of spending— depressing imports. An important insight is that policy interventions usually work through both channels, and it is difficult to disentangle which one is at play. Real devaluation policies (e.g. cutting wages or public expenditure) are meant to stimulate exports by making the real exchange rate more competitive, but they simultaneously suppress the overall level of spending. This observational equivalence problem confounds distributional politics: while in the first case, surpluses yield obvious benefits through an expanding export sector, in the latter, surpluses indicate domestic costs like lower living standards or underinvestment.

Recent empirical findings indicate that Germany’s CA imbalances are rooted in domestic inequality. Dao (2020), for instance, finds a remarkably strong relationship between the rise of the top decile’s income share from 2000 onwards, and the surge of imbalances (the correlation coefficient is 0.94) (Figure 3.1).

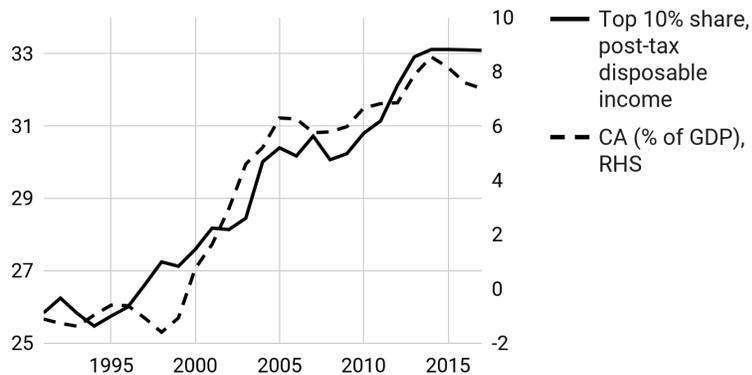


Figure 3.1. Germany's top 10 income share and CA surplus (Data: World Inequality Database, OECD)

But how does inequality drive CA imbalances? A CA surplus means that residents of a country choose to spend (consume or domestically invest) less than what they produce in a given period. The residual income is 'excess' saving (over domestic investment; $CA = S - I$) that is lent abroad. These spending and saving patterns, in turn, can be driven by income redistribution. If wages increase more slowly than productivity (which has been the case in Germany in the last decades), income is shifted from workers to firm-owners (Pettis 2013). Since workers have a higher marginal propensity to consume (MPC), a larger share of the overall income will be saved.

German income inequality has been steadily increasing in the past two decades (Fratzscher 2016, International Monetary Fund 2017a), poverty levels rose in parallel with a decrease in unemployment, as employee share in low-wage sectors grew. Wealth inequality is one of the highest in the euro area – an often-cited figure is that 40% of Germans own no assets at all (homeownership is lowest in the EU). Concentrated corporate ownership and the globalization-induced surge of profits jointly drove up top income inequality (Dao 2020).

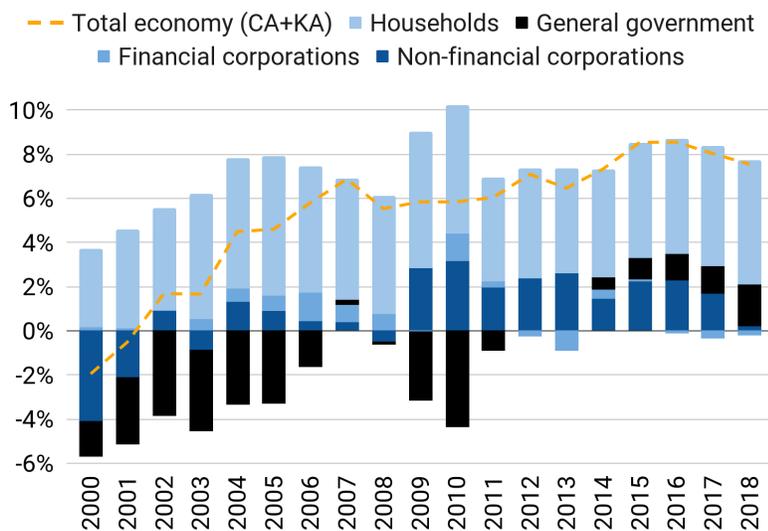


Figure 3.2. Germany, net lending by sector (percent of GDP) (Data: Eurostat)

Decomposing the CA surplus by domestic sectors supports this income shift narrative. On the one hand, it shows that German households save much (with above 15%, Germany has one of the Eurozone’s highest household savings rates) in large part because of pressing demographic changes. But household savings show a constant pattern. The surplus was mostly driven by a surge in corporate savings (a sector that is generally a net investor). Non-financial corporations’ ballooning positive balance here is a proxy for retained profits (not paid as dividends) over the part that is domestically invested (Behringer *et al.* 2020), underlining corporations’ growing ‘stashing wealth’ problem (Redeker 2019). Rather than counteracting the investment shortage, the government also increased savings through balanced budget policies (dubbed ‘Schwarze Null’ or black zero) and the constitutional debt brake (Haffert 2016).

Weak domestic spending normally undermines employment – but favorable demand shocks from China and the United States boosted German job-creation. But social costs beyond unemployment were severe: inequality grew, and workers in lower income brackets saw their purchasing power drop. Underinvestment (public and private) leads to crumbling bridges and faulty digital networks, damaging long-term competitiveness in the era of rapid technological change (Roth

and Wolff 2018). Germany’s public investment gap is striking – the spending net of depreciation has been consistently negative since 1988 (Klein and Pettis 2020, p. 168). While unmet domestic investment needs were plenty, German savings flew into foreign assets, often beyond productive investment opportunities (Fuller 2018). German investors saw a whopping 7 per cent valuation loss on their foreign assets since 1999 (Klein and Pettis 2020, p. 86). It is an important rebuttal to authorities’ frequent reference to an aging society’s imperative to save.

How do CA surpluses hurt trading partners in the context of globally constrained demand and near-zero interest rates (or liquidity trap)? Blanchard and Milesi-Ferretti (2012) lay out the zero-sum multilateral effects of CA surpluses in a simple model. In a liquidity trap, an increase in desired saving in a surplus country leads to lower output in its trading partner. If prices (interest rates) cannot equilibrate the increased saving desire, then quantities (output) become the adjustment variable. In simple terms, surplus countries are exporting *unemployment* to trading partners. It is a beggar-thy-neighbor strategy to rely on (already scarce) foreign demand to escape unemployment at home, without having to undertake domestic stimulus. Productive capacities of exporters continue to be utilized while deficit countries need to endure high unemployment and painful austerity to adjust or see their debt levels rise (Mian *et al.* forthcoming).

	Germany	Trading partners
Costs	<p>Growing inequality, lower living standards</p> <p>Weak demand in domestically oriented sectors</p> <p>Inadequate investment hurts supply potential and public goods provision</p> <p>Risk of trade disputes with partners</p> <p>Losses realized on risky foreign investments</p>	<p>Beggar-thy-neighbor effects of capturing already scarce demand (unemployment, slower growth)</p> <p>Unsustainable debt build-up</p>

Benefits	<p>Economic and employment growth in outward oriented sectors</p> <p>Savings surplus justified by demographic trends</p> <p>Low indebtedness</p>	<p>High import-share of German exports</p> <p>Room for debt-fuelled consumption and growth</p>
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Table 3.1. *Costs and benefits of policies driving CA surpluses*

3.1.2 The political economy of weak domestic spending

Engaging with the central puzzle (the lack of rebalancing in the face of severe domestic costs), the Varieties of Capitalism tradition (Hall 2012, 2014) stresses the role of sectoral interests. Iversen and Soskice (2012) explain how advanced nation states are preoccupied with the policy preferences of their respective highest value-added sectors – export-oriented manufacturing in Germany, Japan, or China; and high-risk, innovative financial services in the United States or United Kingdom. Even if a significant strand of German society loses out from suppressed spending, the overly powerful exporting industry benefits, and blocks rebalancing. (Similarly, citizens of deficit countries like the US do lose out from the disappearance of industrial jobs – but the flipside of surpluses are capital exports, fuelling credit expansion, the vested interest of the financial sector.) The immediate driver can be lobbying or policymakers attuned to the interests of the sector providing well-paid jobs, innovation, and human capital investment (Culpepper 2015).

Dissecting the ‘sectoral interest’ concept, the explanation leaves question marks. First, how exactly do German exporters benefit from suppressed spending? For most Comparative Political Economy accounts (including the growth model framework pioneered by Baccaro and Pontusson (2016), the causal channel is *cost-competitiveness* through Real Effective Exchange Rates (REER): industry aims to keep spending low to prevent REER appreciation that would hurt export sales.

There are reasons to question suppressed domestic spending as the key driver of export growth.

Many argue that Germany's export success from the mid-2000s onwards was not driven by real devaluation, but links to fast-growing trading partners – suggesting export products are less sensitive to relative prices, and more to foreign activity (e.g. Danninger and Joutz 2007, Storm and Naastepad 2015, Neumann 2019). Soyres et al. (2018) show a general decline in exports' price elasticity driven by global value chains. The debate is not settled: others estimate high price elasticities for German exports (e.g. Baccaro and Benassi 2017, Baccaro and Tober 2021). But even with an active REER channel, at least part of the effect (that is often automatically attributed to competitiveness) may be accounted for by external demand shocks, questioning the extent to which exporter firms 'win' from weak spending (Polyak 2021).

To assess whether Germany's exporters have a vested interest in suppressed spending, it is useful to disentangle whose spending we are talking about. Boosting government expenditure, household consumption or investments (G, C, I) could all be possible avenues to rebalance the CA. Starting with fiscal rebalancing (G), sectoral interest-based explanations suggest that exporters are wary of expansionary fiscal policies (G) because they are inflationary (the REER channel). However, surveying stakeholders' policy preferences in Germany, Walter *et al.* (2020) find that export-sector employers are actually quite open to fiscal rebalancing, when contrasted to other alternatives. While costs of real appreciation are doubtful, more spending on public goods like infrastructure also *benefits* business prospects. Turning to household consumption (C), exporters do oppose wage-based rebalancing options (e.g., minimum wage legislation). However, it is important to understand why they might oppose it. One reason – fitting the competitiveness narrative – could be that they fear it would hurt export sales through cost-competitiveness losses. But in this case, we would expect them to be similarly hostile towards other inflationary stimuli. More plausible is that wage-based rebalancing would boost labor's share of income and decrease their profits. Finally, rebalancing could happen through government policies encouraging investment (I), e.g., through tax incentives or regulatory changes. If the abovementioned real appreciation channel is weak (and there are little competitiveness losses from inflationary policies), these would clearly be beneficial to companies: beyond stimulating demand, they would also enhance supply capacity.

Moreover, with its degree of trade openness, the German economy, particularly the export sector, depends greatly on the achievements of European market integration and a globally open trade regime. Threats of disintegration (Walter 2020) or trade conflict may further increase exporters' stake in correcting imbalances.

To sum up, Germany's powerful export industry is unlikely to be the force blocking rebalancing efforts. Why, then, are policymakers so reluctant to change course? Walter and her co-authors' own explanation argues that adjustment efforts were blocked by disagreement over the specific interventions: corporate tax cuts were unacceptable for trade unions; wage increases were unacceptable for employers' organizations. In the realms of Germany's consensus-oriented political institutions with many institutional checks (Haffert 2016), including a rigid federal structure (Bremer *et al.* 2021) this gridlock is a significant force to retain the status quo.

An important factor missing from this narrative is that introduced by the previous chapter and the first fallacy: the status quo is an attractive choice (or rather non-choice) for German policymakers as long as they can rely on foreign demand as an external fallback option. Angela Merkel's governments overrode the gridlock when facing widespread collapses of export markets, both after the global financial crisis (Schelkle 2012), and the COVID-19 shock (Sandbu 2020). Positive demand shocks from China and the United States consistently masked domestic employment costs of surpluses, blunting domestic opposition against wage restraint and fiscal restraint, as explored by the previous chapter. However, neither of these enabling conditions can fully explain why the domestic losers of weak domestic spending, and their representatives like trade unions and left-wing parties are so ineffective in advancing their grievances and pushing for a change in policy course. Low domestic unemployment supported by external demand may be a necessary condition, but not a sufficient one – rising inequality, in-job poverty or underinvestment could all ignite political pushback. If suppressed spending in Germany is not needed to keep export jobs in place, if exporters are lobbying for fiscal rebalancing themselves, why don't policymakers heed their advice?

3.2 Theorizing a disconnect between actual and perceived costs of imbalances

A more fitting theoretical approach distinguishes between actual and *perceived* distributional costs to explain the lack of German rebalancing. Tapping into the rich ideational strand of the political economy literature (Hay and Rosamond 2002, Blyth 2013, Matthijs and McNamara 2015), distributional tensions are conceptualized as emerging from an interplay of objective reality and discursive construction. As Kneafsey and Regan (2020) show, media framing is a powerful tool in this construction process. Discursive framing by media narratives and problem articulation by representatives help us reconstruct distributional tensions and winner-loser relations that do not necessarily coincide with the analysis above.

Economic phenomena are framed in moral terms – narrated as stories about the good (frugal, competitive) and bad (profligate, slacker) (Matthijs and McNamara 2015). A common parallel likens firms competing on the market to economies competing against each other. Exports are often framed as a superior form of generating national income – while consumption is scolded as profligate. Oddly, it is sometimes implied that all countries should rely on exports. A positive trade balance is framed as winning, and deficits are losing, even though the opposite can be argued just as (or even more) convincingly. As Matthew C. Klein (2017) aptly puts it:

Surpluses are a sign that consumers are working to produce things they can't actually use themselves. One could therefore be forgiven for thinking big trade deficits are the sign a country is 'winning' relative to the rest of the world. After all, the 'losers' with their surpluses are 'giving away' goods and services in exchange for paper promises that any good dealmaker could renegotiate in the future.

Similarly misleading is the microeconomic parallel between spending and saving choices of households and state budgets. This is what John Maynard Keynes famously called the *paradox of thrift*: since one's spending is another one's income, if all want to save at the same time, no one can save, since there would be no income to save from. Hence, individually rational behavior leads to collectively damaging outcomes.

Excessive imbalances become profoundly counterintuitive for the German audience if framed as ‘too competitive firms’ or ‘too much saving.’ Consequently, the role of ideas has a strong case to explain why governments and voters opt for certain policies even against their self-interest. The analysis looks for evidence to support the hypothesized misrepresentation of domestic costs – whether imbalances are framed as a conflict *between* countries, not *within* them. The empirical marker of such a framing would be an underrepresentation of domestic stakeholders’ grievances in the debate.

Such a portrayal of imbalances can be reinforced by a debate that revolves around traditional levers of trade policy: external variables like exchange rates and tariffs as opposed to policies boosting domestic demand. In macroeconomic terminology, these adjustment channels are called *expenditure switching* and *expenditure changing*. Expenditure switching means changing the relative prices of foreign and domestic goods, thus changing the real exchange rate – either its nominal exchange rate component or the domestic price level. Expenditure changing means changing the level of spending – at fixed relative prices, consuming more (or less) on both domestic and import goods. The second hypothesized pattern is that the data will reveal the dominance of frames related to competitiveness or expenditure switching.

If the debate remains focused on expenditure switching – nominal euro exchange rates or tariffs – a convenient ‘arena-shifting’ strategy (Flinders and Buller 2006) opens for the German side: both monetary policy and trade policy are delegated to the European level, so German policymakers can stress their limited policy discretion. The analysis is expected to find evidence for this strategy.

3.3 Empirical analysis of media discourse and parliamentary debates

3.3.1 Data and methods

The empirical strategy is the content analysis of officials’ and stakeholders’ public claims covered by the German news media. A dataset is compiled from news items containing the keywords ‘export surplus’ and ‘trade surplus’ at the German-language Reuters site – an internationally oriented news agency targeted at business executives. It is a comprehensive source: notable events concerning the issue are

reported here, including press releases and public statements (also those expressed in other media outlets). It excludes commentaries or opinion pieces. The studied timeframe is a nine-year period between 01/01/2010 and 12/31/2018.¹¹ The period was chosen to include two important events when the surplus issue received heightened attention, the Eurozone crisis and the trade dispute with the Trump administration.

The database of 201 news items is further disaggregated, collecting stakeholder statements quoted by each news item. This yielded a database of 408 statements (an average of 2.02 per news item) which were hand-coded. There are two codes used – ‘critical statements’ (CSs) mention the surplus in a negative context, ‘defensive statements’ (DSs) in a positive one.¹² Stakeholders are categorized by the organization they belong to. Note that only stakeholder statements (quotes) are recorded, descriptive reports (e.g. “*last quarter, Germany’s export surplus reached a record high*”) are not. Since quotes already display speakers’ positions, they help produce clear-cut categories. In the rare case of more neutral, “*on the one hand ... on the other hand*” claims (e.g. Commission President Barroso or Minister for Economy Gabriel voiced cautious criticism while praising German competitiveness), *two* statements are recorded – one critical, one defensive.¹³ As a robustness check, the dataset is supplemented by an analysis of peak events through the coverage in two dailies of national reach (Frankfurter Allgemeine Zeitung, Süddeutsche Zeitung) and redtop daily Bild, as well as news broadcasts of German public television (ARD). Official policy documents are also reviewed.

A supplementary analysis turns to parliamentary debates in the Bundestag, using the online database of plenary protocols (DIP). In the studied period, a keyword search is used to identify 49 plenary debates (official government statements or Regierungserklärungen, planned debates and

¹¹ The 2010-2018 period roughly corresponds to two German electoral periods between Oct 27, 2009 and Oct 24, 2017. The starting point was chosen due to data availability: articles were accessible from Jan 1, 2010. The year 2018 was included to cover an important episode (the Trump trade war).

¹² The datasets are openly available on the Harvard Dataverse under <https://doi.org/10.7910/DVN/SRF1BG>

¹³ Codes refer to the substance of statements, *tone* within the two categories does differ – politicians use stronger language than more neutral experts.

parliamentary questions), where MPs discussed the issue of surpluses. A database of 101 remarks is compiled, which were also hand coded.

The empirical strategy has limitations. While a qualitative technique with hand-coding allows deeper engagement with the complex frames, it introduces potential inaccuracies and biases. Moreover, the corpus of 201 news items and 49 parliamentary debates over a nine-year period shows that the overall frequency of discussing the surplus is rather low (unsurprisingly, given its technical nature). The discussion below also addresses what the ‘silences’ may imply for the analysis. The sample size suffices for the simple cross-tabulations required and for identifying broader patterns.

3.3.2 Distributional costs mirrored in media narratives

What were the triggers of media attention, i.e. the events pushing the surplus issue onto the agenda? Peaks indicate that it was outside criticism.

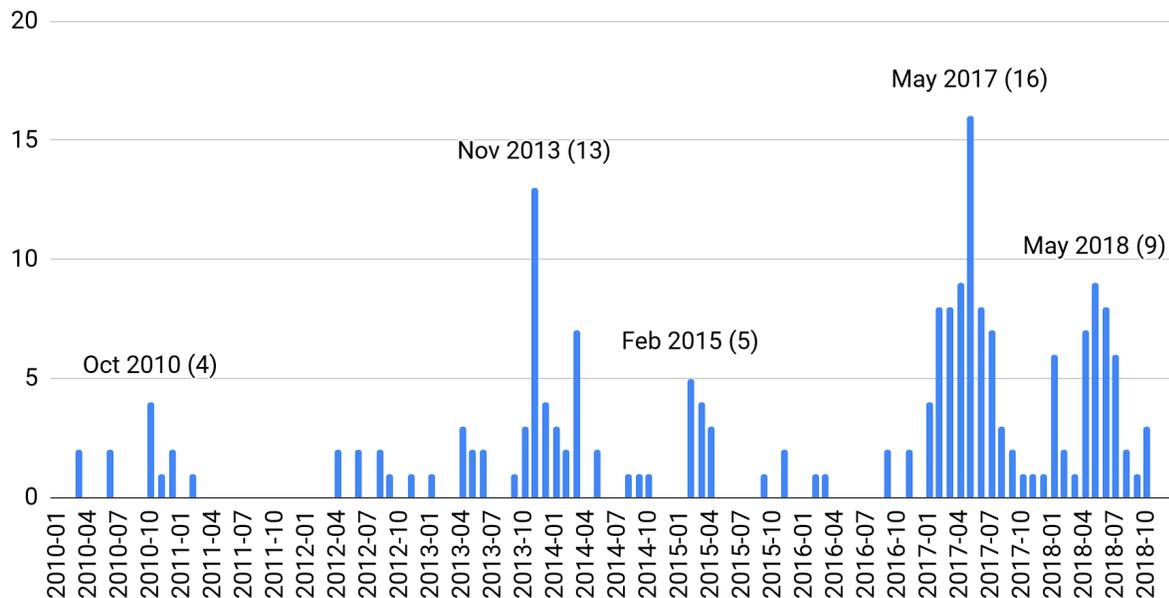


Figure 3.3. Monthly number of news items with codewords ‘export surplus’ or ‘trade surplus’ (data scraped from reuters.de)

This first finding already foreshadows the dynamic of the debate. The fact that attention turned to the issue due to outside criticism strengthens the perception that the surplus is someone else’s problem. The first peak was in October 2010, when Obama’s Treasury Secretary Geithner called out surplus countries and floated the idea of a corrective mechanism. In November 2013, two events occurred: the US Treasury expressed criticism in its official monitoring of trade practices and the European Commission announced its investigation into German imbalances. In February 2015, the trigger was a German counteroffensive: turning the EU’s own criticism against them, Finance Minister Schäuble used the issue to criticize ECB policies weakening the euro. In early to mid-2017 and 2018, the Trump administration resumed Obama-era criticism in a harsher, threatening tone.

Who are the main critics, and who are the defenders activated by criticism? Overwhelmingly, criticism originates from the outside. The United States government (92 CSs), the European Commission (46 CSs) and international organizations (25 CSs) are the most prominent critics. The biggest defenders are the German government (93 DSs) and employers’ organizations (44 DSs). Trade unions only feature 3 times, voicing critical remarks.

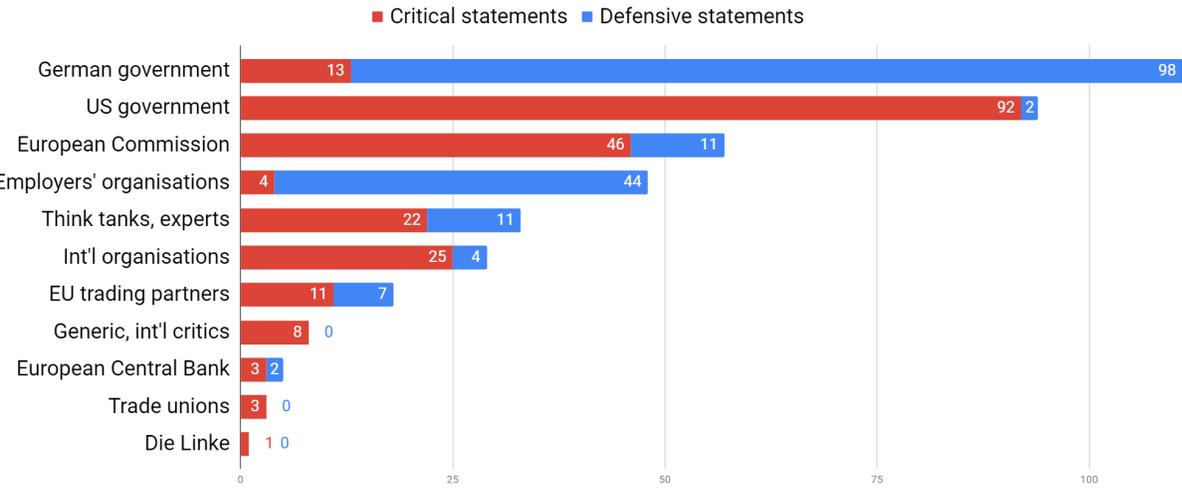


Figure 3.4. Number of critical and defensive statements by stakeholder category

This piece of evidence supports the proposition that CA imbalances are framed as a conflict *between* countries, not *within* them. The issue arrives on the agenda from the outside, the government responds on the defensive. As surpluses pertain to ‘trade’ and ‘export’, the export industry’s voice is activated, while unions and left-wing parties remain silent, even though (as shown above) they are relevant stakeholders.

The following section presents the content patterns (frames and arguments) revealed by critics’ and defenders’ remarks. The analysis succeeds chronologically, identifying six key stages.

1) Wage-dumping charges from Eurozone partners

The first highly publicized exchange in the period studied (the two German electoral periods between Oct 27, 2009 and Oct 24, 2017) ensued in early 2010, as the euro crisis was recently underway. Officials representing Eurozone partners expressed their criticism with a focus on wages. French Finance Minister Christine Lagarde called Germany’s downward wage competition unsustainable. Luxembourg Prime Minister Jean-Claude Juncker accused Germany of having improved competitiveness through ‘wage and social dumping.’¹⁴ German officials dismissed the charges, stressing that critics should rather follow Germany’s ‘no pain, no gain’ recipe to increase competitiveness and exports. Typical of these early narratives was the long report in German public television’s nightly news show, framing the problem as German companies prudently keeping wages low to safeguard employment and being scolded for their success. They asked: ‘should now the model student get worse just to get the class average right?’¹⁵

2) Exchange rate manipulation charges from the United States

US Treasury Secretary Timothy Geithner criticized surplus countries’ contribution to external imbalances at a G20 summit and proposed an adjustment mechanism, maximizing surpluses in 4% of

¹⁴ ‘Lagarde criticizes Berlin policy’ Financial Times, Mar 14, 2010; ‘Die deutsche Wirtschaft ist parasitär’, Tagesspiegel, Nov 11, 2010

¹⁵ Tagesthemen, Mar 16, 2010

GDP.¹⁶ The proposal was widely cited in German media and triggered a fierce response from Finance Minister Schäuble –

The reason for Germany's export success is not some kind of currency sleight-of-hand, but the increased competitiveness of our firms. The American growth model, on the other hand, is stuck in a deep crisis. (...) There are many reasons for the American economy's problems – German export surpluses are not among them.¹⁷

Schäuble makes a veiled reference to Americans' frequent accusation of Chinese currency manipulation, dismissing it as a misguided assessment in the German case. Minister for Economy Rainer Brüderle (FDP) called Geithner's threats a 'shocking relapse into planned economy thinking.'¹⁸

3) Concerted calls for demand stimulus, timed for coalition talks

The peak in November 2013 consisted of two events – in a harshly critical report, the Obama administration condemned Germany's 'anaemic pace of domestic demand growth and dependence on exports'¹⁹ (US Treasury 2013, p. 3) as it creates deflationary pressures globally.

In two weeks, Commission President Barroso and Commissioner Rehn held a press conference announcing a Commission probe into German export surplus within the Macroeconomic Imbalance Procedure (MIP), a monitoring regime established in 2011. They emphasized that their aim is not weakening German competitiveness but strengthening domestic demand.²⁰ Again, ARD's Tagesschau gave a typical summary of the German position, with an important nod to domestic costs (the infrastructure investment gap) –

The purpose of this investigation is above all a political one. It is difficult for other Europeans to bear that they are tantalized for their problems while Germany is

¹⁶ 'Deutsche sollen kaufen, nicht exportieren' Der Spiegel, Oct 22, 2010

¹⁷ 'Zu lange auf Pump gelebt' Der Spiegel, Nov 8, 2010

¹⁸ 'Brüderle kritisiert Geithner' Die Welt, Oct 26, 2010

¹⁹ Treasury Report on International Economic and Exchange Rate Policies, Oct 31, 2013

²⁰ 'Turning Germany's surplus into a win-win for the eurozone.' Olli Rehn's Blog Nov 11, 2013; 'Was Handelsüberschüsse mit dem Euro zu tun haben.' Frankfurter Allgemeine Zeitung, Nov 11, 2013

celebrating their successes. The Commission has to prove that, as agreed, they scrutinize everyone, including the good ones. They do not want and cannot do anything against Germany's export strength. But their reminder that Germany can do more to revive domestic demand is not so easy to dismiss in view of broken motorway bridges and dilapidated school buildings.²¹

It is important to note the *timing* of US and Commission criticism. This was the immediate aftermath of the 2013 German federal elections, as Union and SPD were in formal coalition talks. It is plausible that outside pressure was increased to influence outcomes in a susceptible moment when a range of questions were opened for negotiation.

4) Incremental change: minimum wage and investments

In November 2013, a new government was formed, and center right FDP was substituted by center left SPD as junior partner – positions and policies changed. The most important measure from the aggregate demand point of view was the introduction of the statutory minimum wage of EUR 8.50, effective from January 2015.²²

Early 2014, *Süddeutsche Zeitung* released quotes from a government position paper acknowledging the persistent surplus as a problem for Eurozone stability. The brief for Minister for Economy Sigmar Gabriel concluded that 'reasons are complex, one important driver is the weakness of investments.'²³ Later that year, Gabriel appointed an expert commission led by economist Marcel Fratzscher to propose steps to boost investments. However, careful rhetoric foreshadowed careful outcomes: public investment increased – but the government stuck to balanced budget policies, undermining any investment strategy. As investments rose somewhat, officials started emphasizing that it was 'highest in years' and all capacities were utilized.

²¹ ARD Tagesschau, Nov 13, 2013

²² 'Working together for Germany – With courage and compassion' Coalition Agreement between the CDU, CSU and SPD, 2013

²³ 'SZ - Bundesregierung erkennt Exportüberschuss als Problem an' Mar 5, 2014, Reuters

Importantly, these incremental steps to strengthen aggregate demand were not linked to the surplus issue in public communications. The critical position paper was a leak, SPD did not criticize surpluses. This implies the willingness to do something about the imbalance problem without openly linking interventions to it, being wary of its profound counter-intuitiveness as a message.

5) Shifting strategies: ‘the best defense is a good offense’

From 2015 onwards, there is a visible discursive shift – mirroring a shift in the officials’ strategy. This was the time the European Central Bank started its asset purchase program amidst fierce German resistance. Exceptionally, it was Finance Minister Schäuble bringing up the surplus issue on multiple occasions. As he explained –

I have a lot of Eurozone colleagues who argued for QE. I did not. (...) The bond purchases will lead to a bigger German surplus. It is quite ironic that those who argue for QE then criticize Germany.²⁴

From this point, German officials regularly turned ECB’s own criticism of German surpluses against them, to voice dissent against low rates and QE.

6) Threats of the Trump administration

Donald Trump took office with a highly politicized position on bilateral trade deficits. Although his focus was China, shortly before inauguration, he put Germany in his crosshairs too. In an interview, he threatened German car makers with a 35% tariff. Minister Gabriel fired back that the US should ‘build better cars.’²⁵ Shortly thereafter, Economic Advisor Peter Navarro accused Germany of currency manipulation. From January 2017 to May 2017 (as media attention peaked again), the German government responded to intensifying threats with every rhetorical tool of previous years.

²⁴ ‘Schäuble sieht expansive Geldpolitik mit Skepsis’ Apr 15, 2015, Reuters

²⁵ ‘Trump threatens German carmakers with 35 percent U.S. import tariff’ Jan 16, 2017, Reuters

	Quote	Strategy
Sigmar Gabriel, Jan 16, 2017	rather than trying to penalize German carmakers, the United States should instead respond by building better and more desirable cars	Pointing to market forces
Wolfgang Schäuble, Feb 5, 2017	Also in Washington, it will soon sink in that European monetary policy is not made by the German Government, but by the European Central Bank. And they will also realize that the German Finance Minister is not exactly a fervent fan of this monetary policy.	Arena-shifting (plus ECB criticism)
Angela Merkel, Mar 10, 2017	Trade policy is a responsibility of the European Union.	Arena-shifting
Brigitte Zypries, Mar 12, 2017	I believe the governor of South Carolina has no interest in BMW taking away jobs or reducing investment there.	Appealing to trading partners' benefits
Brigitte Zypries, Apr 19, 2017	Germany's economy is competitive and strong. No one has to apologize for the fact that our high-quality machines and equipment are in demand from abroad.	Pre-eminence of the German model
Wolfgang Schäuble, Apr 20, 2017	There are no sensible measures to reduce Germany's current account surplus, nor do we need active economic policy intervention to achieve this	Stressing limited policy discretion

Table 3.2. *German responses to the Trump tariff threats*

3.3.3 Domestic contestation in the German Bundestag

The other part of the analysis examines how the issue filtered into the parliamentary arena. A database of 101 remarks is compiled, which are hand coded as critical (62) and defensive (39).

Plotting remarks by party, The Left (Die Linke) stands out as the most active critic. Also critical is the Green Party (Bündnis 90/Die Grünen), although with little attention to the topic. Social Democrats (SPD) are divided in the orientation of their remarks – explained by their move from

opposition (2009-13) to government (2013-17). In the first electoral period, SPD MPs' remarks were only critical (10-0), in the second one, mostly defensive (3-5). Most defenses are coming from the center-right Christian Democratic Union (CDU), senior partner in both governments. While they were in parliament (2009-13), liberal Free Democratic Party (FDP) was also a staunch defender of surpluses. Ideological positions of the parties largely explain their positions.

The Left and to a lesser extent, the Greens frame the surplus as a problem for the German domestic economy – with frequent references to suppressed wages, also criticizing that surpluses contribute to deficit countries' indebtedness. The Left also uses frames like stability (accusing the government of violating Germany's Stability Act) and pro-Europeanism. There are multiple MPs expressing solidarity with austerity-stricken periphery countries. This is consistent with the findings of Kinski (2018) who identified a pattern of 'Euro-sceptic Europeanization': Euro-sceptic (left-wing) MPs claiming to represent European citizens as well.

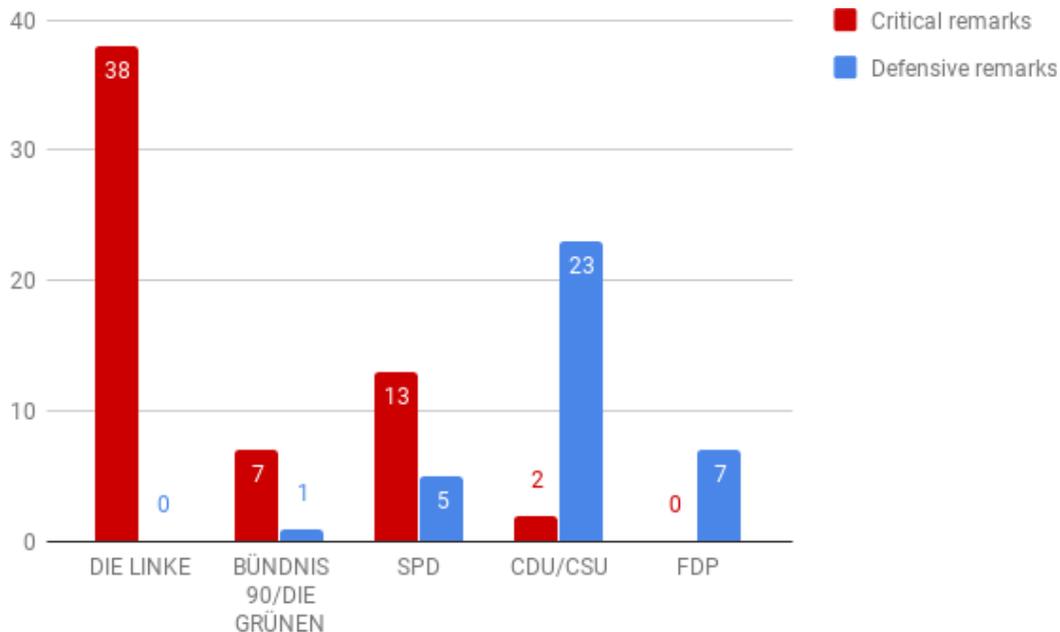


Figure 3.5. Number of critical and defensive statements by party

Representatives of FDP and CDU/CSU, and while in government, also SPD, often argued that the surplus is a market outcome, a result of German firms' hard work and competitiveness. FDP politicians repeatedly stated that 'anyone who demands the reduction of the German export surplus in Germany or abroad wants to reduce the number of jobs,' conflating the surplus with gross exports (reducing a surplus, a *difference*, could as well mean increasing imports).

Arguments focused on market forces are often paired with allegations that those who wish to correct surpluses are against the principle of free trade, do not believe in competition and want to succeed without hard work or by cheating. Football metaphors are numerous, strengthening the 'competitiveness' narrative. Bettina Kudla (CDU) likened rebalancing to 'German national football teams sending off (captains) Birgit Prinz and Philipp Lahm to help opponents.' MPs also emphasize that they do not accept a sort of 'downward balancing' in Europe, as 'weakening the strong will not strengthen the weak.'

MPs also refer to outside criticism, as problematization of the issue often comes from abroad. Out of 101 remarks, over one third, 34 explicitly mention critics (29 in critical, 5 in defensive context). Each contestation episode outlined by the media analysis is mentioned at least once by parliamentarians. Criticism from Brussels is referenced the most: critical MPs cite that Germany violates EU regulations and use European partners' condemnation to underscore their point. Defenders (14) refer to the Commission's *positive* judgment (emphasizing that no excessive imbalances were ever found) and criticize European authorities for bringing up the surplus at all.

3.3.4 Discussion of results

Not only defenders, but most critics also stay in the competitiveness (expenditure switching) narrative, in line with expectations. Both Europeans' wage-based critiques (Stage 1) and Americans' nominal exchange rate manipulation charges (Stage 6) are competitiveness-based. Critics often accuse Germany of beggar-thy-neighbor exchange rate devaluation through an undervalued euro or unfair 'wage dumping' (note that low wages are not framed as a weak demand problem, but as a competitive edge).

However, as shown above, German imbalances are not rooted in relative prices, but the domestic *level* of spending (which could be adjusted by expenditure changing). Exchange rate movements explain the size of the surplus to a limited extent, as it was already excessive at stronger USD/EUR rates. Critics sticking to the expenditure switching framework provide easy rebuttals from German policymakers: exchange rates and trade are European-level prerogatives, and Germany does not advocate for a weak euro – quite the contrary, as the Schäuble versus ECB debate (Stage 5) indicates (see also: Brunnermeier *et al.* 2016, p. 74).

Wage-based competitiveness arguments also strengthen the narrative that low German wages were the price of export growth – a channel that is, as discussed above, questioned by recent empirical findings. German export products' low price elasticity implies wage-hikes in Germany (through the expenditure switching channel) would neither hurt German exporters, nor help partners much in competitive positions. That said, wage policy would be an important lever to stimulate domestic demand (through the expenditure changing channel). Shifting income to people with a higher propensity to consume would increase imports and boost global GDP. So German wage suppression is not a *beggar-thy-neighbor* policy as it is generally understood (competitive devaluation) – it is first and foremost a *beggar-thyself* policy that also 'beggars' trading partners through deflationary effects in a liquidity trap. But policies connected to another country's spending choices – like household consumption or public investment – are rarely advocated by outside critics.

Although most critics and defenders stay in the competitiveness framework, there are notable exceptions – Obama-era US critics, and partly also the messaging from the European Commission (Stage 3) identified weak domestic spending as the key problem. Authorities seemed more open to these critics, taking some (timid) steps to boost aggregate demand, largely at the urging of SPD (Stage 4). Importantly, these incremental steps were not linked to the surplus issue in public communications. The critical position paper was a leak, and SPD politicians endorsed it only half-heartedly, albeit following up on its policy recommendations. This implies the willingness to do something about the imbalance problem without openly linking interventions to it, being wary of its profound

counter-intuitiveness as a message. Coalition dynamics on the one hand, and public opinion on the other restrain the SPD's deviation from the hegemonic narrative. Proactive criticism of the surplus remained a fringe position, which also explains the 'silences' in the datasets – shown, among others, by the little attention to the topic by the left-leaning Green Party, or the fact that media attention is triggered almost exclusively by foreigners.

Patterns follow ideological party lines. Those with a more right-wing agenda stress that the surplus is a consequence of German competitiveness based on painful reforms (that others are free to follow); and since it is driven by market demand for products 'Made in Germany,' the government has limited tools to reduce it – invoking a depoliticization or 'No Alternative' logic (Watson and Hay 2003). They also discredit critics by pointing to the success of the German model compared to crisis-stricken competitors. Plausibly because of former President Trump's unpopularity, defensive reactions to his criticism were particularly enthusiastic, across the political aisle.

The harsher the criticism, the stronger the 'us versus them' or identitarian framing. German successes on export markets are often narrated as a source of national pride (akin to football triumphs) and export strength is part of 'who we are': 'We are an export nation' ('Wir sind Exportnation') and 'we are export world champions' are recurring tropes invoked in response to outside criticism.

3.4 Deficiencies in international and European economic governance

To address how Germany gets away with its overreliance on trading partners, this final section turns to the global and European levels.

The fundamental institutional deficiencies of the global economic order were already foreshadowed by the famous debate between John Maynard Keynes, a representative of Great Britain, and Harry Dexter White, a representative of the United States in Bretton Woods (Eichengreen and Temin 2010). Keynes advocated for a so-called 'clearing union', an institutionalized corrective mechanism to curtail surpluses as well as deficits. The United States (ironically, the main proponent of such a mechanism today) had a vested interest against it, as they were running large and consistent

surpluses vis-à-vis Britain's deficits. White had the upper hand, and a clearing union never came to fruition. Although the idea of surplus country adjustment was revived in the wake of the crisis (Jones 2009), there are limited means to achieve it. As opposed to deficits, where changes in investor sentiment and sudden stops of capital inflows can force a sharp and painful adjustment, surplus countries cannot be forced to adjust by market pressures. There is an inherent asymmetry here – excessive borrowing can be stopped by the lenders, but excessive lending (or saving) cannot.

There is one market manifestation of Keynes' plan for a corrective mechanism: negative interest rates, which work as a de facto fine on excess savings. Interest rates are a market price steered by the supply and demand of financial assets (savings vehicles) – and they are in part so low because of Germany's excess saving desire. While German officials warn against meddling in market outcomes when it comes to surpluses, they see interest rates differently. Rates are understood to be determined by ECB discretion (even though there is an equilibrium market rate the ECB does not set but follows). German authorities, even joined by the Constitutional Court, vehemently criticize the ECB.²⁶ They denounce penalties on excess savings – again, contesting the profound moral counter-intuitiveness of 'too much saving.'

European coordination, although taking steps in the direction, proved unable to constrain Germany. An important episode was the Macroeconomic Imbalance Procedure (MIP) – a surveillance mechanism with a corrective arm, established in 2011. One of the novelties of the MIP was that it monitors surpluses as well as deficits, although with explicitly different weights: thresholds are 3 per cent for deficits, 6 per cent for surpluses (European Commission 2012, p. 8). Beyond the asymmetry (dubbed 'intelligent symmetry') of cut-off values, the analysis of Darvas and Leandro (2015) shows MIP monitoring gradually abandoned recommendations regarding surpluses. In 2012, 2013 and 2014 reports called for the reduction of surpluses in clear and strong wording, by 2015, the aim of symmetric adjustment disappeared altogether. The overall credibility of the MIP's surplus rule is weak. The Excessive Imbalance Procedure was never launched, and Germany pushed through a declaration

²⁶ 'Germany's ECB critics toast courtroom success' Financial Times, May 8, 2020

stating that large and sustained surpluses are not as problematic as deficits, so they do not warrant sanctions (Council of the European Union 2011, p. 9).

Not only is the EU a flawed institutional framework to correct imbalances (Moschella 2014), but European integration can also exacerbate imbalances (Johnston and Regan 2018). Sharing a currency with structurally weaker economies eliminates the equilibrating mechanism of a floating exchange rate. If a country runs a CA surplus, an automatic appreciation pressure ensues on its currency, offsetting the surplus. In the case of the euro, this pressure is drowned out by other factors outside of surplus economies, weakening the euro. It is an important rebuttal to charges against currency manipulation, often cited by German authorities. However, as discussed above, exchange rate movements drive German imbalances to a limited extent.

The analysis above identifies a further channel opened by European integration: arena-shifting (Flinders and Buller 2006). As trade policy is delegated to the EU-level, German officials usually refer critics to Brussels (and Frankfurt). The EU is the world's largest trading bloc, wielding immense leverage over trading partners (bigger than Germany alone), making it difficult to strong-arm them into concessions. Monetary policy is also delegated. German policymakers use this to criticize ECB's monetary stimulus (most notably, Quantitative Easing), claiming that the surplus is driven up by QE – even though it is implausible. While QE does indeed weaken the euro, the relationship between imbalances and the euro exchange rate is weak (see above). Moreover, monetary stimulus has a positive impact on domestic demand through the expenditure changing channel, raising the level of spending.

The German side rarely acknowledges that beyond explicitly trade-linked policies like nominal exchange rates or tariffs, domestic macroeconomic policies have an impact on trade (Pettis 2013), and those policies are the German government's prerogative to change.

3.5 Conclusion

The analysis showed how Germany's excessive current account imbalances – although mirroring domestic distortions like rising inequality, in-job poverty, and underinvestment – are portrayed as a

distributional tension *between* countries not *within* Germany. Instead of discussing the underlying domestic spending problem at the root of excessive imbalances, the debate is thus side-tracked into a profoundly counterintuitive bickering about the German economy being ‘too competitive’ and ‘exporting too much.’ As evidenced above, surpluses are almost exclusively problematized by outside actors – mainly US administrations and the European Commission. This criticism, in turn, provokes the German government and representatives of the exporting industry, who respond with a fierce defense of ‘the German model.’ The national interest is portrayed as monolithic and associated with the interests of export sector producer groups, as opposed to consumers or domestically oriented sectors. The logic of this ‘us versus them’ debate leaves little space for actors representing the domestic losers of surpluses (like trade unions or left-wing parties), and their voice remains muted. This contributes to the blunted domestic pushback against the policies upholding imbalances and may help explain the puzzling absence of German rebalancing.

The story of a proud export nation with record-breaking surpluses akin to football triumphs just cannot be squared with harsh outside criticism from problem children like the United States or Eurozone partners. Considering the passionate defenses they trigger, attacks often seem to reinforce the narrative of a resoundingly successful German economy, the envy of the world. Against this backdrop, domestic critics have a hard time expressing more overarching, programmatic reform proposals or raising awareness to systematic problems, contributing to the stance Bremer and McDaniel (2019) call ‘the ideational foundations of social democratic austerity.’ An important avenue of further research could explore how this discursive bias against left-wing voices like trade unions may interact with and feed into structural causes of the erosion of these actors’ power (Hassel 2014). The only consistently critical voice is a small left-wing party, and criticism is viewed as fringe – bizarrely putting centrist economists of the Obama administration or conservative-affiliated Christine Lagarde on the same platform with the German far left.

As a further original contribution, the analysis shed light on the limits of European coordination to rein in surpluses. The European Union took timid steps towards the monitoring and

curbing of German imbalances – but European integration also has adverse impacts that end up exacerbating them. Integration opens an opportunity for an arena-shifting strategy: as the debate remains fixated on traditional levers of trade policy like exchange rates and tariffs (as opposed to domestic macroeconomic policies), the German side can refuse direct responsibility, stress their limited policy discretion, and emphasize that both monetary and trade policy are delegated to the European-level.

These insights are tied to a wider discussion about the destabilizing effects of domestic distortions in an open, globalized economy, and how disregarding domestic-level issues like social inequality or underinvestment may thwart the correction of global imbalances (Klein and Pettis 2020). Outside critics have limited ways to rectify the weakness of household consumption or public investment in surplus countries – even though in the context of weak demand and near-zero interest rates, they are directly hurt by it. The key is held by domestic residents, whose purchasing power is undermined and who suffer from an erosion of public goods like infrastructure, but who are rarely part of the imbalances discussion. Although trade in the 21st century is organized in value chains spanning multiple continents and is increasingly decoupled from nation states, it is narrated as a noisy rivalry *between* nations, drowning out dissatisfied voices *within* them.

THIRD FALLACY: MISTAKING MULTINATIONALS' ACCOUNTING TRICKS FOR EXPORTS

The case of Ireland

In the wake of the Eurozone crisis of the early 2010s, Ireland was praised as a poster child by Jean-Claude Trichet, then-President of the European Central Bank, who said in 2010, 'Greece has a role model, and that role model is Ireland.' After implementing painful austerity measures, the Irish recovery was sturdier than that of the Southern periphery, and this was understood to be a vindication of internal devaluation, European institutions' designated crisis management strategy. Internal devaluation aimed to suppress the domestic price level through fiscal austerity and wage cuts, and contribute to the increased competitiveness of exports, thereby fueling the recovery (Hardiman and Regan 2013, Frieden and Walter 2017, Walter *et al.* 2020). The first fallacy explored how it was Ireland's 'external enablers,' – to the largest part, strong external demand from the United States – that explained the stronger rebound, not austerity-induced competitiveness gains. The country could capitalize on the unique geographic and sectoral composition of its trade: as opposed to Southern Europe, whose trade links are more concentrated in the Eurozone. Ireland is very differently integrated in the global economy: the strong Transatlantic link, and integration in global value chains presented growth opportunities the other countries did not have.

But this explanation leaves an important question mark, giving rise to the third fallacy. As a growing number of observers warn: much of Ireland's economic and export activity only exists on paper (Seabrooke and Wigan 2014, Lane 2017, Frank and Setser 2018, Damgaard *et al.* 2019, Department of Finance 2019, Setser 2019, Klein and Pettis 2020, Kneafsey and Regan 2020, Brazys and Regan 2021). The activity measured by economic and trade statistics is artificially inflated by large

multinational firms' efforts to move profits to low-tax jurisdictions like Ireland without moving actual production there. The analysis of Ireland's external enablers addresses that problem to an extent, and controls for these discrepancies by using export-sector employment. Employment-based measures grasp job-sustaining economic activity, beyond accounting fiction. The analysis establishes *whether* export-led growth in Ireland was there (also compared to other program countries), but it does not answer *to what extent* Irish exports are inflated by these accounting tricks. This chapter turns to this latter question, and carries out a systematic mapping exercise to unveil the sectors and trade relationships where fictitious activity is most prevalent.

The third fallacy adds an important aspect to the costs and benefits of the Eurozone's pursuit of trade surpluses, the theme of this dissertation. It shows that these export-reliant strategies seem more beneficial on paper, because of the statistical mismeasurement of exports in global value chains. Designating Ireland as an 'export champion' misconstrues multinationals' accounting fiction – that looks like real economic performance, but it isn't.

4.1 Jobs and fiction: identifying the effect of corporate tax avoidance inflating export measures in Ireland

After outperforming crisis-hit peers in the Eurozone crisis, a decade later, in the face of the COVID-19 shock, forecasts tapped the Irish economy to be on track to repeat this recovery, 'boosted by exports from multinational companies specializing in medical equipment, pharmaceuticals and computer services' (European Commission 2021, p. 25). Ireland's emergence as a European hub for multinationals is undoubtedly key to understanding its recent economic trajectory, but assessing the contribution of 'big tech' and 'big pharma' to the Irish economy is far from straightforward (Regan and Brazys 2017). Large corporations' aggressive tax avoidance obscures trade and economic dynamics (Seabrooke and Wigan 2014, Lane 2017, Setser 2019, Klein and Pettis 2020, Kneafsey and Regan 2020, 2020a).

Multinationals go out of their way to book their profits in low-tax jurisdictions like Ireland, often without moving actual production there, and by doing so, they artificially inflate measures of national economic activity. On paper, a product shows up in the Irish GDP figure, even though no Irish labor or capital was employed in its creation – from the Irish economy’s point of view, it is an accounting fiction. In 2015, the sudden surge in Irish GDP was so implausible, it was famously labeled ‘leprechaun economics’ by Paul Krugman. We have ample anecdotal evidence on multinationals’ profit shifting and the distortions it causes in Irish export statistics, but more systematic empirical investigations have been largely absent in political economy research. The Irish economy is a critical case of a broader phenomenon: the growing detachment of globalized, spatially fluid economic activity from the statistical measures used to monitor it, especially since national economies remain the most common unit of analysis (Bryan *et al.* 2017, Avdjiev *et al.* 2018, Linsi and Mügge 2019). Ambiguity and misalignment are not only technical matters. They strain the fiscal apparatus and regulatory capacity of states (Seabrooke and Wigan 2016, Saez and Zucman 2019) and blur the boundaries between the national interest and the often non-congruent interest of a global corporation in the eyes of the electorate (Kneafsey and Regan 2020).

Consequently, the question emerges: in light of inflated trade statistics, was Ireland’s recent growth trajectory at all export-led? Assessments of Ireland’s statistical problems often go as far as to claim that ‘profit shifting by multinational corporations doesn’t distort Ireland’s balance of payments; it constitutes Ireland’s balance of payments’ (Frank and Setser 2018). In contrast, works in Comparative Political Economy (CPE), that classify discrete national economies as varieties of capitalism (Hall and Soskice 2001) or growth models (Baccaro and Pontusson 2016), generally view recent (post euro crisis) Irish growth as export-led (Hall 2017), and many in policymaking circles agree. That is not to say statistical distortions go unacknowledged, but they do not prompt most observers to substantially question exports as a key growth engine in Ireland. This paper aims to deepen our understanding about a national economy’s ‘export orientation’ or ‘export-led growth’ by integrating insights from International Political Economy research, that has long been occupied with the spatial

dispersion of economic activity in the era of global value chains and production networks (Palan 1988, Henderson *et al.* 2002, Gereffi *et al.* 2005, Ponte and Sturgeon 2014).

The empirical strategy rests on contrasting sectoral export growth measured in a traditional value added perspective derived from the headline GDP figure (and expected to include fictitious activity) to the dynamics of export sector employment and wages (expected to include job-sustaining economic activity only). It leverages a simple insight: if increases in exports are driven by fictitious activity, we should not see corresponding growth in export sector jobs and earnings; and conversely: if jobs and earnings grow, it is evidence for economic activity beyond accounting fiction. A systematic sectoral mapping allows us to identify the industries where traditional and employment-based measures show large, sudden disconnects. The analysis does find substantial and unexplained discrepancies and finds them along the hypothesized pattern: in sectors dominated by multinational corporations and US ownership, specifically the chemical manufacturing (pharmaceutical) and information and communication (ICT) industries. In chemical manufacturing, there was a 200 per cent jump in activity from 2014 to 2015 that cannot be accounted for by other measures, as both employment and earnings stagnated; in ICT, value added grew four times the rate of the sectoral wage bill between 2016 and 2019 – a trend that could only be explained by a sudden, radical power-shift between capital and labor, even though labor’s share of income is understood to be relatively stable over time and such an unusual shift is absent in other countries’ ICT sectors. Findings are linked to brief qualitative case studies that fit the temporal patterns of the quantitative analysis.

As a subsequent question, the paper asks: controlling for the above outlined distortions, is it still justified to describe Ireland’s growth performance as export-driven? It finds that it is. Controlling for the effects of inflated exports, the analysis of employment-corrected measures shows that compared to other crisis-hit peers, foreign final demand did fuel the country’s superior jobs recovery from the euro crisis. However, the gross overestimation of pharmaceutical and ICT giants’ contribution to Ireland’s growth have several far-reaching implications for research and policy going forward.

4.1.1 Export-orientation: a common thread in Ireland's recent growth trajectory

Famously labelled 'the Celtic Tiger,' Ireland enjoyed a period of remarkable economic growth in the 1990s (Ó Riain 2014). The boom was rooted in the country's success in attracting large shares of Foreign Direct Investment (FDI) from the late 1980s onwards. This FDI-inflow laid the foundations for an economy geared towards exports, as multinationals – mainly computer manufacturing and pharmaceutical firms from the United States – used the Irish economy as an export platform. What were the drivers of Ireland attracting a larger share of export-platform FDI than competitors? Empirical accounts highlight the favorable corporate tax regime, Ireland's geographical proximity to the US and the effectiveness of the Industrial Development Agency (IDA) (Barry 2004, Brazys and Regan 2017, Hardiman 2017). The IDA is often credited for being ahead of the curve, courting companies like Apple, Microsoft, Intel or Dell into Ireland's now-famous ICT cluster often before their international breakout (Bohle and Regan 2021). This export-orientation was also underpinned by labor market policy: centralized wage setting institutions established in the late 1980s delivered wage restraint (Johnston and Regan 2016).

For a period in the 2000s, Ireland's export-driven growth shifted towards domestic spending, financed by rapid credit expansion, mainly in the construction sector (Dellepiane-Avellaneda *et al.* 2021). A trigger for this was a slowdown in ICT investments prompted by the dotcom crash in the United States (Bohle and Regan 2021). This sharp turnaround demonstrates why Ireland has been a difficult case to pin down by the Varieties of Capitalism framework. While export-orientation and centralized bargaining would be markers of Coordinated Market Economies (CME), this period would firmly put the economy in the Liberal Market Economy (LME) camp characterized by financial dominance, and an overheated, inflation-prone economy. The global financial crisis turned the Irish expansion into a boom-bust cycle. After the asset price bubble burst and the Irish housing market crashed in 2007, Ireland reached the verge of a financial sector collapse. A sharp decline in fiscal revenues and costs associated with bank rescues culminated in a sovereign debt crisis and the Irish government had to request external financial assistance. The program consisted of reforms and

spending cuts (Hardiman and Regan 2013). Savings rates, therefore, were forced up, improving Ireland’s current account balance and pushing the economy towards export-reliant growth automatically. In 2013, Ireland exited the program as first among the crisis countries. Mainly driven by a steady growth of net exports, which helped to offset contractionary effects of fiscal policy, GDP started growing in 2013 and by 2014-15, Ireland has become the fastest growing economy in the EU. In a comparative perspective, Ireland’s more successful recovery is well demonstrated by its faster employment growth: job numbers have been steeply improving from 2012 onwards, making Ireland the only program country to reach its 2007 employment levels in 10 years.

As the second chapter explores, a strong driver of the successful Irish recovery was the unique geographic and sectoral composition of Irish trade (see also: Barry and Bergin 2012, 2017). A whopping 35% of Ireland’s export goods and services are bought by two countries – the United States and the United Kingdom. Faster recovery in these non-euro area trading partners boosted Irish growth. IMF Article IV reports and European Semester documents from the 2010-2015 period highlight this channel as well.

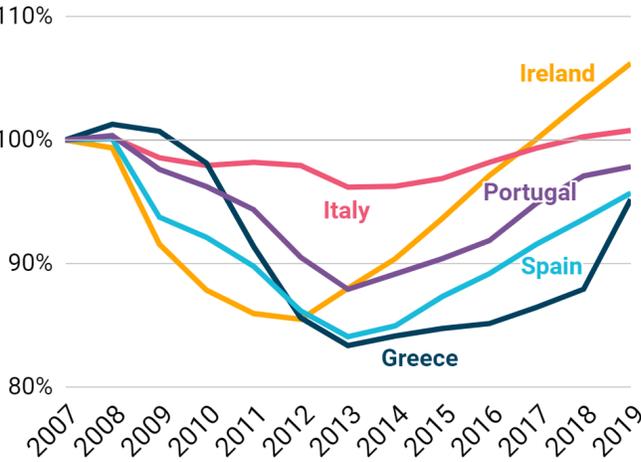


Figure 4.1. Total employment in program countries, 2007=100% (Data: Eurostat)

The fact that most euro area economies are integrated in the European trade area (led by the German economy, the world's biggest saver) limited inward-trading members' room for export-led growth, but gave a unique opportunity to Ireland to exploit its existing Transatlantic ties and grow faster than the rest of the continent. Ireland's highly open economy (trade amounted to 188% of GDP in 2011) had a substantial advantage in this respect.

Ireland was well-positioned to exploit the positive demand shock from the United States, in large part because of the existing exporting infrastructure established in the above discussed period of rapid FDI-inflows. As Regan and Brazys (2017) show, this post-crisis period was a revival of the earlier FDI-focused phase, as a new wave of largely United States-based companies in the high-tech internet services sector flocked to Ireland. Google, Facebook, Twitter, Amazon and their 'big tech' peers set up shop along Dublin's Grand Canal Docks, giving rise to the city's newest tech cluster, the 'Silicon Docks.' Similarly to the previous period, the IDA's active facilitation was an important factor, as were low corporate taxes and cash subsidies. Access to the European common market – the world's biggest consumer market – and the opportunity to tap into Europe's free-moving labor force also were significant incentives.

The surge of global demand for business sector services, mainly intermediate services inputs within these tech giants' value chains, provided an alternative to domestic demand stimulus in Ireland. Exports cushioned some of the social and economic fallout from fiscal austerity and private deleveraging, plausibly also contributing to Ireland's divergent political reception to the Troika reforms (Pappas and O'Malley 2014).

It is visible that the literature interprets Ireland's recent economic trajectory as export-oriented; it is either an explicit or implicit assumption in most works. In short: steady inflows of export- platform FDI laid the foundations of export successes from the 1980s onwards; for a brief period in the 2000s, an overinflated domestic construction sector took over as the main jobs engine, but after the credit-fueled real estate bubble burst and painful adjustment throttled domestic sources of growth, the country could fall back on an existing trading infrastructure (particularly the Transatlantic link) to

revive the export-led model. All of these narratives place exports in the heart of Ireland's growth trajectory, without deeper engagement with measurement problems rooted in foreign multinationals' profit shifting. There is an important debate whether it was successful internal devaluation that drove exports through the cost-competitiveness channel (e.g. European Commission 2015), or whether it was a favorable foreign demand shock as argued above, but both sides remain in the realms of an export-driven explanation, implying that artificially inflated trade statistics do not warrant a fundamental reassessment of exports as a key driver of growth.

Regan and Brazys (2017) as well as Bohle and Regan (2021) use the term 'FDI-led growth' to describe the Irish growth model. Their approach introduces an important conceptual nuance: highlighting the role of foreign direct investment and setting up a parallel between the paths of Ireland and similarly FDI-dominated Baltic and Visegrád countries (Bohle and Greskovits 2012). Johnston and Regan (2018) add that the promotion of an FDI-centered growth strategy has been integrated into the explicit policy agenda of the European Union. Labeling growth FDI-led, however, does not answer whether we assume growth to be export-led or not, since FDI-led and export-led growth are not mutually exclusive categories. To disentangle these factors, the channel linking FDI inflows and GDP growth is worth a closer look.

FDI is a financing category, while net exports is a demand component of growth (in the expenditure side approach to GDP). In period t_{-1} when the inflow arrives, FDI has a neutral effect on GDP growth. It is an investment financed by capital import, so in the national accounts equation ($Y = C + I + G + NX$), investment (I) goes up, net exports (NX) goes down by the same amount, resulting in a net zero effect in the initial time period. 'FDI-led growth' occurs in subsequent period t_0 , when FDI-financed investment gives a boost to the economy's supply capacity. It thereby influences the economy's long-term growth potential, not only current aggregate demand. However, in t_0 , that FDI will be employed to produce goods or services— and that will be either sold to foreigners (resulting in export-led growth) or to domestic residents (resulting in domestic spending-led growth).

In conclusion, deeper critical engagement with inflated export statistics is an important shortcoming of existing works engaged with export-led growth in general and Ireland's path in particular. The next section delves into the specific problem of corporate tax avoidance strategies and statistical distortions.

4.2 Empirical analysis: a novel approach to distinguish jobs and fiction

4.2.1 How multinationals' profit shifting obscures economic statistics

A growing number of commentators (Lane 2017, Frank and Setser 2018, Damgaard *et al.* 2019, Setser 2019, Klein and Pettis 2020) are ringing the alarm bell about the impact of foreign multinationals' profit shifting activities on our ability to understand and observe Ireland's actual export performance. Swings in Irish GDP and exports without underlying economic activity are large enough to distort Eurozone-wide data (Setser 2020a). The case exemplifies the theoretical construct Seabrooke and Wigan (2014, 2017) call global wealth chains – created to 'hide, obscure and relocate wealth to the extent that they break loose from the location of value creation' (Seabrooke and Wigan 2014, p. 257). Multinational corporations use creative ways to book as much profits as possible in jurisdictions with low or zero corporate tax rates. The most common distortions stem from corporations (1) transferring intangible assets like intellectual property (IP), (2) redomiciling (or inverting) group headquarters, and (3) engaging in contract manufacturing activities (Department of Finance 2019, pp. 11–14).

How do these channels work? First, transferring so-called 'intangible' assets (assets lacking physical substance) like intellectual property to subsidiaries in low-tax jurisdictions ensures that on paper, a product is sold (exported) from an Irish-based subsidiary to a buyer, often the next country along the line in the value chain. Although no Irish labor or capital was employed in the product's creation, IP rights are owned by the Irish-based entity. An important mechanism here is transfer pricing (TP). TPs are inter-value chain prices: the company sells intermediate inputs to itself. Importantly, they are not market prices but prices set by the company, who has a vested interest in setting them in a way that they eat away a large chunk of the tax base. As Bryan *et al.* (2017) elaborate,

intangible capital is no longer a residual category in corporate finance, it has become the dominant one for many of the world's largest corporations, magnifying such distortion channels to excessive levels.

Second, as multinationals set up group headquarters in Ireland, profits from their global operations show up in Ireland's national accounts without generating the corresponding economic activity. Retained profits (corporate savings), in turn, increase Ireland's current account surplus. Third, a phrase often popping up in discussions around inflated Irish goods exports is 'contract manufacturing' – when a foreign subcontractor produces an input on behalf of an Irish company, but never assumes legal ownership over the product; the ownership change takes place between Ireland and the purchaser, not the subcontractor and the purchaser. Analyzing the United States and the United Kingdom, Coyle and Nguyen (2020) show how such 'factoryless manufacturing,' a growing phenomenon, is most prevalent in the electronics and pharmaceutical industries. The production of iPhones by Apple Inc. is perhaps the most high-profile case of contract manufacturing (Setser 2017).

Irish authorities have acknowledged the problem and pledged to make efforts to overcome it. Ireland's Central Statistical Office (CSO) constructed an adjusted Gross National Income (GNI*) measure, better grasping Ireland's economic output than GDP, and from 2005 onwards, also a 'modified' current account balance (CA*) to remove 'globalization-related' distortions from the headline figure. The main factors that are stripped from the adjusted figure are flows connected to R&D and intellectual property assets, aircraft leasing activities and profits of redomiciled plcs.

So do we see rebalancing (Ireland's pre-crisis CA deficit turning into a surplus) in the modified balance? Indeed, it shows that Ireland gradually switched from excessively high spending (as growth was driven by a credit-fueled construction bubble) to an excess of saving of over 6% of GNI*. The modified CA* balance decomposed to institutional sectors shows an immense private deleveraging effort by Irish households, the main driver of the CA deficit in the pre-crisis years. The government also steeply increased its savings, switching to a net saving position in 2018.

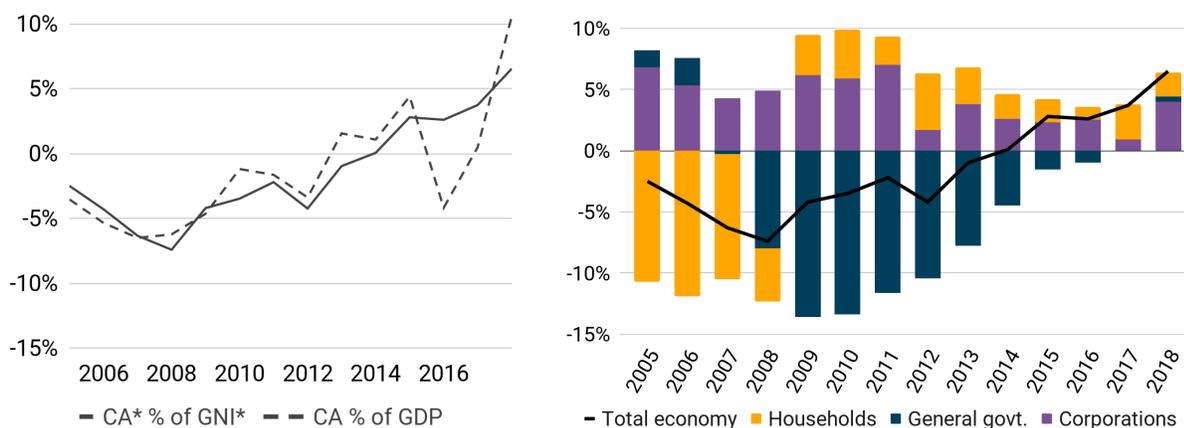


Figure 4.2. Ireland's modified CA* balance as a per cent of GNI* compared to the CA balance as per cent of GDP (L); CA* decomposed to institutional sectors (R) (Data: Department of Finance, OECD)

These modified macro figures lend support to the narrative that beyond statistical distortions, Ireland did improve its CA balance quite steeply. It shows the economy squeezed domestic demand in both the public and private sectors and increasingly relied on external demand to generate strong employment growth. CA rebalancing per se is not evidence for strong export performance – the balance is a difference, and could just as well show a collapse in imports.²⁷ To get a more reliable picture of export performance, it is useful to project export data onto sectoral employment.

4.2.2 Empirical strategy: mapping discrepancies

To identify the discrepancy between job-sustaining economic activity and (likely) accounting fiction, an empirical strategy is to analyze growth differentials of export value added and export-sector jobs. The aim of the analysis is to pinpoint the trade links, broken down by industry, where there are large, unexplained discrepancies between the two measures, suggesting fictitious activity. Based on theoretical insights outlined above, the analysis departs from the starting hypothesis that such discrepancies will

²⁷ Dramatic rebalancing trends in euro periphery countries in the aftermath of the euro crisis are often mistaken for strong exports– even though it was the import component that drove the effect. In Greece, for instance, exports actually decreased in the aftermath of the euro crisis, but imports dropped by an even larger amount, improving the balance (Petroulakis 2017, p. 5).

emerge in sectors dominated by foreign multinationals. Let us start by operationalising the latter concept.

According to CSO's definition, a sector dominated by foreign owned multinational enterprises (MNEs) is defined as a sector 'where MNE turnover on average exceeds 85% of the sector total.' Based on this, the major sectors classified as MNE dominated are 'Chemicals and chemical products' (NACE 20-21, 'Computers, electronic and electrical equipment' (NACE 26-27)²⁸ and 'Information and Communication' (NACE 58-63).²⁹

This classification is supported by data from Eurostat's structural business statistics database, mapping foreign control of enterprises. As Table 4.1 shows, manufacturing visibly stands out as a sector dominated by foreign owned firms in general, and US firms in particular. In 2018, 90.1 per cent of the sector's total value added was produced by foreign owned firms, and a whopping 84.4 per cent by US owned firms. The ICT sector is the other sector above the 85 per cent cutoff, showing similar patterns. It is striking to see that about *half* of total turnover and value added in the Irish business economy is attributed to US owned firms.

²⁸ both subcategories within 'Manufacturing'

²⁹ CSO also adds two small manufacturing subcategories: 'Reproduction of recorded media' (NACE/ISIC 18.2) and 'Medical and dental instruments and supplies' (NACE/ISIC 32.5). Unfortunately, the datasets used for the analysis do not cover such detailed disaggregation levels and small sectors. This also underscores that treating 'Manufacturing' as a whole as an MNE-dominated sector is a good proxy.

	FOREIGN OWNED FIRMS' SHARE OF SECTOR TOTAL (%)		of which: US OWNED FIRMS' SHARE OF SECTOR TOTAL (%)	
	Turnover	Value Added	Turnover	Value Added
TOTAL Business economy	65.60%	66.76%	49.70%	55.44%
B ³⁰ Mining and quarrying	36.67%	42.06%		
C Manufacturing	86.67%	90.99%	76.99%	84.39%
D Electricity, gas, steam and air conditioning supply	21.81%	21.81%		
E Water supply, waste management	11.40%	11.40%		
F Construction	9.72%	9.72%		
G Wholesale and retail trade	45.42%	45.42%	18.96%	18.21%
H Transportation and storage	23.72%	23.72%		
I Accommodation and food service activities	14.63%	12.58%	3.27%	3.51%
J Information and communication	91.78%	88.35%	83.43%	76.52%
L Real estate activities	12.53%	12.53%		4.24%
M Professional, scientific and technical activities	25.64%	25.64%	18.95%	5.94%
N Administrative and support service activities	37.62%	37.62%		29.88%

Table 4.1. *Foreign owned and US owned enterprises in Ireland: their share of each sector's total turnover and value added (Author's calculations based on: Eurostat structural business statistics; year 2018)*

The analysis of discrepancies in export measures is based on three complementary databases. The OECD's Trade in Value Added (TiVA) data is a valuable source, since it deals with an important problem of trade statistics in the world of globally integrated value chains: it tracks value-added based on the source of its *final* demand, integrating the insight that in GVCs, intermediate goods and

³⁰ NACE codes (Nomenclature of Economic Activities, used by Eurostat and Irish CSO databases) are indicated throughout the paper; they are harmonized with ISIC codes (International Standard Industrial Classification of All Economic Activities, used by OECD databases)

services cross borders multiple times. The data is disaggregated by sectors and trading partners. Based on TiVA data, OECD researchers also estimate the effects of GVC trade on labor markets (Horvát *et al.* 2020). Their employment-based measures in the Trade in Employment (TiM) database show the share of jobs and the share of earnings that are sustained by foreign final demand (FFD) as opposed to domestic final demand (DFD). Since the OECD TiVA and TiM databases only cover the period between 2005 and 2015, as a robustness test, they are augmented by an analysis of sectoral value added and employment trends from the Eurostat database. Since the latter dataset does not distinguish between the whole economy and the FFD-led portion, it provides a more conservative estimate and a further robustness check for the discrepancy.

The concrete measure for exports from the value-added perspective is the ‘domestic value-added embodied in foreign final demand’ variable (FFD_DVA; millions of USD) from TiVA, that is deflated by the export deflators from CSO/Eurostat and exchanged to EUR. The employment-based perspective can be grasped by the ‘domestic employment embodied in FFD’ variable (FFD_DEM; thousands of persons) and the ‘compensation of employees embodied in FFD’ (FFD_DCE; millions of USD) from TiM, it is deflated in the same way. Growth rates are plotted with the year 2005 (=1) as a base.

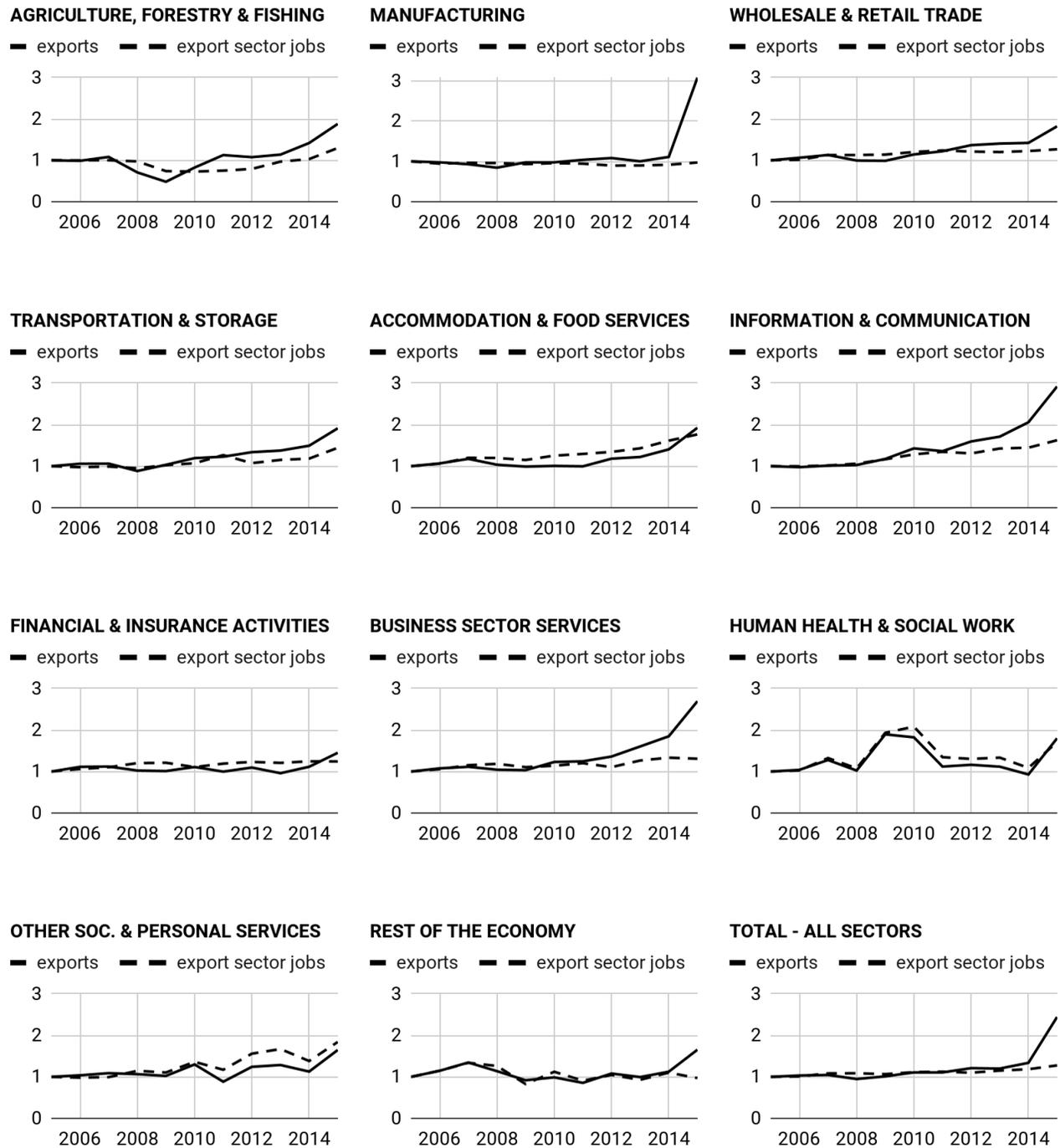


Figure 4.3. Growth of domestic value-added sustained by foreign final demand ('exports') and domestic employment sustained by foreign final demand ('exporting jobs') in the top 10 exporting industries and the rest of the economy, 2005=1 (Author's calculations based on: OECD TiVA and OECD TiM)

If there are differences between the growth dynamics of exports and export sector employment, they can be explained by two factors. First, if the labor intensity in the sector changes over time (from one year to the next, productivity improves and fewer jobs are needed for the same product or service). In this case, slopes of export growth and export-sustained employment growth will diverge (jobs will grow slower than exports). Some degree of change in labor intensity is reasonable to assume, so we do not expect trendlines to go in perfect lockstep. But large discrepancies may emerge if export numbers are inflated: they are not generating actual job-sustaining activity. If we find significant discrepancies and sudden, large swings in some years, we can pinpoint the industries where the fictitious activity is likely to be most prevalent.

So, which sectors drive the discrepancy between value-added versus employment-based measures of Irish exports? It is clear from the analysis of differentials presented in Figure 3. that in most sectors, the differentials are stable over time (trendlines are more or less on top of each other). In some sectors, however, employment-based export measures yield very different patterns than the GDP-based (value added) figures. The significant, 15.9 per cent jump in the year-on-year growth of exports from 2014 to 2015 is especially striking. Employment does not show an even remotely similar path (even though exporting jobs grew by quite a respectable 9 per cent that year). The biggest disconnect is found in the manufacturing sector. Zooming in on the contributions of this highly irregular jump in Irish manufacturing exports from 2014 to 2015, the visible dominance of pharmaceutical manufacturing stands out.

This finding is in line with existing analyses and anecdotal evidence. Irish pharmaceutical exports are dominated by US multinationals (final demand from the US accounted for 33.18 per cent of the sector's exports in 2015) widely known for their aggressive profit shifting activity (Setser 2019, 2020b, 2020a). And as for this particular snapshot in time – there are two concrete cases of corporate tax inversion deals which could plausibly explain part of the discrepancy visible in the data.

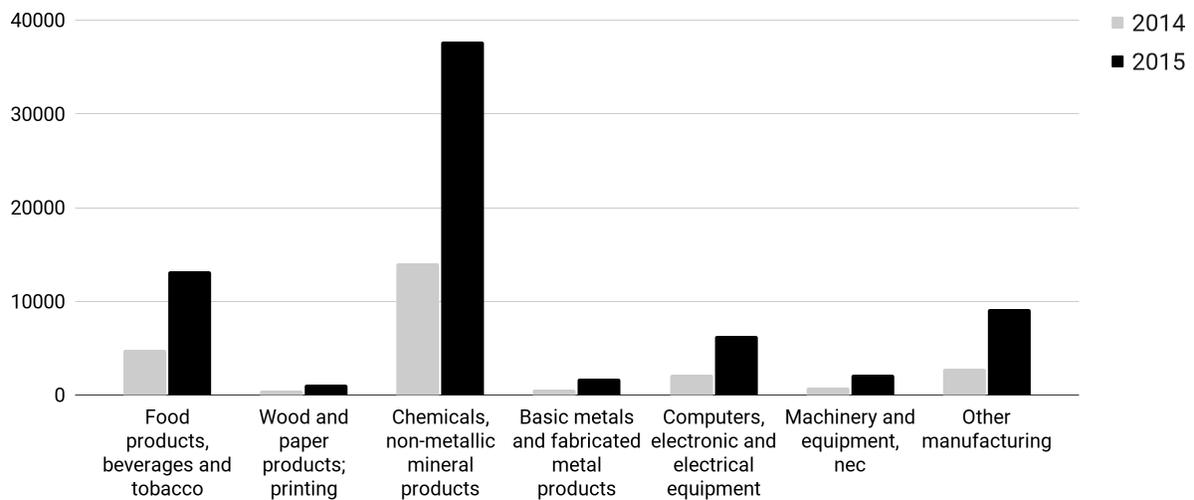


Figure 4.4. *Export value added in manufacturing by subsectors, 2014 and 2015 (million EUR, constant prices) (Author’s calculations based on: OECD TiVA)*

As many observers reported in 2015, two large medical technology firms, Covidien and former competitor Medtronic merged and shifted their headquarters to Ireland, in a 48 billion USD deal (Taylor 2016). A similar merger took place between US pharmaceutical giant Allergan and Actavis, a 66 billion USD deal (Frank and Setser 2018). The smaller deal already qualified as the biggest corporate tax inversion in history (to illustrate the scale – total Irish export value added was 180 billion in 2015). The merger resulted in the post-inversion companies’ manufacturing activity (that was already taking place elsewhere) to show up in Irish GDP – with presumably little or no shift in production.

As expected, there is a visible and growing disconnect in the information and communication sector: export value added shows a 200 per cent increase in ten years, while employment grew by 50 per cent. The case behind this discrepancy in the ICT sector is well documented: much of it is fictitious exports from Apple (Bowers 2017, Coffey 2018). Investigative journalists relying on the ‘Paradise Paper’ leaks detailed how Apple’s 2015 corporate restructuring contributed to inexplicable jumps in Irish national account statistics. In 2015, bowing to international pressure, the Irish state closed a tax loophole called the ‘Double Irish,’ an offshoring scheme for companies to triangulate their tax residencies in a way that allowed them to be a ‘tax resident of nowhere’ (Seabrooke and Wigan 2014, p.

260). Prompted by this regulatory change, Apple Inc. carried out a corporate reorganization and moved ('onshored') intellectual property assets to Ireland effective from January 1, 2015, resulting in Apple exports showing up as Irish exports, without actual production ever changing locations. As Apple's high-yielding IP assets are based in Ireland, the distortion permanently moved to Irish GDP, creating distortions year after year.

An almost identical trend is visible in the sector labeled 'business sector services', denoting various miscellaneous services like research and development, business consultancy, legal work, accounting, leasing services etc. (Professional, scientific and technical activities [NACE M] and Administrative and support service activities [NACE N].)

To check for the robustness of these findings – keeping in mind that a jump in productivity could also explain the difference between growth rates of exports and employment – it is worth examining whether other countries also saw a similar discrepancy in the sectors where the discrepancy is the biggest (chemical manufacturing, information and communication, other business sector services.) Compared to the rest of the Euro area (EA19 less IE), Ireland clearly is an outlier. Whereas in the rest of the Euro area, the two measures – domestic value added sustained by foreign final demand and employment sustained by foreign final demand – grew in an almost identical lockstep, in Ireland, there is a visible discrepancy between the two. In business sector services' and ICT, the trends start to diverge in 2011, while in chemical manufacturing, the year 2015 saw a striking, three-fold jump in exports measured in value added terms, while the employment-based measure grew only slightly. The comparison to the rest of the Euro area underscores the implausibility of a sudden productivity improvement behind the discrepancy – Ireland could hardly engineer such immense productivity gains that were absent in the rest of the currency area.

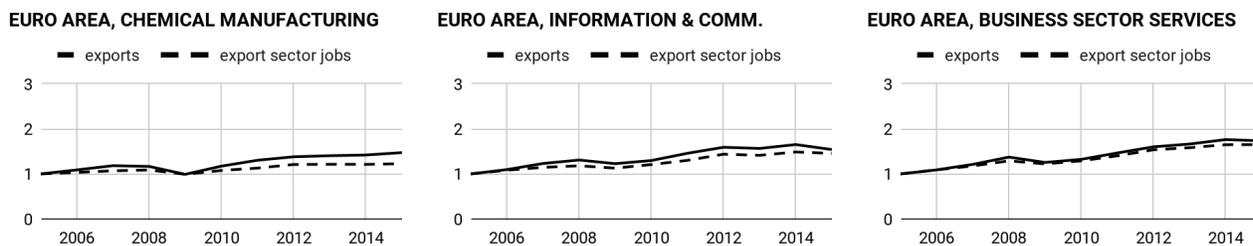


Figure 4.5. Euro area: Growth of domestic value-added sustained by foreign final demand and domestic employment sustained by foreign final demand in various sectors, 2005=1 (Author's calculations based on: OECD TiVA and OECD TiM; 'Euro area' denotes EA19, without Ireland)

A limitation of the OECD's TiVA and TiM databases is that they only cover the period until 2015, making it difficult to draw more timely lessons. However, we can track the discrepancy between value added and employment by widening the scope of the inquiry to the whole economy (beyond the export sector.) This gives a conservative estimate for the discrepancy – that is expected to be higher in the export-oriented part of the economy dominated by foreign multinationals than in the domestically oriented part. If the discrepancy remains, it builds a stronger case for the argument. Using national account data from Eurostat, we thus compare the growth trends of gross value added to growth trends of employment in the same sectors.

The inquiry is limited to the sectors with the largest visible discrepancy: manufacturing, ICT and business services. The exercise yields the same patterns seen above – the three sectors show significant discrepancies not visible in the rest of the economy. In manufacturing, recent data points confirm that the 2015 jump was not a one-off error; the presumably inflated measurement keeps showing up in Irish GDP and export figures. From 2015 onwards, the data does not show strong further divergence. A progressively widening trend is found in the ICT sector, however. There is an accelerating divergence between measures of value added and employment. Gross value added shows a whopping four-fold increase in a ten year period, with a visibly slower corresponding growth rate in jobs.

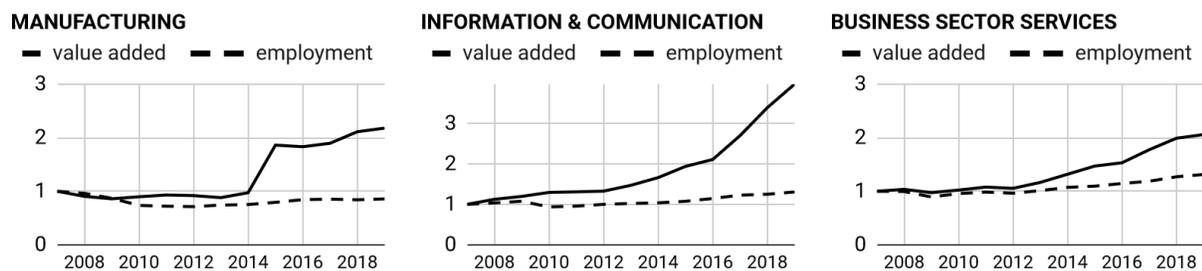


Figure 4.6. Growth of gross value added compared to growth of employment in the whole economy (beyond the export sector), 2007=1 (Author's calculations based on: Eurostat)

Again, it is possible that the disconnect is the result of sudden surges of productivity growth. A way to control for that is to compare growth dynamics of gross value added with that of wages (using the 'compensation of employees' variable from Eurostat's national accounts database.) Similarly to employment headcounts, wages are expected to show job-sustaining economic activity, but the wage-based measure also controls for potential productivity increases, to the extent they show up in higher wages. The ratio of these two variables is the labor income share of value added, that is expected to show less movement than productivity, unless there are structural changes in market power between labor and capital. The wage-based analysis strengthens the claim that the large spike in manufacturing sector activity cannot be accounted for by employment-based measures. In ICT, wage growth does make up for some of the gap, but the 200 per cent increase in value added is significantly larger than warranted by wage dynamics. From 2016 onwards, value added shows a 186.45 per cent growth, a dramatic contrast with a 51.42 per cent growth of the sectoral wage bill, which would be a sturdy increase in its own right. The trend is visibly widening.

In business sector services, however, the discrepancy narrows when corrected for wage growth. This insight suggests that various business sector service activities generally associated with foreign multinationals such as legal and business consultancy, market research or accounting were indeed a prominent growth engine in the recovery phase (from 2012 onwards), showing strong growth in the sectoral wage bill, although less so in the employment headcount (suggesting a composition shift towards higher-paying jobs.)

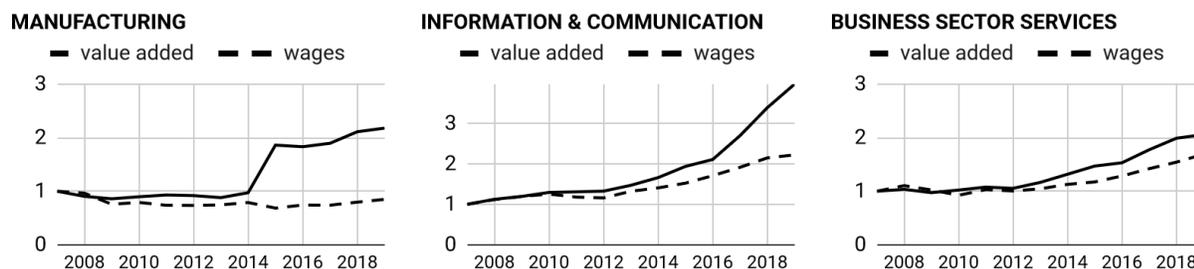


Figure 4.7. Growth of gross value added compared to growth of wages, 2007=1 (Author’s calculations based on: Eurostat)

These sectors are dominated by Irish owned firms (see Table 1 above) and show a much smaller disconnect than ICT or pharmaceuticals. It is quite plausible, however, that they are linked to the presence of these tech and pharma giants, feeding into the bigger ecosystem these firms create. This claim is also supported by OECD regional employment data, which shows that similarly to ICT and pharma, job growth in these sectors are concentrated in the Dublin area. This finding suggests that to understand Ireland’s growth performance, it is advisable to look beyond ‘big pharma’ and ‘big tech’ — to the burgeoning operation of business service firms catering for their needs.

Finally, a growth decomposition exercise is useful to demonstrate how much each sector contributes to the distortions and assign numerical values to them to estimate their scale. The growth of value added and wages in the whole economy is disaggregated to show each sector’s contribution. It is immediately visible that there are substantial discrepancies in the case of manufacturing and ICT — the manufacturing sector’s 30.4 per cent contribution to total value added growth (that was 73 per cent in the recovery phase) stands in stark contrast to its 0.8 per cent contribution to the growth of the total wage bill in the same period (which grew by 8.7 per cent). ICT contributed 19 percent to the overall value added growth, and only 2.3 per cent to the overall growth in earnings. Discrepancies are strongly correlated with the share of foreign owned firms in each sector (the correlation coefficient is 0.89).

NACE code	Sector	CONTRIBUTION TO GROWTH, 2012-2019		DISCREPANCY	FOREIGN OWNERSHIP
		value added	wages		
A	Agriculture, forestry and fishing	0.80%	0.18%	0.62%	
B, D, E	Industry (ex Manufacturing)	0.77%	0.41%	0.36%	22.61%
C	Manufacturing	30.43%	1.85%	28.58%	90.99%
F	Construction	1.15%	0.45%	0.70%	9.72%
G-I	Trade, transport and hospitality	6.05%	6.43%	-0.38%	36.38%
J	Information and communication	19.01%	5.30%	13.71%	88.35%
K	Financial and insurance services	0.86%	0.16%	0.69%	
L	Real estate activities	0.86%	0.09%	0.76%	12.53%
M-N	Business sector services	9.08%	6.37%	2.71%	31.63%
O-Q	Public administration, defence, education, health and social work	3.40%	5.62%	-2.22%	
R-U	Rest of the economy	0.67%	-6.84%	7.51%	
TOTAL	All NACE activities	73.07%	20.03%		

Table 4.2. *Each sector's contribution to value added growth in the whole economy (as a % of total growth in value added, 2012-2019) and to wage growth in the whole economy (as a % of total growth in compensation of employees, 2012-2019); the discrepancy by sector (defined as the difference between contributions to value added growth and wage growth); and foreign owned firms' share of the total value added by sector (% of sector total, only available for the 'business sector' [NACE B-N ex K]) (Author's calculations; data: Eurostat)*

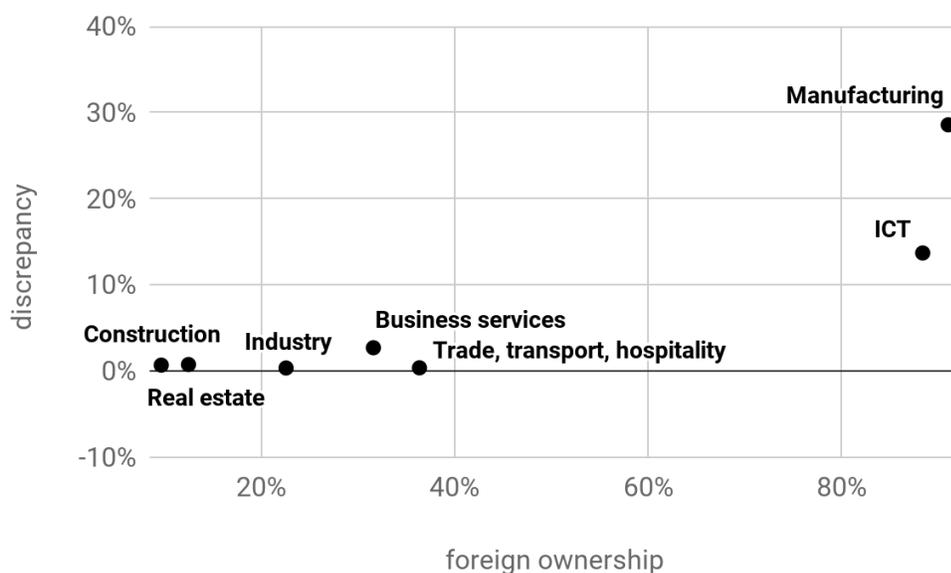


Figure 4.8. *Discrepancy by sector (defined as the difference between contribution to value added growth and contribution to wage growth, %); and foreign owned firms' share of the total value added by sector (% of sector total) (Author's calculations based on: Eurostat)*

4.3 What do results imply for Ireland's export-led growth?

The employment-based approach can also be used to control for distortions when it comes to our assessment of Ireland's recent growth performance and allows us to formulate more precise lessons going forward. The following section contrasts Ireland to three other program countries hit hard by the euro crisis of the early 2010s – Portugal, Spain and Greece – focusing on the employment recovery.

First of all, how do Ireland and other deficit countries fare in terms of the share of employment sustained by foreign demand (FFD) and who are the trading partners contributing most? As expected, Ireland stands out in the share of jobs sustained by foreign demand. 50 per cent of Irish employment relies on FFD – this is a significantly larger share than that of Portugal (30), Spain (24) or Greece (22). It is another measure of the extreme openness of the island's economy. The role of US demand also stands out when compared to the others. Based on TiM estimates, 8.2 percent of all Irish jobs are

supported by final demand from the United States, while this number is below 2 per cent for the other three program countries.

The Irish labor market's reliance on foreign markets has far reaching implications. Assessing the contribution of foreign or domestic demand sources to jobs recoveries in the four countries (plotting change over the period covered by the OECD TiM database, 2007-2015), it is visible that superior employment performance of Ireland was driven by a relatively smaller decline in jobs sustained by domestic demand, and a bigger increase in jobs sustained by foreign demand. As explored above, suppressing domestic spending – the policy prescription to all euro crisis countries – is not so costly for an economy that is less reliant on domestic spending in the first place.

Zooming in on the period of rapid employment growth in Ireland, the sectors with the biggest contributions to the expanding labor market in the post-crisis phase between 2012 and 2018 were hospitality (+58,000 jobs) and business sector services (+54,300). Construction (+47,400), industry (+37,900), trade (+32,500) and education (+30,500) also contributed significantly. Note that three of these sectors (business services, industry and trade) have an over 75 per cent share of jobs that are export driven, while in hospitality, around 40 per cent of jobs are sustained by foreign final demand. Among the biggest contributors, the slowly recovering construction sector and the education sector were the only domestically powered jobs engines. This supports the claim that notwithstanding inflated export figures, foreign markets continue to be a meaningful driver behind Irish growth, also when measured in labor market performance, thereby controlling for fictitious activity.

Curiously missing from the top sectors driving the jobs expansion is ICT, notwithstanding its enormous contribution to Ireland's economic activity on paper. The sector expanded by 15,800 jobs (28 per cent) between 2012 and 2018, that is in stark contrast to the almost 300 per cent value added growth in the same period. ICT is different from pharmaceuticals in this sense: steady job growth in the sector labelled 'Industry' (NACE B-E, including Manufacturing) was propelled by pharmaceutical manufacturing.

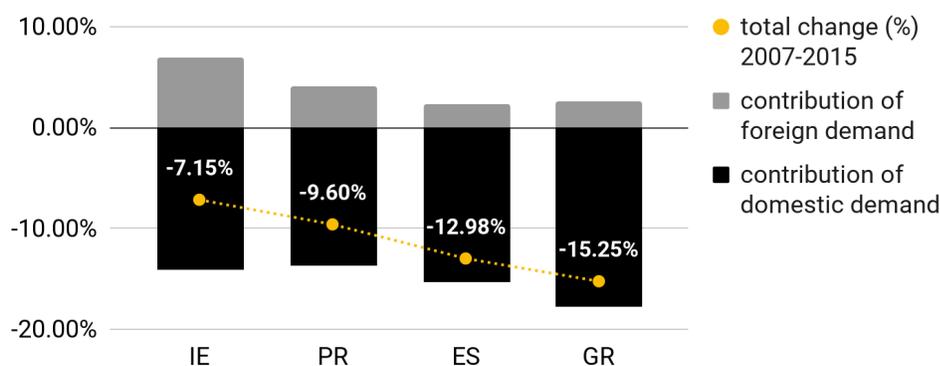


Figure 4.9. Percentage change in employment between 2007 and 2015, decomposed by sources of demand— Ireland compared to Portugal, Spain and Greece (Data: OECD TiM)

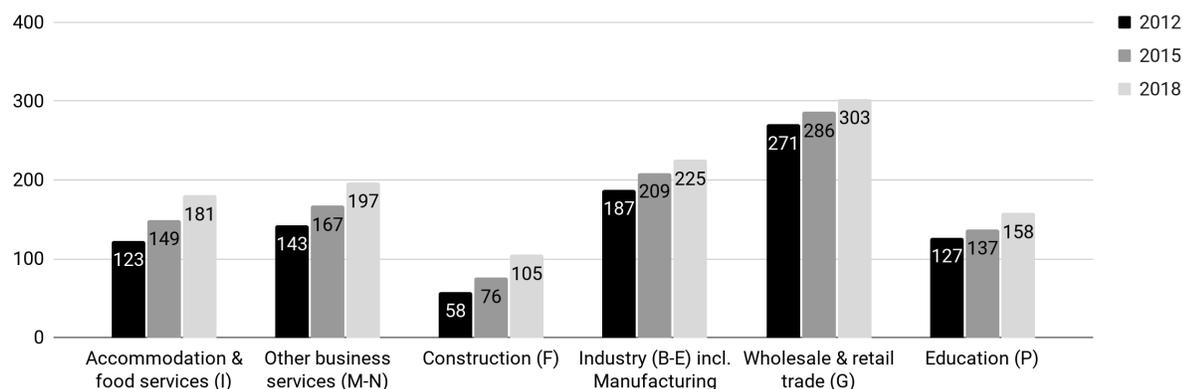


Figure 4.10. Which sectors drove Ireland's jobs recovery? Industries gaining at least 30,000 extra jobs between 2012 and 2018 (thousand persons) (Data: CSO)

Business sector services (M-N)	78.30%	Education (P)	5.60%
Wholesale & retail trade (G)	77.60%	Construction (F)	0.70%
Industry (B-E) incl. Manufacturing	75.00%		
Accommodation & food services (I)	40.80%		

Table 4.3. Share of domestic employment embodied in foreign final demand in sectors with the fastest employment growth between 2012 and 2018 (Data: OECD TiM, % of sector total)

These patterns of labor market recovery after the euro crisis allow us to draw some lessons for Ireland's ability to cope with the recession in the wake of the COVID-19 pandemic. First, lockdowns introduced to slow the spread of the pandemic hit domestically oriented sectors the most, so Ireland's extremely open economy and overreliance on export-driven employment is a boon. Reliance on spending by the United States, in particular, allows Ireland to take advantage of the Biden administration's large fiscal stimulus package 'leaking' abroad (Financial Times 2021). However, statistical distortions do not bode well for Ireland when it comes to designing an own stimulus package or participating in the European Union's stimulus. Since statistical measures for economic output are used to anchor policymaking, serve as the basis for the design of stimulus packages or the allocation key for European Union recovery funds, Irish and European authorities run the risk of gross misalignments in policy responses (Noble Stairs 2020).

As evidenced above, Ireland's export portfolio is dominated by pharmaceuticals and ICT, the two sectors that are plausibly the most shielded in this specific crisis. A public health emergency with lockdowns and social distancing measures hurts large swathes of the economy but gives a boost to both the pharma industry and the digital economy (from remote working platforms to e-commerce). However, as we saw, these are the sectors where fictitious activity is most prevalent, and the ICT sector in particular is not a strong jobs engine – so analysts should be cautious to draw inferences from these firms' strong performance and apply them to the economy at large.

Finally, it is worth taking a quick look at the hospitality sector, that is, along with construction, one of the main employers in the lower skilled segment. A rapid expansion of hospitality jobs in the post crisis period partially offset the dramatic fall in construction jobs. A plausible narrative behind this surge is that multinationals' employment and wage growth had a positive spillover effect on the sector, effectively making hospitality sort of a 'transmission belt,' through which multinationals have an impact on the wider Irish economy (this is supported by geographic concentration of these jobs: employment in hospitality surged in the regions where MNE employment did). This would impact Ireland's recovery from the COVID-19 shock. Lockdowns obviously hit hospitality more than any

other sector. If this transmission belt is absent, the Irish economy and society at large are expected to benefit from strong export performance to a lesser degree, highlighting the importance of targeted relief for these sectors.

4.4 Conclusion

This chapter used a novel analytical approach to show how multinational firms' aggressive profit shifting artificially inflates trade statistics, using Ireland as an illustrative case and arguing that the Dublin-based 'Silicon Docks' cluster's contribution to Ireland's economic performance seems larger on paper than it actually is. It establishes how the 'third fallacy' – mistaking fictitious activity for export performance – inflates the benefits of pursuing an export-oriented strategy based on foreign multinational firms.

The analysis contributes to the literature in three important ways. First, while terms like 'leprechaun economics' or 'phantom FDI' have gained wide traction, and US-based 'big tech' and 'big pharma' are automatically assumed to be the main culprits, more systematic empirical investigations into mismeasurement of multinationals' economic activity have been largely absent in political economy research. This inquiry contrasts traditional measures of export growth to employment and earnings dynamics to identify job-sustaining economic activity, sector by sector. It departs from a simple assumption: if export growth reflects fictitious activity, there should be no corresponding growth in export sector jobs and earnings; and conversely: if jobs and earnings grow, it is evidence for economic activity beyond accounting fiction. Although diverging growth rates are no definitive proof and can be explained by other factors – namely shifts in productivity or the labor share of income – large, sudden discrepancies between traditional and employment-based measures that are absent in other countries' sectoral data are indicative evidence for fictitious activity. Along with theoretical expectations, the analysis finds substantive discrepancies concentrated in the tech and pharmaceutical industries – two sectors dominated by US multinational firms. The findings align with a large swathe of anecdotal case evidence: in pharma, the Covidien/Medtronic and Allergan/Actavis mergers, and in ICT, the high-profile case of Apple (Setser 2017, Frank and Setser 2018).

After identifying significant distortions, the paper examines whether their scale warrants a reassessment of Ireland's classification as an export-driven economy. Although some commentators dismiss Ireland's entire export performance as an illusion, results here do not support this claim. Nor do they imply that these distortions would fundamentally rewrite our assessment of Ireland's growth trajectory, which has long been viewed as export-led. Quite the contrary: the analysis of employment-corrected measures finds that even with substantial distortions in place, Ireland outperforms euro area peers on the global market. But results should caution analysts to extrapolate from the success of 'big tech' and 'big pharma' to national economic performance – a lesson particularly relevant in the light of COVID-19 shock, a crisis leaving these specific industries largely unscathed. A stronger jobs and export engine is the business services sector, denoting activities like legal and business consultancy or accounting. This sector is dominated by Irish-owned firms (foreign ownership is around 30 per cent), but supply services that are generally targeted at foreign multinationals. This finding suggests that paradoxically, a substantial amount of real economic activity in Ireland might feed into multinational firms *faking* economic activity.

Finally, results have implications to refine the notion of an 'export-led national growth model', pioneered by Baccaro and Pontusson (2016) and widely used by Comparative Political Economists. Beyond demand components of GDP and national accounts statistics, the study of national growth models could integrate alternative measures of activity such as sectoral employment sustained by foreign final demand and be attentive to the distortions caused by multinational corporations. Although export-led national growth strategies and public policies underpinning them continue to be relevant, both academics and policymakers should view them against the backdrop of globalized economic activity that is spatially dispersed and increasingly decoupled from the nation state.

CONCLUSION

5.1 The Eurozone's demand management: a case of self-harming mercantilism

Improving the balance of trade at any cost has been an obsession of mercantilist states for centuries – not only through positive interventions like the encouragement of domestic industry, but also through harshly restrictive ones, like suppressing imports. 17th century French finance minister Jean Baptiste Colbert argued that by banning textiles from Spain or Flanders from entering France, French consumers would turn to domestically produced textiles, helping French manufacturers grow and flourish (Cole 1939). Mercantilists struggled to build an economic case against the likes of David Ricardo, who succinctly described how the international division of labor allows all participants to become richer. But some elements of the doctrine, like early French mercantilists' aim to foster infant industries, can be explained by (longer term) economic self-interest (Keynes 1936, Ch. 23/I). Political drivers of mercantilism are even more straightforward: the superior power and influence of capital over labor can explain policies that hurt consumers to help producers; and imperialist motives often drove the conquest of export markets around the globe (Rodrik 2011, 2017, Klein and Pettis 2020).

This thesis laid out a much more destructive form of pursuing trade surpluses: a type of *self-harming mercantilism* that is not only beggar-thy-neighbor, but also beggar-thyself. The analysis explored how the Eurozone's ballooning trade surpluses from 2010 onwards were not driven by traditional mercantilist policy levers like exchange rates or tariffs (directing spending from imports towards domestically produced goods). Instead, fiscal austerity and growing inequality suppressed the *overall* level of spending (on imported and home-produced goods alike). Accusations of competitive devaluation, or currency manipulation, leveled by critics at international summits, do not stand up to closer scrutiny. What the analysis reveals, however, is a policy strategy that is even more damaging.

	How are CA surpluses reached?	Implication for distributive politics
<i>Competitive devaluation</i>	expenditure switching, downward adjustment of prices (REER)	zero-sum game, beggar-thy-neighbor
<i>Demand suppression</i>	expenditure changing, downward adjustment of quantities (D_d)	negative-sum game, beggar thyself and thy neighbor

Table 5.1. *Overview of the strategies to pursue CA surpluses*

A Pyrrhic victory indeed: the Eurozone reached record-large surpluses by impoverishing itself. The distributional politics (in other words: the winners and losers) of pursuing CA surpluses are fundamentally altered by these insights.

The core argument of this dissertation is that the Eurozone’s pursuit of trade surpluses was harmful for the world, and harmful for Europe. If it was a beggar-thy-neighbor strategy, it would have meant Europe reaping benefits at the expense of others in a zero-sum game. Instead, Eurozone members’ policy choices add up to a global negative-sum game.

Since the Eurozone crisis began in 2009/2010, a large body of research and commentary has argued that these record-large surpluses, driven by austere fiscal policy and growing social disparities, had significant global and domestic costs (e.g. Frieden *et al.* 2012, Pettis 2013, International Monetary Fund 2017b, Mody 2018, Tooze 2018, Klein and Pettis 2020, Walter *et al.* 2020). The argument advanced here goes one step further, adding that the depressed fiscal spending did not even benefit domestic producer groups, whose entrenched interests are usually assumed to be behind it (e.g. Iversen and Soskice 2012, Baccaro and Pontusson 2016, Hall 2017). Exporters do not gain from the lack of real appreciation to the extent that it is often thought, but extreme fiscal restraint does hurt them through multiple channels: through the trade uncertainty triggered by excessive imbalances, or the gaps

in public investment (e.g. faulty physical or digital infrastructure) that undermine their long-term competitiveness.

Why, then, did Eurozone members stick to this strategy? The ‘three fallacies’ framework shows how self-harming choices can be rooted in the inherently obscure nature of national costs and benefits attached to global imbalances. Net gains from surpluses are inflated: their benefits are overstated and their costs are understated. The approach lends explanatory power to distributive interests and rational incentives, while remaining attentive to ideational factors. Imbalances are a fitting case to show that distributive interests are not exogenously given; they arise from the interaction of objective interests and narrative construction (Hay and Rosamond 2002, Kneafsey and Regan 2020, Ferrara *et al.* 2021).

The framework puts imbalances in a global perspective, concentrating on external enablers, ‘trade war’ politics and global value chains – and thus hopes to offer fresh angles to existing accounts that are more domestically or Eurozone-focused. Empirically, the argument rests on case studies that seek to demystify the success of two Eurozone ‘export champions’ – Germany and Ireland.

The aim of this concluding chapter is twofold. Firstly, to give a short summary of the ‘three fallacies’ framework and the dissertation’s main findings, and secondly, to discuss what its most important takeaways mean in terms of policymaking and for the future of international economic cooperation.

5.2 Austerity vindicated? Problematizing the success cases of export-led recovery

The Eurozone’s official growth strategy had long been centered around competitiveness and exports, and the currency area’s severe balance of payments crisis gave further impetus to continue this path. The crisis itself was diagnosed as a competitiveness crisis: caused by irresponsibly high levels of public and private spending and consequent inflationary growth in deficit countries. Adjustment programs targeted convergence to core countries’, especially Germany’s superior competitiveness levels through internal devaluation: cutting wage costs and keeping domestic consumption at bay. The policy advice

to members during the recession was to ‘export themselves out of trouble’ without the use of extensive fiscal stimulus.

The Eurozone’s austerity bias perplexed many (mainly Anglo-Saxon) observers. Critics stressed that in the face of recessionary shocks, fiscal policy should support the recovery, and not further aggravate unemployment by tightening – invoking standard macroeconomic arguments for the use of stimulus to fight a recession. However, the case for rejecting this Keynesian wisdom was supported by the success stories of austerity. Beside ‘export world champion’ Germany, whose performance is widely understood to be rooted in cost-competitiveness, achieved by wage restraint and fiscal restraint, Ireland emerged as a poster child among the crisis countries. The Irish economy, although hit hard by the crisis and forced to undertake painful internal devaluation, managed to rebound and grow significantly faster than Southern European crisis countries.

Although much has been written about the Eurozone crisis, fewer works have problematized these ‘success stories’ of export-led recovery. This thesis aimed to do just that, arguing that demand suppressing policy strategies only *appeared to* be the key to the superior performances by these two countries. This apparent success was rooted in three fallacies – false assumptions that cause policymakers and the public to misattribute the reasons for economic success, while also obscuring the costs of austerity. These fallacies are the following: (1) mistaking external enablers for domestic competitiveness, (2) confusing weak imports for strong exports, and (3) mismeasuring the contributions of multinational companies to national exports. Identifying these three fallacies is the main theoretical contribution of this dissertation.

5.2.1 The three fallacies framework: a summary

The first fallacy showed how Eurozone austerity was facilitated by the presence of ‘external enablers.’ While superior employment growth experienced by Germany and Ireland was widely attributed to real effective exchange rate (REER) devaluation, the chapter uses disaggregated current account statistics, and comparative case studies to argue that their success was actually driven by their extensive trade

relations with rapidly growing partners like the United States and China, which left them better positioned to benefit from foreign demand (Y^*) shocks. Members without such external options, like Austria or Finland, were forced to rebalance their economies and stimulate domestic spending to escape unemployment. The observational equivalence of Y^* shocks and REER shocks give rise to this fallacy. External enablers serve as a political incentive structure to keep these (otherwise harmful) policy configurations in place, as they eliminate some of their adverse effects. In a closed economy, suppressing domestic spending would lead to a spike-up in unemployment, but trading partners can fill this demand gap. Cutting this important feedback channel allowed Eurozone policymakers to get away with their mistakes – as they were not penalized for them in the form of unemployment. It was not austerity driving export performance, but the other way around: export performance enabled austerity measures.

The second fallacy explored how weak imports can be mistaken for strong exports. The previous chapter showed how the suppression of domestic spending could appear successful in Germany due to foreign demand shocks, as these shocks helped mask employment costs and blunted the effects of austerity. However, this does not provide a complete explanation for why these policies were kept in place. Beyond the headline employment number, depressed spending through in-work poverty, underinvestment and growing inequality add up to severely detrimental economic and social effects. This residual puzzle may be answered by the second fallacy — German surpluses were understood, and framed by the media, as an export surplus (rooted in supreme competitiveness), while they are an import deficit (rooted in weak domestic spending and excess saving). While the first reading of the imbalances would imply a problem for Germany's trading partners in a zero-sum game, the import deficit reading reveals that costs of imbalances were also severe for domestic residents, making it a negative-sum game. Thus, the two fallacies together reinforce one another, providing a more complete picture of the German case.

The chapter rests on an analysis of media narratives about the surplus issue, based on an original database compiled from stakeholders' public statements. It finds that this false view of German

imbalances are mirrored in, and thus bolstered by the public discourse surrounding them. Imbalances were depicted as a conflict between nations, where surplus countries win. Meanwhile, the ‘import deficit’ problem and the domestic losers it creates were largely ignored in media coverage of the issue. Criticism of these policies came almost exclusively from outside actors, which, in turn, provoked a fierce defense from the German government. As such, the surplus debate became increasingly characterized by an ‘us versus them’ logic. Furthermore, these surpluses were tied to German national identity, as the discourse was frequently peppered with identitarian tropes such as ‘we are an export nation.’ This left little room for the domestic losers of Germany’s current account imbalances to voice their criticisms or to offer viable policy alternatives – doing so in such a context would have appeared as siding with the country’s foreign critics. The noisy international conflict over export surpluses drowned out domestic conflict over import deficits — in other words: *trade wars* drowned out *class wars*.

The third fallacy zeroes in on the growing dominance of global value chains in international trade, and assesses the complications it causes. It answers a ‘residual puzzle’ in the case of Ireland. The first analytical chapter explores how Ireland saw a more successful, export-led recovery compared to other crisis-hit Eurozone members, and how this recovery is misinterpreted as a result of austerity and structural reforms – while it was Ireland’s more favorable trade ties and external enablers that allowed the quicker rebound. But it leaves an important question mark: to what extent did that export performance actually materialize, given the widely known distortions in economic statistics caused by multinationals’ profit shifting? These mismeasurement problems introduce a fundamental uncertainty into the cost-benefit calculus of CA surpluses. In an extreme case, Irish surpluses can also be sustained deficits.

The chapter used a novel empirical approach to distinguish job-sustaining economic activity from accounting fiction. By contrasting traditional measures of export growth with export sector employment and earnings, it identifies sectors with sudden, unexplained discrepancies between the two that are indicative signs for fictitious activity. Supporting the hypothesized pattern, discrepancies

cluster in the ICT and pharmaceutical industries, which are dominated by multinationals from the United States. The investigation also finds that controlling for distortions, external demand and the Transatlantic trade link remain key drivers of Irish growth – serving as a robustness check for the results in the ‘external enablers’ chapter. But the findings should caution analysts to extrapolate from the success of large foreign multinationals to national economic performance.

The following table gives an overview of the three fallacies – showing channels through which observational equivalence inflates the net gains from CA surpluses, overstating benefits and understating costs.

	Observationally equivalent drivers of CA surpluses	How does the fallacy obscure the cost/benefit calculus?
<i>First fallacy</i>	REER competitiveness shocks and Y* shocks	Broken feedback channel: employment costs of REER devaluation are masked by Y*
<i>Second fallacy</i>	Export surpluses and import deficits	Narrative bias: <i>international</i> conflict over export surpluses drowns out <i>domestic</i> conflict over import deficits
<i>Third fallacy</i>	Real export performance and MNEs’ profit-shifting	Statistical mismeasurement: profit-shifting inflates the benefits of MNE-driven export models

Table 5.2. *Overview of the three fallacies*

5.2.2 Avenues for further research

The fact that the analysis finds similar policy strategies in two starkly dissimilar cases – a core country (Germany) and a periphery country (Ireland) – underlines that the pursuit of surpluses has wide traction in the European Union, and continues to be a relevant field of research. Relying on exports to grow (as opposed to ‘profligate’ domestic spending) has become an explicit European-level policy agenda. For members without Germany’s traditional export prowess, achieving this meant opening up the economy and seeking integration into global value chains. Scholars investigating the intersection of

EU integration and national growth models have shown how the EU's policy framework has been shaped in a way that is conducive to these particular growth strategies, and strongly disincentivizes domestic spending driven strategies (Johnston and Regan 2016, 2018, Bohle 2018).

An important addition to the German-Irish comparison, and an avenue of further research could be the inclusion of Europe's Eastern periphery, where export-led and foreign direct investment fueled growth strategies are also prevalent and strongly supported by the EU (Bohle and Greskovits 2012, Bruszt and Vukov 2017, 2018, Vukov 2021). Slovakia, a Eurozone member, could be a fitting case to explore: a Central and Eastern European (CEE) small and open economy that managed to keep fiscal spending moderate while relying on foreign demand, thereby serving as a model for Southern European crisis countries (Pérez and Matsaganis 2019). There are strong parallels with the Irish case: the growth strategy also involved slashing corporate taxes and delivering wage restraint to attract foreign direct investment. While Ireland attracted US multinationals, the Slovak economy latched onto German (automotive) manufacturing value chains: around 15% of the total value added in the Slovak business economy is attributed to German-owned firms,³¹ the highest share in the Eurozone. This connection to Germany also exposes the case to the external enablers fallacy: for CEE economies, foreign final demand from the United States and China is also expected to show an enabling role, helping the economy rely less on domestic demand sources. CEE cases also trace out yet another (fourth) potential fallacy, putting in doubt whether their export-led success can be a model for Southern European economies to emulate: the significant role of European Union development funds for new member states (e.g. Bohle and Greskovits 2019, Medve-Bálint and Šćepanović 2020). Investment through the so-called structural and cohesion policy framework was a growth engine unavailable for the Southern periphery – while enabling the CEE region's much lauded efforts for fiscal restraint and wage restraint (i.e. cost-competitiveness), and making it easier to grow while relying less on domestic demand.

³¹ Source of data: Eurostat ('Foreign control of enterprises by economic activity and a selection of controlling countries')

Deeper engagement with the ‘external enablers’ of Eurozone policies – namely investigating China and the United States as standalone cases – offers further important avenues to explore. China is presented in an unusual light here: a global ‘spender of last resort’ (similar to the United States), as opposed to a source of large and sustained CA surpluses and a drain on global demand (similar to Germany). Indeed, this was an uncharacteristic path, specific to the particular time period. Throughout the 2000s, China was widely criticized as the ‘new mercantilist’ spoiler of world trade, showered with accusations of currency manipulation and the unfair handling of intellectual property. Chinese surpluses were momentous: year after year, they persistently sold vastly more to the world than what was consumed or invested at home. On the flipside of these surpluses were deficits, mostly driven by spending and borrowing in the United States. The ‘Chimerica’ nexus turned out to be unsustainable, and was broadly understood to be a contributing factor to the global financial crisis of 2008-09. What remains somewhat underdiscussed, is that after the crash, China engineered a dramatic rebalancing, slashing its surplus from around 10% of its GDP to a near balance. Chapter 2 explores how China’s investment-heavy fiscal stimulus presented a unique opportunity for Germany especially, whose strong trade ties to the region helped to engineer an export boom, compensating for the demand shortfall at home. Although China’s post-crisis rebalancing is a dramatic shift in global demand patterns that deserve more attention, the works of Michael Pettis (2013) also suggest that the structural factors suppressing domestic spending in China remain unresolved. Most importantly, China’s inadequate system of social insurance is a forceful motive for precautionary saving. The powerful narrative presented by Pettis and his co-author Matthew C. Klein (2020) builds a parallel between China and Germany, explaining how social disparities (fueling ‘class wars’) are the roots of both countries’ desperate reliance on foreign demand and the ability to export (fueling ‘trade wars’).

Another important aspect to explore more in depth is the role of the United States, as the only major world region willing to spend. The case raises an obvious question: if it is social inequality that drives down spending propensities, why is it the US (a highly unequal society) who runs sustained deficits? The answer lies on the financial side of imbalances: the ability and willingness of American residents to spend on *credit*, as opposed to German residents, for instance. As briefly mentioned above,

the depth and sophistication of US financial markets, and the ensuing ability to issue highly demanded ‘safe assets’ (savings vehicles for surplus countries) means that the US was ‘*absorbing the weak domestic aggregate demand of the rest of the world*’ (Caballero *et al.* 2017, p. 35). Income inequality in the United States is coupled with liberalized financial markets giving rise to a phenomenon Atif Mian, Ludwig Straub, and Amir Sufi (*forthcoming*) call ‘indebted demand.’ A deeper engagement with the financial markets focused political economy literature on the Eurozone, and Germany in particular (e.g. Braun and Deeg 2020, Jones 2021), is a promising avenue to explore this question.

5.3 Implications for policymaking and the future of global economic cooperation

5.3.1 Domestic and European policymaking

The policy conclusion arising from the analysis is quite blunt: pursuing current account surpluses is a misguided path. Surpluses are a bad target to guide policy – if achieved through underconsumption, underinvestment and growing social disparities, they are clearly detrimental to the welfare of citizens. The dissertation showed how fallacies masked the true costs of suppressing domestic spending, and diverted policymakers’ attention away from the dire need to remedy demand shortfalls in the Eurozone.

The analysis highlights the deeply contradictory nature of a continent-wide internal devaluation strategy. A core aim of Europe’s Economic and Monetary Union was to enhance economic integration within the continent. Most members did just that, and cultivated strong trading relationships with other Eurozone economies. But as domestic demand (including spending on imports) took a nosedive, these euro-centric trade ties became a liability. Expecting exports to thrive, while stifling spending in the main partner economies was ill-considered, to say the least. As the only logical source of demand, members were suddenly forced to look for markets outside the Eurozone. The main (and arguably: the only) strategy they had at their disposal was internal devaluation. Cheaper exports were supposed to bring about a surge in global markets – in a magnitude to compensate for the jobs lost because of the squeeze in domestic demand plus the squeeze in *external* demand caused by the

simultaneous internal devaluations of (far more important) Eurozone trading partners. Even assuming that exports are strongly price elastic, and cuts in prices translate to increases in export sales to global partners (an assumption that is not a given), this strategy was never going to work. The apparent success of Germany or Ireland is no vindication either – demand shortfalls were just as harmful there, but stronger trade ties outside of the ailing Eurozone masked some of their most adverse effects.

There is nothing inevitable about Eurozone members' unwillingness to spend more and borrow more, not even in Germany, the archetype of fiscal conservatism. An important insight arising from this analysis is that boosting domestic spending – for instance through rethinking overly strict fiscal rules or significantly increasing public investment – would not hurt entrenched export interests to the extent that it is usually assumed. Germany's high-tech, high value added export products are not price elastic (rely far more on non-price competitiveness factors), and are not as vulnerable to an exchange rate appreciation as often thought. But even if firms would lose export markets, they could make up for them by higher domestic demand. It is quite plausible that Germany's powerful exporter firms, who are supplying high-tech machinery for Chinese grand investment projects, were just as happy (even happier) to sell the same products for construction projects in Germany or Southern Europe, satisfying unmet investment needs on the continent. The overreliance on global export markets makes the German economy unnecessarily vulnerable amidst a highly uncertain global political landscape. Reducing Germany's desperate dependence on Chinese demand may also give more degrees of freedom to pursue other goals – above all, European geopolitical or security interests.

The sustainability of multinationals-based export strategies is a more difficult question. It is possible that the COVID-19 shock will give an impetus for a paradigm-shift in global corporate taxation. Surging profits and stock prices of ICT and pharmaceutical giants (the backbone of Ireland's export strategy) have been showered with criticism and many are calling for more solidarity – while momentum is building for a global minimum corporate tax rate of 15%.³² While closing some

³² As agreed by the G7 group of the largest industrialized economies in a June 2021 communique. 'Finance Leaders Reach Global Tax Deal Aimed at Ending Profit Shifting', New York Times, Jun 11, 2021

corporate tax loopholes will not necessarily result in multinationals downsizing or seizing their European operations, the extreme dependence on these highly mobile firms as a primary source of job creation, investment and growth should be critically assessed, and a more balanced strategy should be considered.

For rebalancing to happen, Eurozone countries with ample fiscal space to spend (like Germany) would need to ease their self-inflicted, misguided limits on budgetary spending. Other members, whose fiscal space is limited by legacy debt problems, should be given more solidarity to grow out of their debt burden. As one's spending is another one's income, this would also help others.

There are signs for cautious optimism. In the aftermath of the COVID-19 shock, the European Union put together a joint stimulus package named 'Next Generation EU', also allowing for some redistribution among members. As a historic first, the package will be financed by jointly issued debt or 'Eurobonds.' The decision of European fiscal hawks to go for a more Keynesian route surprised some commentators – but it is consistent with the expectations outlined in the 'external enablers' chapter. As opposed to the Eurozone crisis (a regional shock), COVID-19 triggered a more widespread collapse in global export markets – so this time, banking on US and Chinese spending was less of an option. Although a promising first step, this first round of European stimulus is also criticised by many as woefully inadequate (Sandbu 2021, Tooze 2021).

5.3.2 Implications for the future of global economic cooperation

If domestic and European efforts to rebalance remain feeble to none, pressures from trading partners will almost certainly escalate. There is an inherent political trade-off here: on the one hand, fallacies reduce domestic pressures on policymakers to stimulate demand (they are not punished for their folly in the form of employment collapse, for instance), but on the other hand, imbalances invite international pressures, growing in lockstep with ballooning surpluses.

From the point of view of trading partners, a low-rate, weak demand environment (or liquidity trap) means that CA surpluses have harsh beggar-thy-neighbor effects, whichever way they are reached.

Surpluses in one country hurt growth and employment of trading partners, by essentially capturing some of the scarce global demand. Simply put, if Europeans refuse to spend, the rest of the world cannot produce as much as they would like to, and have fewer jobs as a result. So along with their cars, Europeans also export unemployment. From the early 2010s onwards, for almost a decade, the Eurozone was a drag on global recovery, exacerbating economic discontent and political backlash abroad. These adverse effects duly triggered contestation and criticism from partners, most notably but not exclusively, in the form of growing tensions in US–EU trade relations (Bastasin 2015, Jacoby 2017). This points to the deeply contradictory nature of these models: on the long run, they might jeopardize the globally open trade regime they themselves depend on.

While Europe’s obsession with surpluses deserves ample criticism, the fallacies also shed light on the mistaken approach of most critics. Misguided accusations of currency manipulation or competitive devaluation sidetracks the discussion into a pointless bickering about Europe (mainly Germany) being ‘too competitive’ or ‘exporting too much’ – while the problem is weak spending at home. These accusations also let the German side off the hook: neither exchange rates, nor trade is their prerogative to change, these policy fields are delegated to the EU level. Strong-arming Europeans into concessions is a lot more difficult when the entire European Union, a 450-million strong market, sits at the other side of the negotiating table.

What foreign critics would need to call out instead is firstly, Europe’s propensity to free-ride on trading partners’ stimulus efforts, while stubbornly pursuing extreme fiscal stringency. Stimulus measures ‘leak’ abroad in the form of imports – so it is possible to bank on trading partners to do it. As so often in the international arena, cooperation yields the most efficient outcome, but if countries concentrate on the relative gains they can grab by pushing the adjustment burden onto the other (or prematurely withdrawing their efforts), they can easily find themselves in the noncooperative corner of a prisoners’ dilemma. Since coordination is key, policymakers should pursue efforts like the G20 London Summit brokered by Gordon Brown that successfully forced commitments to implement stimulus packages in a multilateral way.

To sustainably move beyond the inevitable political conflict triggered by imbalances, governments would need to address the fundamental institutional deficiencies of the global economic order that were already foreshadowed by the famous debate between John Maynard Keynes and Harry Dexter White in Bretton Woods, explored in depth by economic historians (e.g. Eichengreen and Temin 2010, p. 380). Keynes warned about the deflationary effects of deficit countries asymmetrically bearing the burden to rebalance. He proposed an International Clearing Bank, and automatic sanctions to correct large and sustained surpluses too. His plan did not come to fruition – it was, ironically, the United States (the main surplus economy at the time) who vetoed it.

The final, most important takeaway echoes the conclusion of Pettis and Klein (2020, p. 221): the most devastating force threatening the stability of economic and trade relations is the rise of global inequality.

Trade war is often presented as a conflict between countries. It is not: it is a conflict mainly between bankers and owners of financial assets on one side and ordinary households on the other—between the very rich and everyone else. Rising inequality has produced gluts of manufactured goods, job loss, and rising indebtedness. It is an economic and financial perversion of what global integration was supposed to achieve.

A globally coordinated effort to tackle growing inequality is therefore part and parcel of the imbalances discussion. The most obvious first step is more progressive (corporate) taxation, including a crackdown on tax havens (Saez and Zucman 2019).

The insights arising from this analysis provide ample motivation to revisit the Keynes-White debate. The imbalances debate needs to move beyond the traditional focus on exchange rates or tariffs to the global interdependence and spillover effects of demand management policies. Spending and saving choices in countries are all interconnected, so policy-driven distortions in these choices are, for all practical purposes, interventions in trade (Pettis 2013, p. 47). Distortions in domestic macroeconomic policies put economies on a collision course with their trading partners – and assessed from this perspective, Europe’s export champions emerge as the unlikely disruptors of the international economic order.

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