The Financial Consequences of Export-led Growth in Germany and Italy

Erik Jones*

Abstract: This paper explains the extent to which the export-led growth strategies deployed in Germany and Italy turn out to be self-defeating. The problem lies in the impact of those strategies on the banking systems of the two countries. The German banks become more international; the Italian banks become more locally oriented. In turn, these changes create tensions that cannot be reconciled easily within the institutional framework that made the export-led growth model successful in the first place. The paper also seeks to explain why tensions in export-led growth models today do not always resemble those it experienced in the past – and it examines what are the implications both for how the two countries responded to the economic and financial crisis and how they are responding to the economic consequences of the novel coronavirus pandemic.

Keywords: varieties of capitalism, macroeconomic imbalances, patient capital, export-led growth, banking union

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This paper explores how the efforts made by policymakers in Germany and elsewhere to foster export-led growth create tensions that cannot be reconciled easily within the institutional framework that made the export-led growth model successful in the first place. The paper also explains why tensions in the German model today do not resemble those it experienced in the past, and why the problems Germany is likely to face are different from those confronted by other countries that are nevertheless very similar in important institutional and performative respects. Italy provides the comparative case.

The argument I make is that the export-led growth model in Germany has changed significantly over time and in ways that undermine the institutional complementarities that have contributed to German economic success. Specifically, the operation of the export-led growth model has encouraged a divergence in the interests of German banks and German industry, with the result that German banks are increasingly exposed to financial risk abroad. The Italian export-led growth model has also changed over time, but the changes are not the same as those seen in the German case. Instead, Italian banks have become increasingly exposed to the risks associated with economic performance within Italy, often at the regional or local level. This divergence in German and Italian experiences was important during the global economic and financial crisis that broke out in 2007 and 2008, with consequences in Italy that have lasted for more than a decade. The different consequences of pursuing an export led growth model in Germany and Italy have influenced how the two countries have responded to the onset of the novel coronavirus pandemic as well.

The paper has six sections. The first uses recent contributions by Braun and Deeg (2019) and Blyth and Matthijs (2017) to locate this argument within the debate about institutional complementarities and economic performance. The second section sets out a theoretical framework that highlights the role of ‘patient capital’ in Germany’s ‘variety of capitalism’ and export-led growth model. The primary focus of this second section is on Germany, but with allusions to the Italian case where ‘patient capital’ is present but the ‘variety of capitalism’ is different. The third explores why the role of finance in Germany today looks different from the role banks played in West Germany of the past. The fourth draws out the comparison between Germany and Italy more fully. The fifth sketches implications of the changes that can be seen in both countries and explains why the difference between them is important for Europe’s economic and monetary union. The sixth section concludes.

A Germany-inspired Research Agenda

This first section sets out an intellectual agenda within which my argument contributes a cautionary note about the longer-term consequences of pursuing an export-led growth model using the German example as a case in point and relying on Italy as a secondary illustration. The German economy is often held up as a paradigm for macroeconomic performance and its success at promoting manufacturing exports attracts considerable attention. Nevertheless, it is a mistake to imagine that German ‘success’ has been consistent over time. On the contrary, Germany has experienced periods of relatively strong performance, and periods that have been weaker. Moreover, economists within Germany have
launched strong critiques of the country’s structural evolution. Horst Siebert’s (2005) last book is a good illustration. Siebert (2005: 38-68) argued that the shock of unification is not enough to explain the weakness of German macroeconomic performance during the 1990s and early 2000s. Instead, it is necessary to examine the weakness of investment, the lack of innovation, the low quality of human capital formation, and the proclivity of Germans to invest abroad:

Taking together the competition position on the product markets and German direct investment abroad, one can conclude that German industrial firms are efficient and competitive in selling products in the market, but from the perspective of employment in the economy they are not efficient at creating jobs (Seibert 2005: 64).

Seibert placed much of the blame for German economic performance on the poor functioning of the country’s social contract. He argued in favour of a liberalization of labour market regulations and welfare state institutions. The Hartz reforms in the mid-2000s largely addressed that diagnosis. German economic performance improved thereafter.

Not all analysts are convinced, however, that Germany is structurally engineered for macroeconomic success. In a recent essay in *German Politics*, Braun and Deeg (2019) show how German reliance on export-led growth may be self-defeating insofar as it encourages non-financial firms to liberate themselves from the longer-term influence of German banks. Their argument is that German export-led growth derives from the longer-term investments in manufacturing that result from close bank-firm relationships and ‘patient capital’. This argument is familiar to anyone who has studied the ‘coordinated market economy’ variety of capitalism (Hall and Soskice 2001: 22-24). What Braun and Deeg (2019) note, however, is that the longer-term coincidence of fast productivity growth and continuous wage moderation encourages firms to finance investment out of retained earnings while banks look to book assets elsewhere. My goal is to expand on that insight by highlighting both the longer-term consequences for German financial stability and the lack of close parallels with the Italian case.

The situation Braun and Deeg (2019) describe shares attributes with the diagnosis provided by Siebert (2005). Ultimately, firms become net savers (as they accumulate retained earnings), banks focus their attention abroad (because they have more difficulty booking assets domestically), and the German economy finds itself relatively short of investment in physical capital. Their analysis ‘casts … doubt on the notion of stable institutional equilibria’ at the heart of the varieties of capitalism literature (Braun and Deeg 2019: 17). Germans may be proud of the success of their model, but it is a wasting asset at least insofar as Germany’s banks may be unwilling to continue to defend it.

The argument Braun and Deeg (2019) make complements other critiques of Germany’s export-led growth model – many of which also focus on the central role of finance. For Thomas Haipeter (2018), for example, the limiting factor is found in the relationship between finance and labour. As German firms put downward pressure on wage costs, German workers find themselves in ever more precarious positions both contractually and economically. In essence, firms offload the risks associated with their performance onto the labour force, subjecting workers to ever higher levels of stress and insecurity. That argument contributes to the wider claim I am trying to make. It also resonates with the claims made by Timo Weishaupt in this collection. Nevertheless, the interaction between finance and labour is not central to my analysis and so forms only part of the wider intellectual context.
Haipeter’s (2018) argument has different institutional dimensions, of which finance is only one. Nevertheless, the role of finance is a point of congruence between Haipeter’s argument and that made by Braun and Deeg (2019). In Haipeter’s account, where banks used to buffer both firms and their workers, and so make it easier for managers and works councils to focus on the longer-term perspective, employees now find themselves more exposed to volatility coming from the markets – giving them less room to manoeuvre in negotiations over working conditions and pay and creating ever large incentives to deviate from collectively agreed standards. This allows us to draw parallels with the human capital dimension of Seibert’s (2005) diagnosis. Here again, the argument ‘calls into question the idea of coherency or even complementarity’ among Germany economic institutions: ‘there is no neat coexistence or adaptation between them, but constant struggle and conflict going on with open end in terms of institutional stability’ (Haipeter 2018: 18-19).

The challenge is to bring the arguments made by Braun and Deeg (2019) and Haipeter (2018) into an overarching frame. They have a point of congruence in the role of finance but need more to flesh out a shared causal mechanism. This is where I focus my attention, building on the work of the late Wade Jacoby (2014, 2015, 2020). For Jacoby (2020), the essential link is between financial flows and macroeconomic policy paradigms. The policy paradigms provide the intellectual framework within which Germany policymakers can celebrate the virtues of Germany’s export-led growth model and so look for ways to ‘shift national income from consumers to firms (as profits or capital subsidies) or government (as budget surpluses)’ (Jacoby 2020: 10).

The result of the policies German policymakers adopt is not (or not primarily) to make firms more competitive in a microeconomic sense, but rather to ensure that savings dominate over investment in macroeconomic terms. Nevertheless, any increase in exports is celebrated as a success of the policy mix and a virtue of the German model that supported it. Ultimately, Jacoby (2020) argued, this self-delusion will undermine the functioning of the German economy both domestically and, more important perhaps, in terms of its relationship with the outside world. Whether through imitation elsewhere in Europe or retaliation coming from across the Atlantic, Germany’s export-led growth model will inevitably find its limits.

This argument is not limited to Germany; the phenomenon is more general both in empirical and in theoretical terms. This is the point Blyth and Matthijs (2017) make in their exploration of the macroeconomic targets that are ‘missing’ from much of the analysis of economic performance by students of international political economy. Specifically, Blyth and Matthijs (2017: 208-209) claim that once policymakers focus macroeconomic policymaking on a specific target variable – Blyth and Matthijs look at the alternation between unemployment and inflation – that choice ‘necessarily shapes states’ institutional choices.’ Hence, Blyth and Matthijs (2017: 210) define macroeconomic regimes as ‘economic policy targets embedded within dedicated institutional complexes that are both generative of, and contingent upon, the production of those targets.’

Blyth and Matthijs (2017) insist that it is not accidental that efforts to achieve a specific macroeconomic target draw strength from specific institutional arrangements. Following the Lucas critique, they also argue that it is not surprising that these regimes would give rise to changes in behaviour that would ultimately undermine the pursuit of the target. By implication, the problems identified by Braun and Deeg (2019), Haipeter (2018), and Jacoby (2020) can be folded into a wider research agenda inspired by Germany, but with implications for other countries that try to focus on the same macroeconomic target
and hence adopt a similar macroeconomic regime. The question is whether the influence of policy efforts to promote export-led growth will have similar consequences from one country to the next.

Italy also has long-standing emphasis on export-led growth, that starts in the early post-war period and extends up to the present. The Italian economy may not have been as successful as the German economy in generating consistently large current account surpluses, but it has developed and maintained a substantial export manufacturing base. The Italian industrial model has also attracted significant attention for its ability to foster international competitiveness (Porter 2011). This attention has waxed and waned over time, but the pattern of performance is like Germany’s in terms of these longer-term oscillations – both good, and bad (De Cecco 2007).

To develop this line of argument it is necessary – in the language used by Blyth and Matthijs (2017) – to identify the institutional complex that forms around the macroeconomic regime. In doing so, I turn first to the literature on ‘varieties of capitalism’ because that literature emphasises the importance of institutional complementarities. The idea is that specific combinations of institutional arrangements create incentives for actors to engage in consistent patterns of behaviour with predictable implications for economic performance (Hall and Soskice 2001).

This is where my contribution emerges within the wider research agenda. To unpack the relationship between institutional complementarities and economic performance in terms of a specific macroeconomic regime, it is necessary to narrow the focus. In this case, I highlight three roles banks play in the German model for export-led growth – as a source of finance, predictability, and strategic information. Then I show how those roles have changed over time and as a result of Germany’s export led growth.

The endogeneity is difficult to demonstrate. Critics of ‘varieties of capitalism’ literature have long pointed out that institutions and behaviour tend to change – not always and not in every case, but often enough to weaken the predictive force of the model (Jones 2008). Of course, everything changes. The question is why such change comes about and when it is sufficient to undermine the complementarities between institutions in ways that alter predictions about economic performance. The answer is not self-evident (Culpepper 2005). Hence the second and third sections of this paper emphasize the German case, demonstrating both how the export-led growth regime functioned initially and why it was subject to change. The Italian case is more prominent in the fourth and fifth sections, albeit in a more abbreviated fashion.

**Capital, Patience, and Investment**

Traditional analysis of the German economy, meaning those pre-dating debates about varieties of capitalism, were quick to note the unusual relationship between banks and firms in the German economy (Shonfield 1965, Hennings 1982). In doing so, they focused attention on the dependence of German firms on bank credit for their working capital, the close relationships that built up between firms and their banks, and the role that banks played in corporate governance across firms. As a result of these relationships, firms gained access to financing for investment (‘source’); they retained that access across economic cycles and in the face of exogenous shocks (‘predictability’); and they benefited from the strategic guidance that bank representatives could offer as board members given their long
experience working with industry and their wide knowledge of developments across the economy and within specific sectors (‘information’).

‘Patient capital’ is the generic term for these three elements in combination, and it is central role to the ‘varieties of capitalism’ debate (Deeg, Hardie, and Maxfield 2016: 615-616). The virtues of patient capital lie in its ability to foster longer-term investment in technology and equipment, and in the kind of skills-training necessary to maximise the productivity gains associated with using advanced machinery in manufacturing. As a result, firms and workers benefit from the peculiar form of competitiveness associated with high quality, high value-added production processes: the products they create may be expensive, but the quality is high enough that the demand for these products is consistent despite any fluctuations in relative prices.

This arrangement did not emerge automatically. On the contrary, the West German economy that came out of the Second World War struggled with an overabundance of labour and so had little interest in maximising productivity. The early German export-led growth model focused on maximising labour inputs and drawing resources into the country that could in turn be used for industrial development. For much of the early post-war period, German manufacturers struggled to hold down labour costs to maintain more conventional forms of price competitiveness. From the late 1950s through the early 1970s, export manufacturers also pushed the government to hold down the exchange rate in order to distort relative prices. And they sought state assistance in opening new markets, particularly in Central and Eastern Europe, as more traditional markets became saturated with German goods (Kreile 1977).

The special relationship between German banks and firms operated throughout this period and the institutional complementarities associated with ‘patient capital’ emerged piecemeal over time. Meanwhile, the German government struggled to shelter domestic financial markets from the progressive influence of the country’s consistent current account surpluses. This meant encouraging export manufacturers to retain a significant share of their earnings abroad, recycling foreign exchange reserves into development assistance and export financing, and resisting any effort to internationalise the Deutschemark or to liberalise access to German bond markets (Kreile 1977).

The government’s strategy was not always successful. Periodically Germany experienced sudden inflows of capital that challenged the government’s commitment to hold down the international value of the Deutschemark. Such tensions were particularly pronounced in the early and late 1960s, and again in the early 1970s. More fundamentally, German banks became progressively intertwined in financial relationships with banks abroad. The failure of the Cologne-based Herstatt bank is a classic example. The bank was relatively small, but it was symbolically significant both in Germany and elsewhere. When the bank failed in 1974 because of its losses on foreign exchange transactions, the German government underestimated the extent and structure of the bank’s exposure and so intervened to close down the bank without considering the consequences for regulators in other countries. The example redefined international financial risk and created the impetus for cross-border coordination of financial regulation (Story and Walter 1997).

Nevertheless, the structure of the German banking system made it possible for the German government to focus attention on domestic markets and so constrain the internationalisation of finance. Germany has a decentralised banking system organised in three clusters. The commercial banks are relatively few and include only a handful of large institutions like Deutsche Bank, Dresdner Bank (now Allianz), or Commerzbank. The savings banks, including the Landesbanken, are more numerous but are locally
oriented and have an explicit responsibility to provide access to finance for the local community. The cooperative banks tend to be small and specialised in terms of the markets they serve (Hardie and Howarth 2013: 108). During the early post-war period, the savings and cooperative banks had a clear domestic orientation, with the savings banks tied closely to the small and medium sized enterprise (SME) sector of the economy (that became the principal engine for German manufacturing exports) and the cooperatives tied to the retail sector; the commercial banks tended to be more closely tied to the larger firms and also tended to be more outward looking (Lütz 2000). Hence, the challenge for the government – at least initially – was to restrain the ambitions of the commercial banks.

That challenge became more difficult as Germany’s large firms accumulated assets abroad and as those firms gained access to foreign sources of capital starting in the 1970s and 1980s. The difficulty increased dramatically with the liberalization of European capital markets in the 1990s. The result of this change was a progressive loosening of the relationship between the commercial banks and the large firms, which no longer relied on the banks for finance, predictability, or strategic advice. In the 1990s and early 2000s, the increasing reliance of large firms on alternative sources of funding also resulted in an increasing competition between the different groups of German financial institutions which struggled to maintain profitability in the face of burgeoning savings and declining opportunities for remunerative domestic investment. In this way, Susanne Lütz (2005: 144) explains: ‘the business of issuing and trading securities [became] more attractive than lending money’ (see also Deeg 2005: 179).

Germany’s large firms were responding to the transformation of the global financial environment that took place alongside the rise of offshore banking and the breakdown of the Bretton Woods System (Helleiner 1994), but they contributed to those developments as well as responding to them. Moreover, and in a further reaction to the changes they themselves had wrought, the large German firms began to push the German government to accommodate the requirements of foreign institutional investors even as the commercial banks pushed for greater access to new opportunities to trade in financial services abroad (see also Lütz 2000: 157).

The liberalization of European capital markets at the end of the 1980s was at least partly a result of the difficulty the German government faced in reconciling the demands of finance and industry (Lütz 2000: 157-158). The goal was to complete Europe’s internal market, facilitating the movement of goods and services across European countries — including those services provided by financial institutions. Capital market liberalization was also designed to redistribute capital from those countries that have excess savings, like Germany, to those countries with unmet opportunities for investment. In this way, savers in more advanced industrial societies could get a higher rate of return on their assets and firms in other parts of the internal market could acquire the resources necessary to finance their industrial development. However, once the German government unshackled the commercial banks from their domestic orientation, the pace of transformation accelerated both among firms and among financial institutions in a manner to threatened to eliminate the institutional complementarities that the notion of ‘patient capital’ represents (Lütz 2005: 140-141; Hardie and Howarth 2013: 107-109).

At this point, it is useful to summarize the causal mechanism at work during the first decades of Germany’s export-led growth model. At the beginning, firms and banks worked closely together to foster longer-term industrial investment – initially to expand employment and later to enhance worker productivity. Over time, however, both banks and firms looked for opportunities to establish new financial relationships abroad. German firms retained foreign-currency denominated export earnings
and German banks sought to book foreign assets. Both processes continued through the liberalization of
capital markets in Europe at the end of the 1980s. By the 1990s, therefore, the financial relationship
between German banks and firms was very different from what it had been during the Cold War.

Financial Market Liberalization and Macroeconomic Imbalances

The liberalization of capital markets changed the role of German banks (Lütz 2005). This did not wipe
out the German variety of capitalism overnight. As Pepper Culpepper (2005) demonstrates, old habits
die hard even in the face of changed incentive structures. Increasingly, however, the transformation of
financing conditions for firms and the competitive environment among banks did deprive the German
economy of its traditional patterns finance, predictability, and strategic information. More important,
the transformation of the German banking system exposed the economy to new forms of risk and
uncertainty (Hardie and Howarth 2013). Some of these changes undermined long-held beliefs; some
pushed firms to bolster their strategic interaction; and some chipped away at the assumptions that
underpin popular evaluations of German economic performance (Braun and Deeg 2019, Haipeter 2018,
Jacoby 2020).

The combination of capital market liberalisation and the completion of Europe’s internal market created
a structural break in the German macroeconomic growth model. Prior to the liberalisation of capital
flows, German policymakers had to struggle with the financial implications of net exports (or, better, a
current account surplus). The challenge was to keep money earned abroad from leaking back into the
domestic economy — because the repatriation of capital would necessarily trigger an adjustment
mechanism (currency appreciation, relative inflation, consumption switching from domestic production
to imports) that would bring the current account back into balance (Kreile 1977; Hennings 1982). With
the liberalisation of capital flows, this problem was less acute because capital could move abroad
without having to be earned there. In this way, firms that manufacture for exports could repatriate their
earnings without fear of triggering an adjustment mechanism so long as other actors in the German
economy were willing to send capital abroad.

The liberalisation of European capital markets also made it possible for actors in Germany to invest their
capital in other countries. Indeed, that was one of the goals. But the export of capital by itself is not a
straightforward proposition: first, investing capital abroad involves a higher level of uncertainty,
unfamiliarity, risk, and transaction costs than investing the same capital domestically; second, someone
in the outside world has to find a use for the domestic currency that is exported, and that does not
involve making financial investments in Germany — otherwise the cross-border capital flows will come
back into balance.

Economists refer to this two-fold stickiness in cross-border financial flows as the Feldstein-Horioka
Puzzle (1980). In short form, governments can liberalise capital markets, but that does not mean
domestic actors will invest their money abroad. Within the European Union, that puzzle proved less
intractable than elsewhere. The liberalisation of capital flows did encourage the cross-border flow of
capital. The initial suspicion was that this cross-border capital flow was a function of the institutional
context provided by the European Union, reinforced by the prospect of monetary integration (Blanchard
and Giavazzi 2002). However, legal certainty, increased familiarity, diminished risks, and lower
transaction costs by themselves are insufficient, because capital that flowed out of Germany could flow
back in just as easily. Indeed, during much of the 1990s, the German economy ran a current account deficit on the back of rising government deficits and increased investment in the five new Länder (or regions) of the newly unified Germany.

The point here is not to say that capital did not flow out of Germany. It did. As Figure 1 demonstrates, German banks deposited ever larger volumes of capital in banks abroad starting in the mid-1980s and extending through the late 1990s. At the same time, however, capital flowed into Germany — with foreign investors often accepting a lower rate of return in exchange for enhanced security or in anticipation that the German currency would appreciate relative to other European currencies. The evidence can be found in the exchange rate realignments that took place in 1992, 1993, and 1995. Put another way, foreigners who exported their capital to Germany were not wrong to do so. It is worth stressing, however, that the flow of capital across the decade went both ways. If German banks had not exported their capital by depositing their money in the banks of other countries, Germany’s current account deficit would have been even wider.

What is worth noting in Figure 1 is that German deposits abroad increased continuously before the start of Europe’s economic and monetary union in 1999. Moreover, these increases apply with only minor variation across all three sectors of the German financial community. Only the savings banks show significant variation, and that variation is limited to the immediate aftermath of German unification (Figure 2). This symmetry across different financial sectors is what the changed competitive environment involved. German banks could not remain profitable by investing their money only in Germany, no matter what business line they might be in (Lütz 2000; Lütz 2005). Foreigners might be able to afford to trade off return for relative security on part of their asset portfolios, but German banks competing with one-another could not afford to resist trading off security for return at the same time.

The German economy slowed even further at the start of the new century and the attractiveness of Germany as a secure investment opportunity trailed off. This is where the second element of stickiness became important. If German banks kept exporting capital and yet foreigners saw little interest in investing in Germany, what would those foreigners purchase with the capital Germans exported? The answer lies on the current account, meaning the trade in services and manufactured products (Ford and Horioka 2016). Foreigners could buy German exports with the money German banks invested abroad. In this sense, the resolution of the Feldstein-Horioka puzzle in Europe is more than just a matter of heightened familiarity or legal certainty. The completion of the internal market was also important insofar as it made it easier for foreigners who received the capital that German banks exported to use that money without reinvesting it in Germany.

This interpretation of the balance of payments is different from the interpretation that prevailed in the early post-war period. Under capital controls, the current account clears first, and the financial account accommodates to finance any difference between exports and imports. Current accounts need to be financed, and a sudden reversal of flows on financial accounts will provoke a balance of payments crisis. Once capital controls are lifted, and cross-border capital flows begin to accelerate, it becomes increasingly unlikely that the current account clears first, and the capital account accommodates. Instead, and given the relatively larger volumes of cross-border capital flows relative to the movement
Figure 2: Loans to Foreign Banks, German Saving Banks
of goods and services, it is more reasonable to assume that financial accounts clear first and the current account accommodates as actors decide how best to use the money that is flowing from one country to the next (see, e.g., Young and Semmler 2011: 19). As a result, deviations in current account performance became much larger in the context of liberalised capital markets than they were during the first decades of the postwar period and governments are able to support those deviations — whether surplus or deficit — for much longer periods (Jones 2003).

Figure 3 provides data for West German and unified German current account performance as a percentage of gross domestic product together with similar data for Italy. What the figure shows is just how different Germany’s current account position looks today compared with the past. Many factors contribute to this change in performance (Hassel 2017). What matters is that during the process of this evolution, Germany’s commercial banks have grown more distant from their traditional large corporate clients (Deeg 2005: 182-183, Lutz 2005), Germany’s savings banks have become more exposed to high risk assets in foreign markets (Hardie and Howarth 2009, Hardie and Howarth 2013), and German firms have begun to export capital as well as goods (Braun and Deeg 2019; van der Pijl, Holman, and Raviv 2011).

Here it is possible to add to the causal mechanism summarized at the end of the previous section. As German banks export savings to other countries, the consumers and firms in those countries use some of that money to purchase German goods and services. As a result, German firms export more than they would otherwise. Those firms also wind up holding export earnings that they may choose to invest abroad as well – which only adds to the foreign demand for German exports. This is an important sense in which the German export-led growth regime today is different from the German export-led growth regime of the early postwar period. Germany used to run a current account surplus and then struggled to export capital to accommodate. Now Germany runs a surplus on financial accounts by sending its savings abroad and foreigners use some of that capital to purchase German goods and services. The results may look the same insofar as the German economy winds up producing a current account surplus. But the relationship between banks and firms is different and so are the risks associated with this model for financial stability, capital formation, and employment.

**Italy as the Path Not Taken**

Germany is not the only country to have experienced an evolution in its export-led growth regime. Italy also relied on an export-led growth model at important points during the past half century. Italy’s export-led growth model has also changed over time. Nevertheless, Italian banks did not evolve in the same way German banks did. Italian banks changed to match the new competitive environment implied by the liberalization of European capital markets and the completion of Europe’s internal market. In doing so, however, Italian banks did not take on the same kind of risk-return trade-off that the German banks accepted by moving their money abroad.

The distinction between the two banking systems is a function of historical development and path dependence. During the early Cold War period, Italian banks were different from German banks insofar as they were predominantly state-owned (Deeg 2005: 184). The Italian banks were also unlikely to
Figure 3: Current Account Balances as Percent Gross Domestic Product (GDP)
provide a wide range of services like the ‘universal banks’ that predominate in the German context – not least because they were forbidden by law from doing so (Carletti, Hakenes, and Schnabel 2005: 46). As a result, the Italian banks did not play the same role in providing finance, predictability, and strategic guidance to Italian firms that the German banks did for German firms.

The distinctions between the two systems run deep. Italian firms relied very heavily on bank credit, and yet while there is evidence to suggest that those firms which had fewer banking relationships tended to show better performance over time (Castelli, Dwyer, and Hasan 2012), most firms had multiple banking relationships and the banks played little role in corporate governance (Della Sala 2004: 1045). Italian firms benefited from some forms of ‘patient capital’, predominantly in the form of complex cross shareholding arrangements among larger firms (Culpepper 2005:187). Even so, however, the institutional environment was different from in Germany. At best, in the language of the varieties of capitalism literature, Italy was a mixed case.

Nevertheless, there are enough similarities between the banking systems of Italy and Germany to construct parallel narratives for development. The Italian system has three broad groups of banks – large commercial banks, middle-sized popular banks, and smaller credit institutions. The commercial banks worked with the larger firms; the popular banks had a more regional orientation and maintained relationships with the smaller and medium-sized enterprises; the credit institutions were predominantly local in orientation (De Bonis, Pozzolo, and Stacchini 2012: 1-8). These three groups did not compete with one another and had relatively little competition within each cluster for most of the cold war period either. Such was the ‘advantage’ of the influence of the state both directly and through Mediobanca as an intermediate institution (Deeg 2005: 184).

With the liberalization of European capital markets and the completion of Europe’s internal market, however, that situation changed. Italian policymakers introduced legislation to reform the different types of financial institutions, both through privatization and by allowing them to offer a wider variety of services along the ‘universal banking’ lines that predominated in Germany (Deeg 2005: 185-188). Italian policymakers also fostered the creation of ‘banking foundations’ that would simultaneously play a role in the corporate governance of the newly privatized institutions and ensure that resources continued to flow into the non-market or localized responsibilities that the banks as public institutions used to offer (Carletti, Hakenes, and Schnabel 2005: 34-36).

These reforms nurtured the consolidation and profitability of the Italian banking industry. Over time, the reforms also sparked an increase in bank lending to the Italian economy. Nevertheless, they did not result in the same pattern of internationalization in bank balance sheets in Italy that was apparent in Germany. Some institutions, like the Unicredit conglomerate that emerged from the consolidation process, did invest heavily in retail banking in foreign markets. By and large, however, Italian banks retained a domestic orientation and showed considerable aversion to taking on additional risk abroad – both during the 1990s and after (Carletti, Hakenes, and Schnabel 2005; De Bonis, Pozzolo, and Stacchini 2012).

The relative risk aversion of the Italian banking industry in the context of liberalized capital markets did not prevent the Italian economy from pursuing an export-led growth model. In part, the surplus demand from the German economy during the period that followed unification created a natural centre of gravity. Relative price changes that resulted from exchange rate realignments at the start of the 1990s and from wage moderation toward the end of the decade also played an important part (De Cecco 2007;
Molina and Rhodes 2007). Importantly, however, Italy also enjoyed a ‘technological’ export competitiveness that goes beyond traditional price measures and that reflects the success of bank-financed investments in Italy’s export manufacturing base (Tiffin 2014).

From this perspective, the interaction between Italy’s banking system and the country’s growth model appears relatively unchanged despite the influence of capital market liberalization and the completion of Europe’s internal market. To the extent that Italy relied on export-led growth in the 1990s and early 2000s, it did so in a very conventional way where the cross-border flow of goods and services tended to move independently of flows of capital. This pattern was punctuated by moments when European capital markets turned against the Italian currency in the early 1990s. Nevertheless, it is possible to characterize the relationship between the Italy’s banking system and its growth model more easily in terms of continuity than in terms of change (Culpepper 2005: 188-189; Della Sala 2004: 1049). This contrasts sharply with the experience in Germany (Carletti, Hakenes, and Schnabel 2005: 44-46).

The experience of the two countries was complementary. At least some of the money that flowed out of Germany and other countries with surplus savings like Austria, Belgium, or the Netherlands, flowed into Italian banks and sovereign debt markets. This inflow of capital was not enough to reverse Italy’s position on the current account, but it was enough to push down the cost of government borrowing as well as the cost of capital to Italian firms. Indeed, lowering the cost of capital was one of the main reasons that Italian Prime Minister Romano Prodi made such efforts to take Italy into the single currency. Prodi argued that a credible commitment to monetary integration would increase the attractiveness of Italy for foreign portfolio investment. That program was a success (Jones 2009b). And while successive Italian governments might have done more to take advantage of the boon this inflow of foreign capital represented to consolidate the government’s fiscal accounts and to liberalize its labour and product markets, it is nevertheless possible to point to signs of progress on both fronts during the period before the onset of the global economic and financial crisis (Ferrera and Gualmini 2000).

**Implications of Different Patterns of Export Dependence**

The comparison between Germany and Italy is counterintuitive, at least in broad-brush terms: During the period after the liberalization of European capital markets and alongside the completion of the single market, Germany’s export-led growth model benefited from the efforts made by German banks to seek higher rates of return abroad while Italy’s export-led growth model benefited from the efforts made by Italian banks to finance productive investments at home. That said, it is important to insist on a level of nuance in the interpretation of these causal mechanisms. A better rendering might be that the export of capital facilitated German net exports, lifting them to levels beyond what German firms might otherwise have expected to accomplish. By the same token – and more in keeping with the analysis made by economists at the International Monetary Fund (Tiffin 2014) – Italian exports have done better than the country’s record of low productivity growth and rigid factor markets would lead most observers to expect.

Even this more nuanced telling holds important implications. The German banks built up exposure to risk in foreign markets while the Italian banks found themselves increasingly exposed to the risks associated with domestic economic performance. That distribution of risks is what the onset of the crisis revealed in 2007 and 2008. The German banks experienced the first wave of the crisis as losses on their
foreign exposures mounted. These losses hit all parts of the banking system and threatened to collapse institutions that few expected to be heavily exposed (Hardie and Howarth 2009, Hardie and Howarth 2013). According to data available from the competition authorities at the European Commission, the German government injected just under €53 billion to recapitalize the country’s banking system in 2008 and 2009, and it spent an additional €25 billion in measures to shore up impaired assets. Over the same period, the Italian government provided just €4 billion to recapitalize its banks with no money spent on asset impairments. By 2012, the total amount of money spent on the banks by the German government topped €144 billion. The money spent by Italy was just over €6 billion.

The losses imposed on the Italian banking system came later. There were some problems at Unicredit because of the group’s exposure to markets in Central and Eastern Europe. There were also concerns at Monte Paschi di Siena because of irregularities in the corporate governance of that institution arising from the disproportionate influence of the bank’s foundation (Quaglia 2014). But the real shock to the Italian banking system came from the rapid flight of foreign capital that took place in the summer of 2011, the subsequent growth in non-performing loans made to non-financial firms that were badly hurt by the spike in borrowing costs, and the contraction of credit that followed. As these non-performing loans accumulated on the balance sheets of the smaller institutions, Italian regulators found it increasingly difficult to exercise forbearance and so the state had to step in with liquidity guarantees and, belatedly, fresh capital. The cumulative cost of this support was low. From 2008 to 2017, the Italian state spent just over €23 billion compared to the €144 spent by Germany in the early years of the crisis. Nevertheless, the damage done by the Italian crisis to the local Italian economy was considerable – particularly as it was accompanied by fiscal austerity measures that squeezed domestic demand even as the availability of capital was restricted (Hopkin 2015).

These implications are important because they suggest that neither diversified internationalized banks nor conservative, domestically oriented banks are immune from the impact of financial turmoil. On the contrary, the more banks diversify and internationalize in response to the competitive pressures of liberalized capital markets, or they more they focus tightly on the needs of the local economy, the more acutely their vulnerability will manifest. This is problematic insofar as neither the German nor the Italian banking system has undergone successful reform efforts since the crisis hit either country; there have been reform efforts, but they have been more successful at layering new institutions on top of existing arrangements than at changing the relationship between the national financial system and the country’s growth model (Zimmerman 2012; Moschella 2015). It is also problematic insofar as both Germany and, to a lesser extent, Italy remain wedded to a growth model that centres on exports. Within that framework, the respective vulnerabilities of the two banking systems will not correct themselves.

Conclusion

Both the German and the Italian export led growth models have changed over time. The German model changed as banks and firms focused on investing abroad at the expense of their relationship with one-another. The Italian model changed as banks and firms became ever more tightly intertwined at the regional and local level. The implication is that institutional complementarities tend to erode over time and as a result of the performance of the surrounding growth model. The contribution of this paper has been to show how that process has played out in Germany, and to contrast that German experience with the Italian case. In doing so, I have had the opportunity to add to a rich literature that explores the
unintended consequences of the German export-led growth model for German firms (Braun and Deeg 2019), labor (Haipeter 2018), and macroeconomic performance (Jacoby 2020, Young 2019). The practical insight of this argument is that the pursuit of export-led growth in Germany and Italy has created different forms of financial fragility. The German economy caught the leading edge of the global economic and financial crisis because of the exposure of German banks to losses on their investments abroad; the Italian economy suffered only later as Italian banks experiences losses on their investments in the domestic economy.

That practical insight has implications for performance of Germany and Italy in response to the novel corona virus pandemic. German policymakers should not worry only about the domestic economy. Although it is important to focus attention on the direct impact of government efforts to mitigate the spread of the novel coronavirus on German households and firms, policymakers should not lose sight of the vulnerability of German banks to losses on their assets abroad. This is true particularly for the larger commercial banks, like Deutsche Bank, but the consideration also applies to those other parts of the German banking system that have been purchasing foreign assets in search of a higher rate of return on their investments. Meanwhile, policymakers in Italy should focus more narrowly on domestic considerations. Italian banks are still recovering from the impact of the last crisis on Italian households and firms; at the same time, the few large Italian banking conglomerates like Unicredit that had significant foreign exposure during the last crisis have at least partly retreated to the domestic market. This means that the Italian financial system is even more exposed to losses on domestic assets when Italian macroeconomic performance falters. Since manufacturing for export was the first part of the Italian economy to recover from the last crisis, a collapse in exports would be particularly challenging for Italian banks.
References


