Focus

Germany: TARGET account, the other side of the mirror

- Despite a slight decline, Germany still has a substantial current account surplus (5.7% of GDP in 2011).
- The Bundesbank's position relative to Eurosystem continued to grow strongly at the beginning of this year, reaching €698.6 billion in May.
- The disparities in current account balances between the countries of the eurozone, and differences in competitiveness, require further attention.
- Differences in unit labour costs have narrowed slightly since the end of 2010 thanks to a reduction in costs in some countries, but most importantly to an increase in German unit labour costs.

At 6% of GDP, Germany's current account surplus at the beginning of 2012 was still below its level in 2007 (€180.9 billion, or 7.5% of GDP). However, it remains strong, notably relative to other eurozone countries, despite the particularly grim economic circumstances in a number of them. Amongst other things, the disparities between current account balances within the eurozone, against a background of increasing tension in financial markets, have since 2010 had the corollary of a significant inflow of cash from foreign central banks via the TARGET payment system, swelling the Bundesbank's assets. The risks associated with these imbalances remain limited in the absence of a default by a eurozone member. In this event, losses would be shared between European partners. Competitiveness gaps between eurozone countries, which, alongside the tension on the money markets, are responsible for the recent growth in the Bundesbank's balance sheet, warrant greater attention.

Narrowing of the current account surplus

The current account surplus shrank slightly in 2011 (from €150.7 billion in 2010 to €147.6 million), with the improvement in the balance on goods being insufficient to offset a wider deficit on invisibles (€6.5 billion from €4.2 billion in 2010). The balance of trade in goods improved only very slightly in 2011 (2.1% over the year compared to 11.7% in 2010), with imports growing faster than exports. Exports grew significantly in 2011, but less quickly than in 2010 (11.4% and 18.5% respectively), as they suffered from a deterioration in the terms of trade, following the significant rise in import prices over the last year.

A new use for financing capacity

Net balance in millions of euros

— *Current account;* — *Portfolio investment;* — *Direct investment;* — *Other investment*

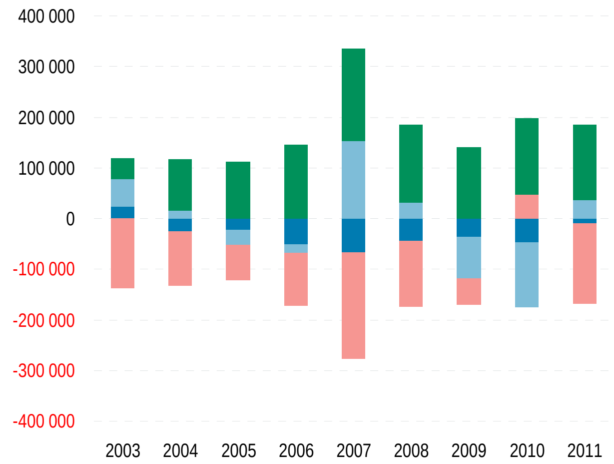

Figure 1 Source: Bundesbank

The growth of the TARGET account

Net balance in millions of euros

— *Current account;* — *Financial accounts excl. net exports of capital (TARGET2) ;* — *TARGET2 (Net exports of capital)*

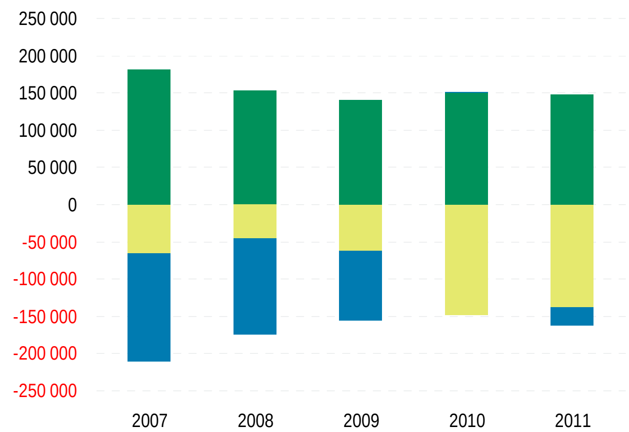

Figure 2 Source: Bundesbank

The Bundesbank's TARGET account: the main counterweight to the current account surplus

Despite a slight decline, Germany still has a substantial current account surplus (5.7% of GDP in 2011). This surplus is counterbalanced by capital flows of around the same amount. However, the sovereign debt crisis and the negative growth prospects for many eurozone countries have affected the relative weighting of financial counterparties (see Figure 1).

Portfolio investments benefited considerably from German stocks' safe haven status. Non-residents purchased little in the way of financial derivatives, due to the climate of uncertainty, the increase in deposits and thus the reduced financing requirements of German banks, but they were massive buyers of German government debt, both in the primary market and from residents in the secondary market. However, the weight of net portfolio investment fell in 2011 (a €37 billion inflow, compared to a €127.7 billion outflow in 2010). German investors sold Greek, Portuguese and Irish securities and scaled back purchases of other foreign securities despite the Bundesbank's buying up of debt securities as part of the Securities Market Programmes. Direct investment (-€10 billion in 2011) again resulted in a net outflow of capital, albeit to a smaller extent than before the crisis. Banks as well as companies and individuals invested less abroad last year. Investors are taking a more long-term approach to direct investment, but the considerable tension in the financial markets last year took the upper hand over their long-term vision.

However, the capital outflows on other investments, which include the Bundesbank's accounts, were particularly substantial in 2011 (an outflow of €157.4 billion, compared to an inflow of €47 billion in 2010). Outflows of capital recorded within TARGET have gradually replaced the net capital outflows generated by the private sector and particularly by lending institutions (see Figure 2). Since the crisis of 2008, and even more so since 2010, with the rising pressure on the sovereign debt of several eurozone countries, financial institutions have provided less money market financing to foreign institutions, whilst banks within the eurozone have accepted substantial amounts through Eurosystem and refinancing operations. The disparities between current account balances within the eurozone, against a background of increasing tension in the money markets, have thus had the corollary of a significant inflow of cash from foreign central banks via the TARGET payment system, which is equivalent to an outflow of capital to the ECB (see focus). Thus the Bundesbank's net external position relative to Eurosystem has grown from €71 billion in 2007 to €463.3 billion by the end of 2011, or 18% of GDP.

The risks associated with TARGET remain uncertain

The current account surplus rose only slightly in the first quarter (to €39.1 billion, or 6% of GDP, from €38.2 billion in Q4 2011), thanks to a small improvement in exports. However, the Bundesbank's position relative to Eurosystem has continued to grow strongly during the beginning of this year, reaching €615.6 billion at the end of the first quarter and €698.6 billion (27% of German GDP) in May. This figure is close to Germany's cumulative trade surplus since 2000.

The losses associated with such an imbalance could become real if a debtor country in the eurozone defaulted and if the collateral used in refinancing operations produced a loss on its original value. This loss would be shared between eurozone national central banks pro rata to their holdings in the capital of the European Central Bank, but the Bundesbank's share would be 27% of the total. The disparities in current account balances, gaps in competitiveness between the countries of the eurozone, and most importantly tension in the interbank market, causing the

The TARGET payment system

The TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system is a technical platform housing the national components of TARGET2 and allowing the settlement of payments in the central bank currency. Thus a German bank, receiving capital from abroad and using the TARGET system, receives a credit from the Bundesbank. In its turn the Bundesbank receives a credit from the national central bank in the source country. This central bank debits the account of the national trade bank. The balances of national central banks that are members of the TARGET system are transferred to the European Central Bank at the end of the day, which net out the various accounts. Within the eurozone, TARGET balances for the central banks, like current account balances, cancel each other out. As the TARGET2 account is considered as a payment account held with the European Central Bank, transactions are considered as capital flows to a non-resident entity. An increase in the Bundesbank's assets within TARGET is therefore treated as a net outflow of capital.

Focus Source: Bundesbank

The start of a small adjustment?

Narrowing of the current account surplus

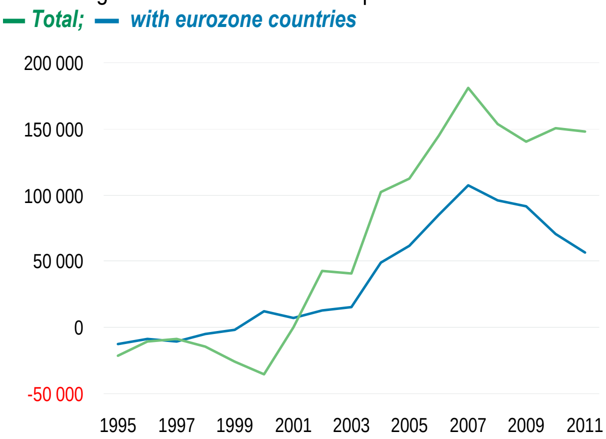

Figure 3 Source: Bundesbank

capital outflows recorded in the TARGET system, are particularly worrying in a currency union.

The competitiveness gaps between certain eurozone members are slowly narrowing

Some adjustments are currently being seen in the euro zone and the current account surplus could narrow still further over the next few months. Export growth began to slow sharply in the second half of 2011 under the effects of the eurozone sovereign debt crisis and lower demand from emerging economies. Exports could well continue to suffer from tough economic conditions over the next few months.

Germany's surplus relative to the rest of the eurozone, which more or less halved between 2007 and 2011, could thus shrink still further (see Figure 3). The reduction in the German current account surplus over the next few months will be due particularly to the depressed conditions in eurozone economies. The latter will benefit from the continued growth, even if only moderate, of Germany's economy (and therefore of its imports) whereas German exports will suffer from the economic weakness of its eurozone partners (40% of exports of goods). However, differences in unit labour costs have narrowed slightly since the end of 2010 thanks in part to a reduction in costs in some countries (Spain and Portugal), but most importantly to an increase in German unit labour costs (see Figure 4). Tension in the German labour market has pushed wages upwards whilst productivity growth has not kept up, after several years of strong gains. The gaps are likely to narrow further still. The slowing of growth in Germany is likely to stem wage increases, but peripheral economies are likely to pursue reforms in their labour markets. These adjustments could eventually help reduce disparities between current account balances in the eurozone. However, significant gaps in cost competitiveness between the countries of the eurozone are likely to persist. Moreover, the German economy enjoys strong non-cost competitiveness in high value added sectors which will help it protect its share of export markets. At the same time, the return of confidence and a calming of the financial markets will remain key requirements to allow a reduction in disparities between TARGET balances within the eurozone.

A new order

Nominal unit labour costs, 2004=100

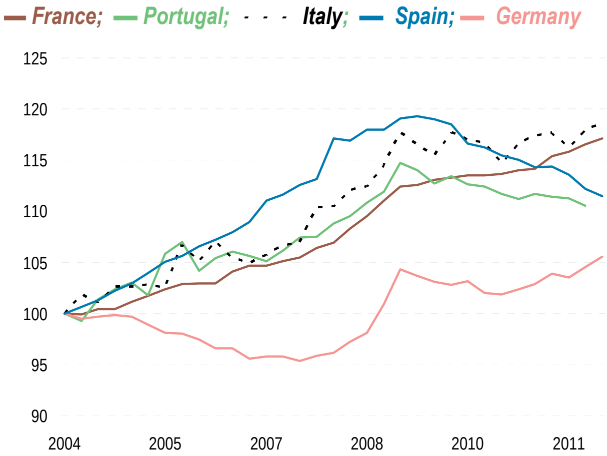

Figure 4 Source: Eurostat