Germany: The current account controversy

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In recent years, Germany has posted substantial current account surpluses, well above the level justified by economic fundamentals. This can be attributed to a substantial increase in savings of the government and the corporate sector. Many observers consider Germany's current account surplus as a threat to the eurozone economy and urge the German authorities to reduce it by boosting wages and investing in infrastructure. These demands have largely been ignored. Supported by model simulations, the German authorities argue that these measures would be detrimental to the German economy, while having hardly any effect on the other eurozone countries. They call for more structural reforms in the European Union, such as a further opening of the services sector.

Over the past decade, Germany has consistently been posting large current account surpluses on its balance of payments. Since 2011, the surplus has been above 6% of GDP, the threshold above which the surplus is qualified excessive by the European Union (EU).

Current account imbalances are in principle not bad. In the case of Germany, they are partly linked to the accumulation of savings by an aging population which are invested in younger and more dynamic economies.

However, they also could be related to currency misalignments. For 2017, the IMF estimates that Germany's cyclically adjusted current account surplus amounted to 8.25%, which is 3.25 - 6.25 % above the interval considered to be in line with economic fundamentals. [1] According to the Fund, the real effective exchange rate is undervalued by 10-20%.

At the eurozone's inception, many thought that national current account balances would not play a role. However, the European sovereign debt crisis has revealed that national balance of payments imbalances still played an important role in the fragmented European financial markets.

In the past few years, Germany has been much criticised for its large current account surplus. International institutions, trading partners and economists have argued that it may represent a risk for macroeconomic stability. They have called on Germany to use its fiscal room to stimulate domestic demand.

These calls have largely fallen on deaf ears. The German authorities argue that the current account surplus is mainly due to structural factors such as population aging and some temporary factors such as relatively weak prices for energy and other commodities. Moreover, a stimulus package would only have a small effect on the balance of payments balances of the other EU countries and the rest of the world.

The German government recently has embarked on an investment programme, but at a modest pace. It fits nicely in the recommendations made by the European Commission to reduce the current account surpluses. Nevertheless, according to the Commission, it would only have a limited effect on the surplus. In the Commission's Autumn Forecast, the current account surplus is projected to decline only to around 7% of GDP by 2020.

[1] IMF, 2018, Germany 2018 Article IV Consultation, Country Report No. 18/208

Germany's current account

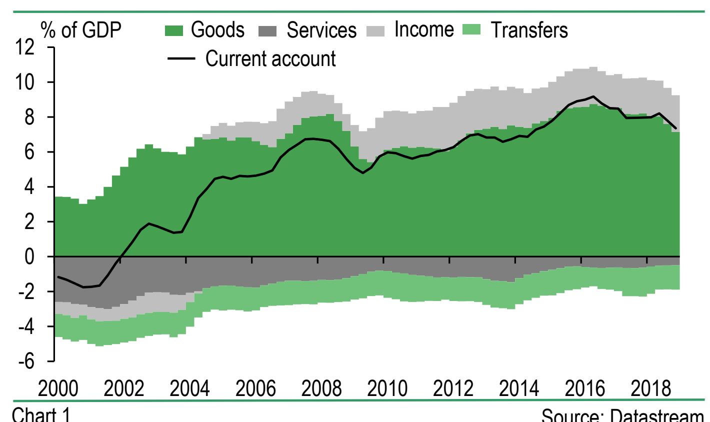

Chart 1 Source: Datastream

What is behind Germany's current account surplus?

Since the creation of the Federal Republic in 1949, the current account has been most of the time in surplus (chart 1). Until the reunification in 1990, West Germany had only two significant episodes of current account deficits, in 1965 and in 1980. This drastically changed with the reunification in 1990. The substantial fiscal stimulus for the reconstruction of the new Länder and the losses in price competitiveness through increases in payroll taxes resulted in a current account deficit that lasted for a decade.

Since the mid-2000s, the economy made a remarkable export-led recovery, only briefly interrupted by the Great Recession, thanks to the strength of the manufacturing sector. An important element was the consensus-based decision making between employers and trade-unions. This allowed firms to adapt better to the emergence of new challenges such as the entry of low-cost neighbours - including Poland, Hungary, the Czech Republic and Slovakia - to the common market and the emergence of China as a major exporter. Firms increasingly opted out of the industry-wide pay deals and concluded wage agreements at company level that suited them better. The 2003-2005 Hartz labour market reforms reinforced the willingness to moderate wages in order to save jobs. Between 2000 and 2010, German unit labour costs per hour

worked in the manufacturing sector declined by 10% compared with France, Italy and even by 22% compared with Spain. As a result German manufacturing regained competitiveness, and was able to maintain its position, whereas in other major economies experienced a drastic decline in particular after the Great Recession (chart 2).

Germany's manufacturing sector maintains its position

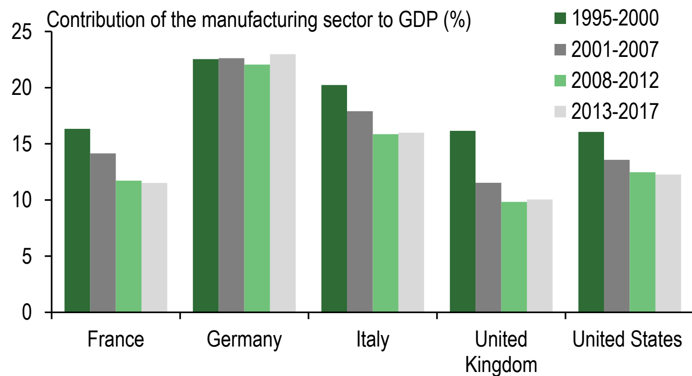

Chart 2 Source: OECD

Regional breakdown of Germany's current account

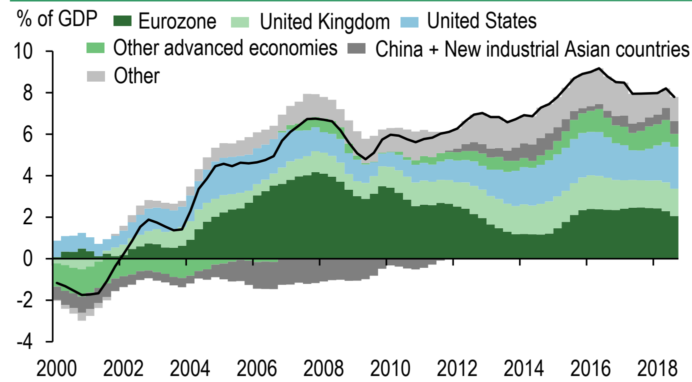

Chart 3 Source: Deutsche Bundesbank

Investment rate in major countries

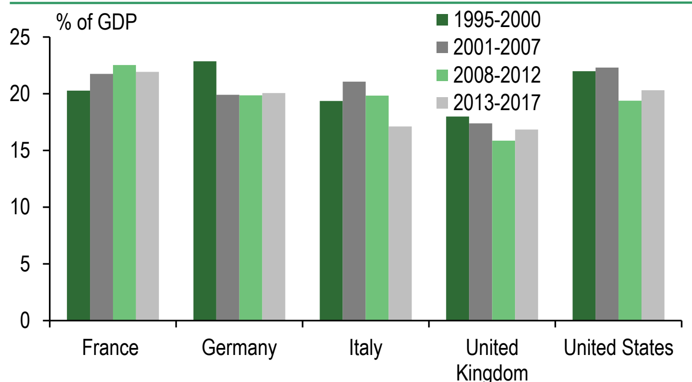

Chart 4 Source: OECD

A regional breakdown of Germany's current account shows that between 2004 and 2010, the main force behind the increase came from the other eurozone countries (chart 3). Since the European sovereign debt crisis, the southern European countries were forced to cut back their spending. Germany's surplus against the rest of the eurozone was reduced. By contrast, partly because of the depreciation of the euro, the surplus vis-à-vis the US widened. In 2017, the euro had lost 17% of its value against the US dollar compared to 2013. Moreover, weaker prices for oil and other commodities strengthened the German balance of payments after 2013.

A country of savers

Current-account positions reflect the difference between domestic savings and investment. This raises the question if the increase in the German surplus since 2000 has been generated by weak investment or rising savings, or a mixture of the two.

It is a widespread view that the rapid increase in the current account surplus was the result of weak public and private investment. However, this is difficult to reconcile with the data. Even though Germany's investment rate is relatively low compared to the other major economies, it has remained remarkably stable since 2001 (chart 4). By contrast the investment rate in some other major economies such as Italy and the US have sharply declined.

If it is not capital spending that has fallen since 2001, it must have been savings that have increased. That is indeed the case. Between 2001 and 2017, the German gross savings rate for the whole economy increased by 7 points (chart 5).

National gross savings rate in major economies

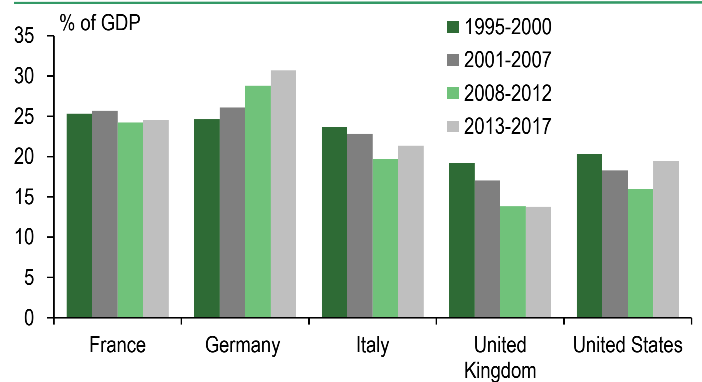

Chart 5 Source : OECD

Looking at the savings rate by sector, the household sector has the highest savings rate, major contributions came from the government sector (4.2 points) and the corporate sector (2.4 points). By contrast, in the other major economies, the national savings rate has declined since the early 2000s. These developments are well illustrated in the Flow of Funds statistics (chart 6). Except for errors and omissions, the balance of the current and capital accounts should equal the total net of the financial account, (see Box 1). If the latter is positive (negative), the country lends to (borrows from) the rest of the world.

Current account, capital account and financial account

The balance of payments registers the transactions of a country with the rest of the world. These transactions are categorised into the **current account, capital account and financial account**.

The current account records mainly flows of goods and services, whereas the financial account records investment flows.

The capital account, for most countries the smallest of three, consists of capital transfers and the acquisition or disposal of non-produced non-financial assets such as natural resources, radio spectra, goodwill, and marketing assets. With the exception of errors and omissions in the data, the three accounts sum up to zero.

Box 1

Flow of funds: financial balances

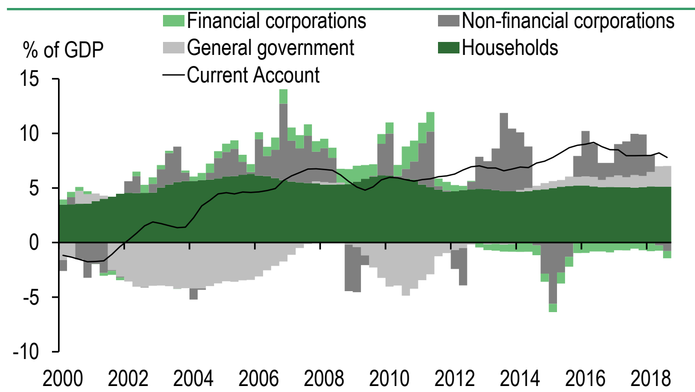

Chart 6 Source: Deutsche Bundesbank

The Flow of Funds statistics show that the increase in the current account surplus (as % of GDP) has as main counterpart the growing financial surplus of the government sector from -3.1% in 2001 to 1.2% in 2017. This consolidation was in particular motivated by growing concerns about future financial liabilities related to population aging, such as higher health care spending and pension costs. To keep the budget under control, the government adopted the so-called debt brake (*Schuldenbremse*) in the country's constitution. It limits the structural deficit for the federal government to only 0.35% of GDP, whereas, from 2020 onwards, the budgets of the Länder should always be in surplus, except in cases of natural disasters or strong recessions. The debt brake is in line with the fiscal requirements of the Stability and Growth Pact.

The government also announced reducing the generosity of the public pension system. To compensate these cuts, the government introduced subsidised private pension provisions such as the so-called Riester pensions. This measure has not resulted in a noticeable increase in overall household savings. It is likely that households shifted savings from existing accounts to the subsidised plans. The financial surplus of the household sector stood at 5% in 2017, only 0.5 percentage point higher than in 2001.

Are German foreign assets a "bad investment"?

Some have argued that German investors would be better off if they had invested the money at home.* Comparing Germany's net international investment position with the cumulated balances of the current account, we notice sizeable losses on net foreign investment since around 2007. These losses amounted to EUR 600 billion or 25% of the cumulated current account balances. If only this were spent on domestic investment, it would have boosted domestic growth, wages would be higher and the government would have received more taxes.

However, it would be surprising that German investors collectively could have made such costly mistakes. The Bundesbank has studied the discrepancies and arrives at a diametrically opposite conclusion.** To a large extend the discrepancies are due to statistically and methodological differences between the flow accounts of the balance of payments and the statement of stocks used in the international investment position and by increases in prices of German external liabilities.

The authors conclude that between 2004 and 2013 the yield on cross-border investment income, excluding valuation effects, equated to a return of 2.8% for German external assets compared with just 2.1% on non-resident's assets in the German market. German direct investment abroad yielded a total return of 7.2%, compared with just 4.9% for foreign enterprises on direct investment in Germany.

*DIW, 2013, *Germany must invest more in its future*, DIW Economic Bulletin, 8/2013
**Deutsche Bundesbank, Monthly Report, May 2014, page 48-50

Growing discrepancy between net foreign assets and current account

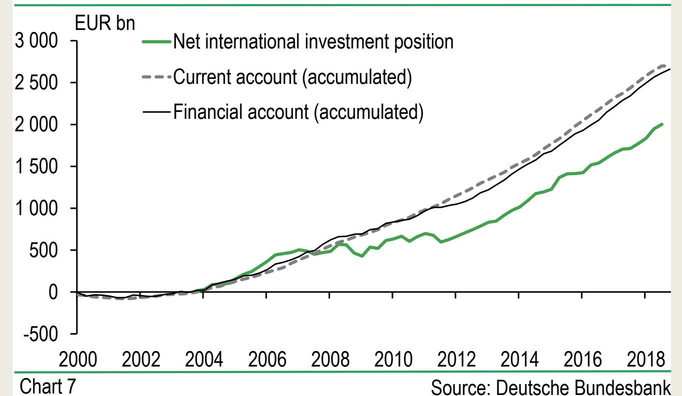

Chart 7 Source: Deutsche Bundesbank

Box 2

Another factor is the balance of the non-financial corporate sector, which improved from close to zero in 2001 to 1.5% of GDP in 2017. The increase in the surplus stands in contrast with the investment surveys, in which companies increasingly indicate a willingness to invest.

However, the shortage of skilled workers has become an obstacle for investment in Germany. Central and eastern Europe (Poland, Czech Republic, Hungary and Slovakia) have become favourite investment destinations because of the well-educated labour force, the relatively low wages, and the proximity of Germany. This has been an important factor in the building up of the net international investment position. In general, these investments have been rather profitable (see Box 2).

Current account imbalances, a cause for concern

The surplus of one country implies the deficit of another one (see Box 3). In the case of Germany, the substantial current account surplus has provoked the ire of some trading partners.

Nevertheless, at the eurozone's inception, trade and current account imbalances between the euro area countries did not receive much attention. The issue was even completely ignored in the 1992 Maastricht Treaty, which set conditions for adhering to the single currency. This is not so surprising as many questioned the significance of the current account balance in currency unions. For example, nobody knows the size of the current account balances of Texas or Scotland. These data are not even collected. Moreover, the growing current account deficits in the periphery countries of the eurozone were not seen as problematic, but considered to be part of the catching-up process.

Unfortunately, the eurozone does not work as an optimal currency area as defined by Mundell in 1961 (see Box 4). This has become most obvious since the beginning of the European sovereign debt crisis in 2010, which has resulted in a substantial fragmentation across national bond markets. Moreover, even though the conversion rates are irrevocable, financial markets have never completely ignored the risk of breaking up.

In particular before the financial crisis, some economists argued that current account imbalances are not very worrisome, as such imbalances are the result of transactions between *"consenting adults"*. [2] Provided that the public sector deficit is not excessive, the current account balance is the result of transactions between optimising, forward-looking households and firms.

The view was defended by the former British Chancellor of the Exchequer Nigel Lawson at the 1988 annual IMF and World Bank meeting in Berlin, and became known as the Lawson doctrine. In his inaugural Adam Smith Lecture in 2010, Lord Lawson reformulated his view.[3] In his opinion, current account imbalances are the result of global capital flows searching for investment opportunities. He sees them as *"a fact of economic life in a globalised word economy, rather than a dangerous effect that has to be remedied."*

Current account discrepancy and the German surplus

The global current account is not zero, but positive and the so-called discrepancy is growing. In 2017, it amounted to USD 440 billion. The discrepancy can be attributed to measurement problems.

Daniel Gros has remarked that the current account discrepancy is narrowly correlated (R^2=0.86) with the German current account surplus.[i] In fact, if the German current account surplus rises by one about 50% of the increase is added to the global discrepancy.

According to him, it suggests that a significant part of today's global current account discrepancy might be due to a mismeasurement of the German numbers. Even though it is somewhat hazardous to draw firm conclusions from a single correlation, it certainly illustrates that we should be careful in interpreting trade and current account data. In the EU and in particular in the eurozone, international transactions can no longer be measured with precision.

Germany's current account and the discrepancy at global level

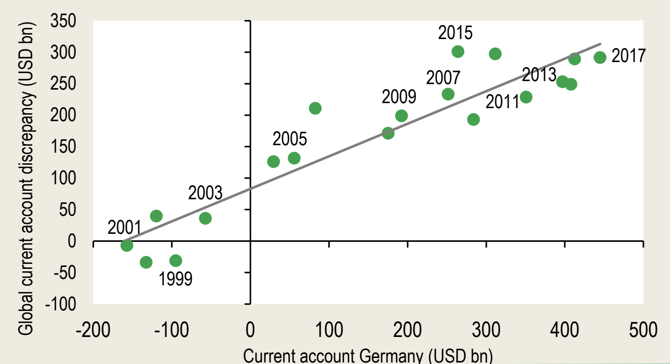

Chart 8 Source: IMF

[i]Daniel Gros, 2017, *Is Germany's current account surplus bad for the world economy?* Letter to the Editor of The Economist, published 27 July 2017.

Box 3

The Great Recession and the subsequent European sovereign debt crisis have drastically changed the perception of the role of the current account, in particular in a currency union. After all, a current account deficit needs to be financed even in a currency union.

It is true that the creation of the eurozone has led to larger and deeper financial markets. Before the debt crisis, this allowed firms to borrow more cheaply, in particular in the southern European countries, resulting in substantial current account deficits. However, because of market fragmentation, it became increasingly difficult for the southern European countries to attract foreign capital during the sovereign debt crisis. To prevent financial stability risks from materialising, public funds were used to substitute for the dried-up private funds.

[2] See Obstfeld, 2012, *Does the current account still matter*, NBER Working Paper 17877.
[3] Lord Lawson, 2010, *Five Myths and a Menace*. Inaugural Adam Smith Lecture at Pembroke College, Cambridge UK.

Moreover, the dividing line between public and private debts becomes hazy precisely in crisis situations. For example, during the Great Recession, because of nationalisations, private sector debt often ended up in the hands of the public sector.

Bundesbank research shows that the adjustment of current account deficits is significantly hampered in countries that are members of a monetary union.[4] This is in particular the case in comparison to a floating exchange rate regime, where current account imbalances are adjusted by means of changes in the exchange rate. But the adjustment is also slower than in a fixed exchange rate regime. In such a regime, national central banks sell foreign currency or raise key interest rates. These policies led to a tightening of credit demand, which ultimately reduces demand for goods and services.

In EMU, the adjustment process is slowed down because, by definition, there is no exchange rate adjustment. Policy operates through the single monetary policy through harmonised short-term interest rates and liquidity assistance measures of the European System of Central Banks (Eurosystem). It cannot be taken for granted that monetary policy at EMU level would be fully in line with the needs of a country with a huge current account surplus and major labour market bottlenecks. As a result, the adjustment needs to come from prices and wages, which tends to be slow. In addition, the bigger the share of intra-eurozone trade, the more it slows the adjustment.

The Bundesbank researchers conclude that *"it is still an open question whether the characteristics of the monetary union are indeed amenable to smoothing necessary corrections and limiting spillovers to other EMU countries, or whether they merely aggravate existing imbalances and delay necessary structural reform."*

Five years on, we have more insight in the question. The southern European deficit countries have indeed slowly adjusted and they now all have current account surpluses. However, they paid a heavy price. Only in Spain and Portugal, GDP is above the pre-crisis peak. By contrast, in Greece, GDP is still around 25% lower than the pre-crisis peak. Moreover, the unemployment rates in Italy, Spain and Greece are still above 10%. Lastly, all these countries struggle with a substantial public sector debt overhang. In Greece, public debt is still around 170% of GDP. One may question if this outcome has been optimal. In a recently carried out survey among economists based across Europe on Germany's trade surplus, more than two-third of the respondents agree or even strongly agree with the proposition that Germany's current account surpluses are a threat to the eurozone economy.

Some even consider the German current account surplus bad for the world economy. According to the former Fed Chair Ben Bernanke it contributes to the global saving glut.[5] Nobel Prize laureate Krugman calls the Germany fiscal surpluses an international version of the paradox of thrift.[6]

[4] Sabine Herrmann and Axel Jochem, 2013, *Current account adjustment in EU countries: Does euro-area membership make a difference?*, Discussion Paper 40/2013, Deutsche Bundesbank.
[5] Ben Bernanke, 2015, *Germany's trade surplus is a problem*, Ben Bernanke's Blog, The Brookings Institution, 3 April 2015.
[6] Paul Krugman, 2013, *The Harm Germany Does*, New York Times, 1 November.

A non-optimal currency area

Being a currency union between sovereign countries, the eurozone has retained some characteristics of a fixed exchange rate regime.

The difference between a currency area consisting of different regions and one consisting of different countries can be illustrated by a following simple example provided by Mundell in 1961. Assume two currency zones, one between two regions A and B and one between two countries A and B. The national governments follow a full-employment policy. What happens if for some reason the initial equilibrium is disturbed by a demand shift from goods of country/region B for goods in country A/region A? To achieve a new equilibrium, a change in the terms of trade will be required. The goods of country/region B should become relative cheaper of compared to those from country A/ region B. In both cases, the monetary authorities can try to inflate the economy by lowering interest rates.

In a currency union between two countries, country A could tighten its macroeconomic policies for example by introducing credit restrictions to prevent prices from rising. In that case, the onus of the adjustment falls completely on country B. The policy of country A to restrict prices results in a recessive tendency world-wide. It makes it even harder for country B to return to full employment.

In the case of currency union between regions, the monetary authorities can increase the money supply. This will fuel inflation in region A and turning the terms of trade against region B. This will again restore full employment in region B.

Mundell, comparing a fixed exchange rate regime and a single currency area, summarizes the situation as follows: *"In a currency area comprising different countries (…) the pace of employment in the deficit countries is set by the willingness of surplus countries to inflate. But in a currency area comprising many regions and a single currency, the pace of inflation is set by the willingness of central authorities to allow unemployment in the deficit regions."**

*Mundell, R. A. (1961). *A theory of optimum currency area*s. The American economic review, 51(4), 657-665.

Box 4

How should policy adapt?

One of the weaknesses of EMU, or by extension, any fixed-exchange rate regime, is that debtor countries have to adapt, while creditor countries are not under any pressure to reduce their surpluses. Already John M. Keynes had perceived the danger of deflationary tendencies in a fixed exchange rate regime during the Bretton Woods negotiations.[7] He thought that the desire of hoarding money was much stronger than the desire to invest because of the risk involved. Investment comes in

[7] Robert Skidelsky, 2010, *Keynes, A very short introduction*, Oxford University Press

bursts of optimism, called animal spirits. A country with a deficit loses foreign exchange reserves and has to deflate its domestic prices. By contrast, a country with a surplus can accumulate liquidities without limit.

Keynes sought to repair this asymmetry between creditors and debtors in his 1941 plan for a Clearing Union. Surplus countries were not anymore allowed to hoard their surplus or lend them out at punitive rates. These funds were to be made available to debtors through the mechanism of an international clearing bank. The Keynes Plan was vetoed by the US, which did not accept that its "*hard-earned*" surpluses to be automatically placed at the disposal of *"profligate"* debtor countries.[8] It is unlikely that Germany would agree with a policy along the lines of Keynes Plan. However, as Martin Wolf justly remarks, *"the eurozone will fail if it is run for the benefit of creditors alone*". [9]

For the moment, the only way to persuade creditor countries to increase their spending is to exercise peer pressure on them. In the recent past, IMF, OECD and ECB have all called on Germany to use the available fiscal space.[10] The European Union has a formal process to monitor countries with balance of payments imbalances. As part of the annual macroeconomic imbalances procedure (MIP), the European Commission has identified Germany as a country with imbalances in its large current account surplus.[11] It recommends Germany to strengthen private and public investment, to improve the efficiency and the investment friendliness of the corporation tax system, to create conditions to promote higher wage growth, and to reduce disincentives to work more hours, in particular for low-wage and second earners. Failure to follow the recommendations exposes the country to the possibility of sanctions, including fines.

The results of the MIP are mixed. According to the European think-tank Brueghel, Germany has one of the lowest implementation rates of country specific recommendations (CSR).[12] That is not very surprising, as the CSR does not play any role in German politics. The coalition agreement, concluded in early 2018, includes an investment programme in particular in digital infrastructure without making any reference to the MIP. Moreover the government remains fully committed to fiscal consolidation and maintaining a budget surplus.

Peter Bofinger, a frequently dissident voice in Germany's Council of Economic Experts, attributes Germany's reluctance to reflate its economy to Walter Eucken's influence on macroeconomics.[13] Walter Eucken (1891-1950) is considered as the father of Ordoliberalism. He rejected demand management, fearing that this would lead to state socialism. His views were formed in Nazi Germany that implemented Keynesian ideas even before the publication of the "General Theory".

Michael Burda (Humboldt University of Berlin) does not share the view that German economists would reject Keynesian demand policies.[14] It is taught in all macroeconomic courses in German universities. In his opinion, the rejection of demand management is simply national interest. Germany is a much more open economy than other large European countries, and would less benefit from such a policy.

This view is also shared by the President of the Bundesbank, Jens Weidmann.[15] According to model simulations, an additional wage increase in Germany of 2 percentage points, would have hardly any effect on the peripheral eurozone countries. Only Ireland could expect a moderate lift. By contrast, the German economy would suffer. Employment would ultimately fall by as much as 1% and output by 0.75%. A credit-financed increase in public spending would boost activity and exports in the periphery countries even less. The reason is that the import share of German public demand is only 9%, compared with 21% for private demand and 41.5% for German exports.

For the German authorities, the solution is supply side reforms. The painful Hartz labour market reforms between 2003 and 2005 have laid the basis of Germany's turnaround in economic performance almost a decade later. This explains why Germans have less patience with short-term policy solutions, such as fiscal stimulus, and put the emphasis on structural reforms.[16]

Weidmann calls in particular for structural reforms in the services sector in Germany and the rest of the European Union. This would strengthen Europe's growth potential. In a report commissioned by the European Policy Centre, Copenhagen Economics estimates that the digital economy can boost EU GDP by at least 4 percent in the longer run [between 2010 and 2020] through the creation of a Digital Single Market.[17] This would not only strengthen the growth potential of Germany but even more so that of those European countries specialised in (digital) services. The further opening of the German services sector to foreign providers may lower the Germany's current account surplus because of a widening deficit on the services balance.

Given current policies, it is likely that Germany's current account surplus will diminish in the coming years thanks to increased public spending and higher pay settlements. Removing the rigidities in the services sector might also contribute. Nevertheless, given the country's demographics, the German current account is likely to remain firmly positive in the foreseeable future.

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[8] The Bretton Woods system did not display the deflationary character that Keynes predicted. This was due to the profligacy of the US, which flooded the world with dollars. It ultimately led to the collapse of the Bretton-Wood between 1971 and 1973.

[9] Martin Wolf, 2016, *Germany is the eurozone's biggest problem*, Financial Times, 10 May 2016.

[10] For example, in the IMF Blog on 17 January 2018, IMF Managing Director Christine Lagarde called on Germany to boosting wages, investing in infrastructure and reducing the large trade surplus.

[11] The European Commission uses as indicator the 3-year average of the current account balance as % of GDP, with as indicative thresholds +6% and -4%.

[12] Konstantinos Efstathiou and Guntram B. Wolff, 2018, *Is the European Semester effective and useful?* Policy Contribution Issue n°09, June 2018, Brueghel.

[13] Peter Bofinger, 2016, German macroeconomics: the long shadow of Walter Eucken, VOXEU, 7 June 2016.

[14] Michael Burda, 2016, *Dispelling three myths on economics in Germany*, VOXEU, 23 September 2015.

[15] J.Weidmann, 2014, *External imbalances in the euro area*, speech at the International Business cycle conference, Kiel institute for the world economy, 17 March 2014.

[16] Germany is also sensible for moral hazard. These views are formed by its experiences with its own federal structure. The German Länder are jointly and severally liable for each other's debt. As a result, the smallest states have allowed their debt to soar.

[17] Copenhagen Economics (2010), *The economic impact of a European digital single market*.

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