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››› Current account balance: reduce surplus, make Germany stronger

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Germany's current account surplus has been very high for a long time and has come under increasing criticism from international institutions such as the IMF and the European Commission, which has been reviewing Germany under the Macroeconomic Imbalance Procedure since 2014. US President Donald Trump's massive criticism of Germany's export surplus has now raised the dispute to a new level. The threat of imposing higher US import tariffs on German products, especially automobiles, is placing a key success factor of the German economy in acute jeopardy. It is therefore high time to take a closer look at the drivers of the surpluses and undertake serious efforts to look for ways of moving Germany out of the line of fire. In general terms, the current account surplus reflects a high surplus of German savings over the – relatively low – level of domestic investment. That means Germany is using a considerable portion of unconsumed economic income to build up monetary capital abroad instead of real capital stock at home. Apart from providing an ageing society with very welcome opportunities for returns, foreign assets also harbour substantial risks ranging from exchange-rate induced devaluations to total losses – at least in individual cases. At the same time, Germany needs modern and efficient real capital stock to launch a productivity initiative that can effectively counteract the demographically induced downward pressure on its potential growth and, thus, its material prosperity. The surplus can therefore be reduced in Germany's interest – but through more domestic investment and imports, not through growth-stifling export cuts.

Criticism of Germany's current account surplus

Today Germany's current account surplus stands at around EUR 261 billion (2016), making it the world's highest in absolute terms, even before China. That is 8.3 % of gross domestic product (GDP). The surplus since 2011 has thus been consistently above the European Commission's indicative threshold of 6 % of GDP which, if it is continuously exceeded, can entail what is known as an in-depth analysis and policy recommendations according to the EU's Macroeconomic Imbalance Procedure. Pointing to the current account surplus, the European Commission formally identified a macro-economic imbalance in Germany for the first time in March 2014 and has confirmed this diagnosis every year since. As an appropriate response to a current account surplus that it regards as generally detrimental both to Germany and to the currency union overall, it is now recommending that Germany should make use of its national budget scope for more public investment and create favourable conditions for stronger real wage growth.[1] Similar recommendations are found in this year's IMF Staff Report for the Article IV Consultations with Germany.[2]

Trump's criticism: not appropriate but threatening

Ever since he was elected, US President Donald Trump has joined the ranks of prominent critics of Germany's surpluses by asserting in very blunt terms how unfair and damaging it was for his country that German automakers were selling a much higher number of cars in the USA than US automakers in Germany.[3] That criticism is improper since bilateral trade imbalances between individual countries and, even more, within individual groups of goods are, after all, mainly an expression of comparative advantages and thus a normal phenomenon of international trade. Nonetheless, it is a source of considerable economic policy conflict because Trump uses it to directly threaten the imposition of massive import duties on German products – he mentioned 35 % – that would inflict significant damage on the competitiveness of Germany's export industry.

The criticism from the USA is inspired by a mercantilistic worldview according to which a country with a trade surplus enriches itself at the expense of another country, and trade is therefore a zero-sum game. By contrast, the recommendations of the European Commission and the IMF are based on the conviction that a very high current account surplus can also be detrimental to the very country that generates it – a highly important difference in the diagnosis that has significant implications for the proper therapy.

Current account surplus and weak investment

The very high current account surplus is generally a reflection of the fact that Germany is using a substantial portion of its economic savings to build up monetary capital abroad instead of investing it in domestic real capital stock (see box 'The surplus from three perspectives' for an explanation of this context). In short: it is also a consequence of the real economic investment weakness which is detrimental to the long-term growth outlook. More investment is urgently needed for demographic reasons. After all, the foreseeable decline in the number of persons of employable age is putting downward pressure on Germany's growth potential, and that pressure will intensify considerably in the 2020s. It can only be counteracted through significantly higher labour productivity. Large, modern and efficient real capital stock is therefore a key element of an effective economic policy response to this situation as capital stock crucially determines the productivity of those who will still be in the workforce in the future.[4] It can therefore not be in Germany's interest to continuously have a very high current account surplus that will inevitably be at the expense of domestic real capital stock.

The surplus from three perspectives

The current account balance mirrors all real economic interactions of a national economy – in this case Germany – with other countries. This includes exports and imports of goods, cross-border service transactions, primary income received from and transferred abroad as factor input (wages, profits and other capital income) as well as secondary income paid without compensation (such as remittances by labour migrants, grants made under development cooperation and similar transfers).

If Germany delivers more goods and services to other countries than it receives from them, thereby generating a current account surplus, other countries on balance have a financing deficit with Germany which they need to offset on a net basis with monetary capital borrowed from Germany. Germany provides these net capital exports, which are captured in the balance on the financial account, to other countries by investing a portion of its savings – the portion of income generated from economic activity and not used for consumption – in foreign monetary capital (bonds, direct investments, bank loans, financial derivatives etc.) and not in domestic real capital. The savings exceeding domestic net investment (net lending / net borrowing balance) thus correspond exactly to the portion of output generated in Germany and not used within the country – that is, neither consumed nor invested. But this is nothing other than Germany's current account surplus with other countries, and we have come full circle.

Because of these interrelationships,

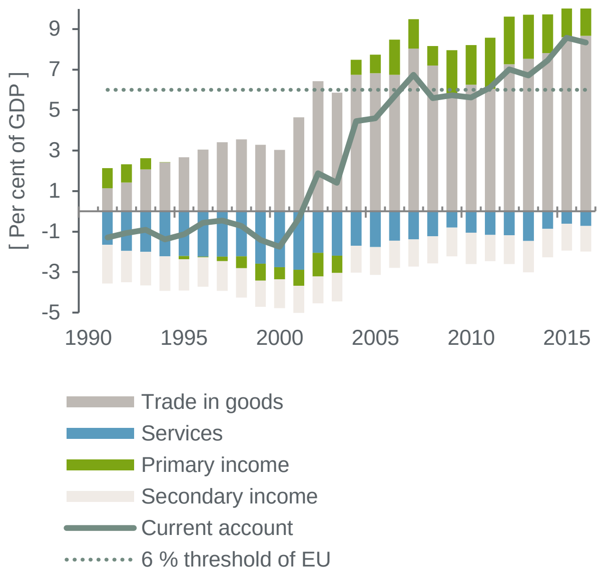
- the current account balance (real economic perspective),
- the balance on the financial account (monetary perspective), and
- the balance of savings and net investment (financing perspective)

must always be the same. Statistical deviations due to measuring problems are possible, however.[5]

Gift cars

The question also arises whether German savings invested as monetary capital abroad are always a good investment. For an ageing society such as Germany it definitely makes sense to diversify risks and place a portion of savings in dynamic, emerging economies. That suggests an at least moderately positive current account balance. On average over the 1970s and 1980s, before unification, a current account surplus of 1.5 % of GDP was common in Germany. Today Germany's enormous foreign assets (net external position at the end of 2016: EUR 1,705 billion, or a good 54 % of GDP) offer many opportunities for returns but also harbour substantial risks from exchange-rate induced devaluations to total losses – at least in individual cases. After the financial crisis the German taxpayer covered a portion of such total losses incurred from, for example, investments in sub-prime papers for the benefit of German savers. From a current account balance perspective, that is like a gift to the USA. In retrospect, the delivery of goods such as the much-quoted German cars to the USA was made without compensation.

Figure 1: Germany's current account balance



Sources: KfW Research, Deutsche Bundesbank.

Trade surplus is widening

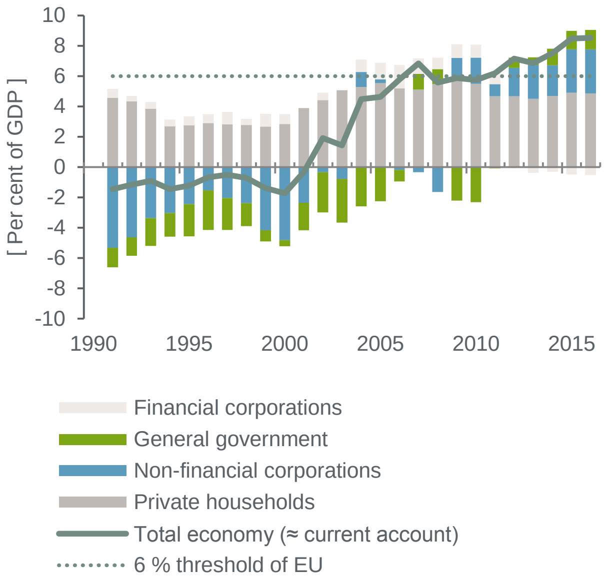
What do we learn from this? In order to provide an answer, it is important to systematically analyse the causes of the current account surplus. Seen through the eyes of the real economy, it was primarily (but not exclusively) the very fast rising trade surpluses between the years 2000 and 2007 that drove Germany's current account surplus to unprecedented levels (Figure 1). We basically see two historic developments operating here: the end of immediate reconstruction work in Germany's east and – subsequently – the rapid growth of the global economy. The colossal need for rebuilding eastern Germany's infrastructure and businesses' real capital stock had initially tied up so much monetary capital in an enlarged territory after unification that Germany temporarily even became a moderate net capital importer on balance, running a slight current account deficit up to 2001. At the end of the 1990s, the greatest needs were largely satisfied while the global economy was booming after the turn of the millennium. That boom was sustained by a very strong investment cycle in large emerging economies, particularly China, to build up internationally competitive capital stock. Sometimes referred to as 'the world's outfitter' specialising in high-quality capital goods, Germany was able to supply the necessary globally attractive products. Viewed from this angle, the growing surpluses since the turn of the millennium are also a reflection of Germany's competitive export sectors, especially manufacturers who succeeded in making the most of emerging business opportunities.

However, the trend towards declining deficits in cross-border service transactions and increasing surpluses in primary incomes also contributed to a growing positive current account balance. Excluding tourism, the services balances of most years since 2008 would actually have been slightly positive. Rising net primary incomes, which have been consistently positive since 2004 – and mainly composed of returns from monetary capital invested abroad – are an almost inevitable consequence of continuing net capital exports which are always associated with the current account surpluses and because of which Germany's foreign assets have grown year after year. Overall, the increase in the current account surplus by a cumulative 10.1 % of GDP between the years 2000 and 2016 can be broken down as follows: trade in goods 5.6 percentage points; primary income 2.3 percentage points; services 2.0 percentage points; secondary income 0.1 percentage points.

Households are saving more

Even from the financing perspective of the current account balance, pronounced shifts can be observed since the turn of the millennium (Figure 2). Private households have expanded their net savings, their net lending position increased by 2.0 percentage points overall from 2.9 % of GDP in 2000 to 4.9 % in 2016. It is generally correct for households to position themselves as net savers (with higher savings than net investments) because by forming assets, households defer consumption to the future and thus provide for old age.

Figure 2: Net savers and net investors



Sources: KfW Research, Destatis.

The increase in household savings during the analysis period is likely due, among other things, to the declining level of security provided by the statutory pay-as-you-go pension system and possibly also to falling interest rates, which make it necessary for households to increase their savings rate in the present in order to secure an intended fixed disbursements amount in the future. But with the cyclical boom, the net lending position is already falling slightly from the high level in the crisis year 2009 (5.9 %).

Businesses and the state swap sides

Much more striking in the long term analysis, however, is the savings and investment pattern of the government and enterprises ('non-financial corporations' in the terminology of national accounts). Traditionally, both sectors have been net investors, investing more than they themselves saved. In doing so, they created the economically sound possibility for private households to invest their surplus savings in domestic public and private real capital stock – arranged through the banking system (the 'monetary financial institutions' whose own net lending/net borrowing position is typically near the zero line). Already since 2009, businesses have consistently switched sides and become net savers, as has the government in recent years. Switching sides was attractive for the government for political reasons, and the change in the public financing balance has contributed a relatively moderate 1.7 percentage points to the increase in the current account surplus. If it readjusted its fiscal policy, the government would have only limited direct leverage to reduce the current account surplus – to the tune of around 1.3 % of GDP, composed of the difference between the current general government surplus in 2016 (0.8 % of GDP) and the EU's medium-term deficit objective of 0.5 % of GDP. Enterprises take the lion's share of the growing current account surplus: their net lending/net borrowing position has grown by 7.7 percentage points between 2000 (-4.8 % of GDP) and 2016 (2.9 % of GDP).

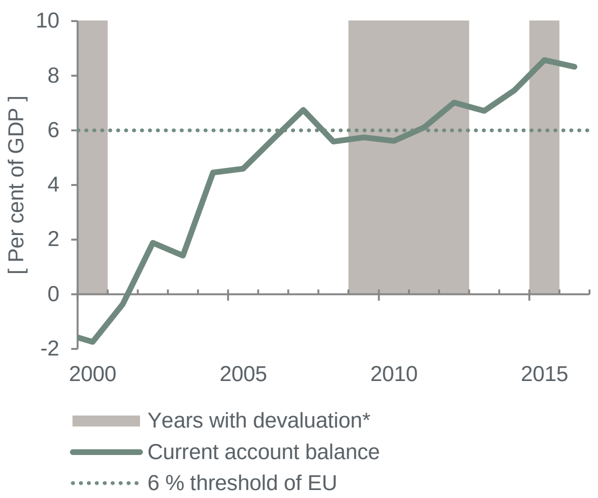
Reasons for enterprises' behaviour partly unclear

The reasons for enterprises' historically atypical enduring shift to the side of net savers, which is observable not just in Germany but in several other industrial countries, are not yet fully understood. However, a number of hypotheses have already been put forward. One explanation being offered is that enterprises have increased their equity ratio to be able to access debt capital at favourable terms once regulatory requirements in the financial sector increase, and to be more stable in a possible crisis. Seen in isolation, that would be economically just as unobjectionable as enterprises' tendency to step up direct investment abroad for the purpose of tapping into new markets or cross-border optimisation of value chains. From the perspective of a national economy, direct investment does not count as domestic fixed capital formation but as accumulation of monetary assets abroad – an activity that increases the savings of the corporate sector, as does bolstering its equity base. We recently commented in detail on the reasons for the simultaneous sharp drop in the corporate fixed investment ratio. In our view, the main drivers are the relative decline in the price of capital goods, shifts towards industries with characteristically lower investment ratios, the ageing of SME entrepreneurs, structural change towards a digital knowledge-based society (with investments in fixed assets becoming less important) and the highly uncertain economic policy environment in the past years, which made many companies reluctant to launch new projects despite the healthy state of the German economy.[6]

Exchange rate is not the prime driver

Finally, we need to clarify the role which macro-political measures in the three large areas of monetary, fiscal and wage policy have played in the emergence of Germany's current account surplus.

Figure 3: Current account balance and exchange rate



* Measured by the real effective exchange rate with 26 industrial countries (Bundesbank indicator).

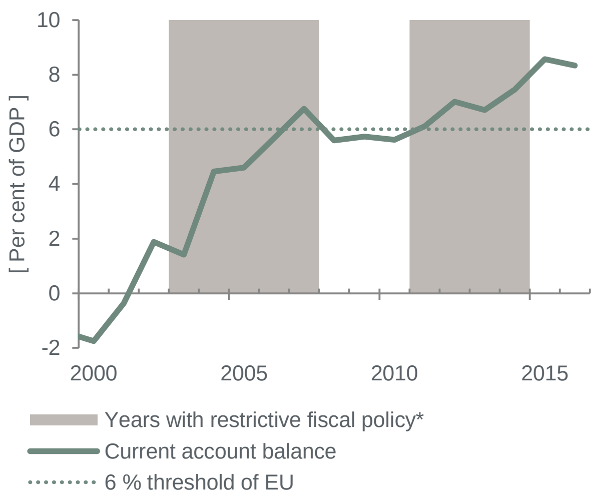
Sources: KfW Research, Deutsche Bundesbank.

First, monetary policy: there is rather little to support the proposition that the ECB policy, which is orientated to the average of the euro area, is too loose for Germany and has promoted the high surplus through currency devaluation. On the contrary – periods with strong increases in the current account surplus (2001 to 2007 and 2014 / 2015) coincided with revaluation trends that reduce the price competitiveness of German industry abroad and generally dampen any increase (Figure 3). At best, it might be argued that from Germany's perspective the revaluation would have had to be even stronger to make the current account more balanced. At least for the early period of 2001 to 2007, that argument is not convincing. With its below-average growth at the time, Germany was referred to as 'Europe's sick man' for whom the common European monetary policy, seen in isolation, was rather too restrictive than too loose. All in all, we interpret this finding as an indication that the exchange rate is not the dominant driver of Germany's current account balance. This is consistent with the fact that Germany has comparative advantages in the production of high-quality industrial and consumer goods for which quality is an important sales argument and which are therefore comparatively price insensitive.

Restrictive fiscal policy slows imports and investment

Clear parallels, on the other hand, are evident between the widening current account surplus and a restrictive fiscal policy course (Figure 4). This is to be expected, because if fiscal policy slows domestic demand, it tends to dampen imports at the same time and – through reduced sales expectations relative to existing capacity – investment, too. The positive news here is that German fiscal policy has shifted to a slightly expansionary course since 2015, so that no further upward pressure on the current account will come from this side for now.

Figure 4: Current account balance and fiscal policy



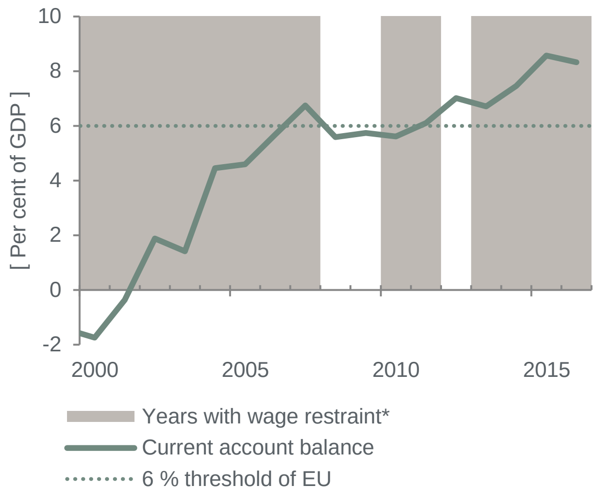
* Decline in the state's structural deficit or increase in structural surplus (IMF indicator) on the previous year.

Sources: KfW Research, IMF, Deutsche Bundesbank.

Relative wage restraint is continuing

Another conspicuous synchronicity can be observed between the development of the current account balance and wages. Years of wage restraint – defined as years in which hourly wage increases are insufficient to compensate the workforce for the growth in their labour productivity and the ECB's target inflation rate – are typically also years in which the current account balance rises (Figure 5). The main channels through which this operates are similar to those of a restrictive fiscal policy, as low wage momentum also dampens domestic demand. At the same time, wage restraint increases external competitiveness, which can definitely be necessary for a certain period of time – as was the case in Germany until long after the turn of the millennium. What is striking, however, is that wage restraint so defined is continuing despite the stable and healthy economy. In other words, the respectable increases in nominal and real wages in the past years do not yet conflict with the ECB's target inflation rate.

Figure 5: Current account balance and wages



* Increase in unit labour costs (hourly basis) is lower than the ECB's target inflation rate (operationalised as 1.9 % per year).

Sources: KfW Research, Destatis, Deutsche Bundesbank.

Maximum has been exceeded, correction must pick up

What conclusion, then, can be drawn from this overall finding? The current account balance is exposed to complex influences, it displays the strengths and weaknesses of an economy like a magnifying glass. There is not 'one' cause and, consequently, not 'the' solution for rectifying the external imbalance. We may be very cautiously optimistic that the peak of the German current account surplus is now behind us. Signs of this are the end of the investment-driven boom in the emerging economies, the return of falling household savings rates and the end of Germany's restrictive fiscal policy since 2015. Moreover, the outstanding labour market situation – with all-time high employment and an unemployment rate that has constantly been testing new lows for unified Germany – is pointing to more dynamic wage development in the future. And indeed: the current account surplus already dropped slightly to 8.3 % of GDP in 2016 from its all-time high of 8.6 % in 2015. In its World Economic Outlook of April 2017, the IMF expects it to keep falling moderately to 7.4 % of GDP by 2022.[7] If the normalisation trend continues at such a slow pace, however, Germany would remain in the spotlight for its high surplus for a long time – and that is dangerous. After all, the therapy proposed under Trump's mercantilistic paradigm of artificially restricting German exports through tariffs and other trade barriers would be very inefficient and costly.

With inverted signs

The ideal solution for reducing the current account surplus is definitely a significant increase in fixed investment. Spending priorities should be education, housing, transport, energy, fast internet, research and development as well as innovations. The recent moves by public authorities and private enterprises to increase capital formation are pointing in the right direction and need to be strengthened. It would be helpful if European member states could further reduce the long and very high political uncertainty by pursuing a convincing future strategy for the EU project and stand together in the Brexit negotiations. Tax cuts should also be discussed. Lower value added tax may strengthen private consumption, accelerated write-downs and tax benefits for research and development would ease pressure on businesses and set incentives for fixed investment. There is generally sufficient budgetary scope for tax relief and higher public investment. The EU rules permit a structural budget deficit of 0.5 % of GDP, of which the German Basic Law permits 0.35 % at federal level. Furthermore, the social partners are likely to soon explore the scope for higher wage increases. These are all measures that have helped to reduce external imbalances in southern Europe, for example – there, however, with inverted signs. ■

[1] See European Commission (2017), Empfehlung für eine Empfehlung des Rates zum nationalen Reformprogramm Deutschlands 2017 mit einer Stellungnahme des Rates zum Stabilitätsprogramm Deutschlands 2017 (Recommendation for a Council recommendation on Germany's 2017 national reform programme with a commentary from the Council on Germany's 2017 Stability Programme - in German), Brussels, 22 May 2017 (https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations_-_germany-de.pdf).

[2] See IMF (2017), Germany: Staff Concluding Statement of the 2017 Article IV Mission, May 15, 2017 (http://www.imf.org/en/News/Articles/2017/05/15/mcs05152017-Germany-Staff-Concluding-Statement-of-the-2017-Article-IV-Mission).

[3] See Diekmann, K., Gove, M. and Biskup D. (2017), Was an mir deutsch ist? – Ich mag Ordnung! (*What is typically German about me? – I like order!*), Interview with Donald Trump, Bild-Zeitung, edition 16 January 2017, pages 2–3.

[4] For more on this see Borger, K. (2016), 'Germany's demographic trap: integrating refugees is only part of the solution', KfW Research, Fokus on Economics No. 124, April 2016.

[5] The balance of payments item 'balance of statistically unclassifiable transactions' makes these transparent. The relationships described here in a slightly simplified fashion omit the balance on the capital account, which captures one-time asset transfers made without compensation between the domestic economy and other countries that do not directly alter income or consumption (such as debt cancellations, for example). In Germany these are almost negligible in quantitative terms. Thus, in 2016 the balance on the capital account was only a good EUR 1 billion, for example, or a mere 0.4% of the current account balance.

[6] For details see Borger, K. (2017), Business investment: waiting for Godot?, KfW Research, Focus on Economics No. 168, April 2017.

[7] See World Economic Outlook Database April 2017 (http://www.imf.org/external/pubs/ft/weo/2017/01/weodata/index.aspx).