On German external imbalances

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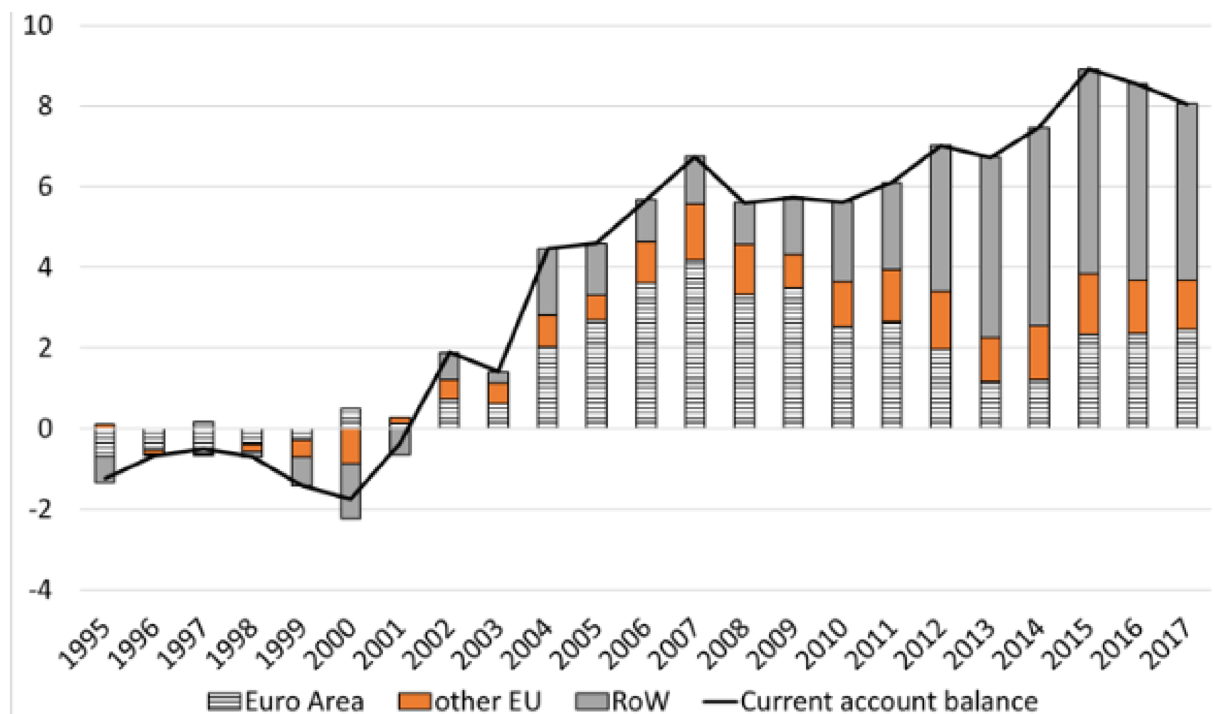
Germany's current account surplus is among the largest in the world. In this post, Stefano Micossi, Alexandra D’Onofrio and Fabrizia Peirce identify four features of the German economy that are at the root of its external imbalances, and which may indicate that a substantial correction of those imbalances is hardly in sight.

When the euro was introduced in 1999, Germany had a current deficit in its balance of payments amounting to about 1.4% of GDP; in 2016 that balance had improved by some 10 percentage points of GDP, reaching a surplus of 8.5% of GDP and hovering just below 8% in the ensuing two years. In absolute terms, this surplus in the current accounts is the largest in the entire world. When the financial crisis in 2008-09 forced Germany’s partners in the euro area to adjust their deficits, the German surplus was in large part shifted onto the rest of the world (Figure 1), generating a euro area overall surplus of some 3.2% of aggregate GDP.

In a recent paper (Micossi et al. 2018), we identify four features of the German economy at the root of its external imbalances, which may indicate that a substantial correction of those imbalances is barely in sight: the evolution of its real exchange rate; the underlying

trends in productivity and unit labour costs; the persistent shortfall of investment relative to domestic savings; and the deployment of much of the current external surplus in portfolio investments outside the euro area.

Figure 1 German current account, by partner (% of GDP)



Source: Deutsche Bundesbank and Ameco

The German real exchange rate and current external accounts

Figure 2 shows the evolution of the German real exchange rate and current external balance since the 1960s. The real exchange rate is calculated as a weighted average of bilateral nominal exchange rates with 27 trading partners deflated by corresponding relative consumer price indices. The index is calculated by setting 1971=100.

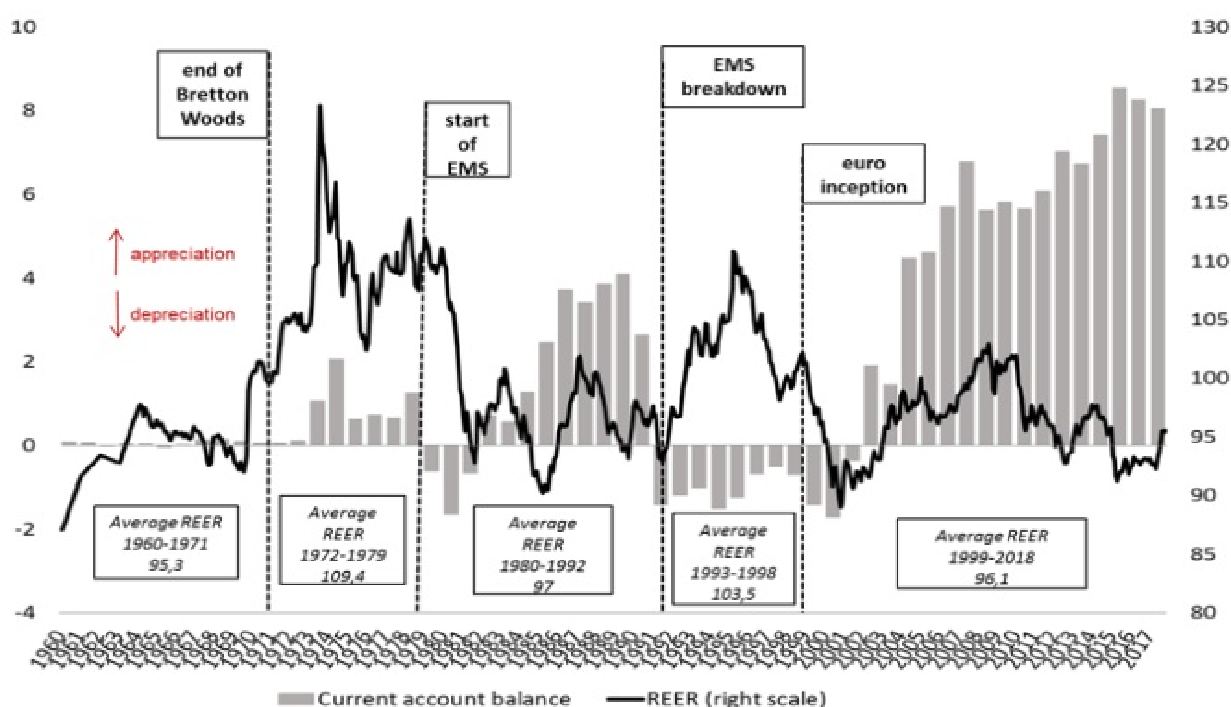
Three main facts stand out.

- The first fact is that nominal exchange rate changes did lead to persistent real exchange rate changes, and that the German current account balance seemingly responded to real exchange rate variations, with appreciations above the 1971 value corresponding to reduced surpluses or, occasionally, even to deficits, and depreciations below that value coinciding with rising surpluses.
- The second fact is that the current external payments position of Germany is strong during periods of fixed exchange rates vis-à-vis its European partners, while its external surpluses recede when the Deutsche Mark is floating against all currencies.
- The third fact is that the German current account of the balance of payments since the 1960s has shown a surplus most of the time, but this surplus has run completely out of proportion since the euro inception.

Germany constantly resisted Deutsche Mark revaluations under fixed exchange rates arrangements – Bretton Woods in the 1960s, the EMS in the 1980s and early 1990s, and the euro since 1999 – arguing that it could not take action that would purportedly weaken the international competitiveness of its industry. There is, however, a fundamental difference between previous adjustable peg regimes and the euro area. Within the former arrangements strong pressure to revalue the Deutsche Mark was generated by international capital inflows, which could not be indefinitely sterilised and put pressure on domestic monetary growth, until eventually the Deutsche Mark parity was changed.

When, after 1987, EMS partners decided to remove the possibility of exchange rate realignments, persistent inflation and productivity divergences between participating states led to the breakdown of the system in 1993, under irresistible speculative pressures. This experience played an important role in convincing future participants in the euro area that adjustable pegs were unstable, leading to the decision to fix mutual exchange rates irrevocably. Thus, albeit with delay, as long as exchange rates could be realigned, international capital flows worked to establish some symmetry in external adjustment obligations between surplus and deficit countries. No such mechanism has been at work within the euro area, where domestic liquidity creation is under the control of an independent central bank. The evidence that has been presented so far already highlights some solid justifications for Germany's 'revealed preference' for fixed exchange rates, and indeed for currency union, with its European trading partners.

Figure 2 Real effective exchange rates of Germany and current account balance (% of GDP, 1971=100)



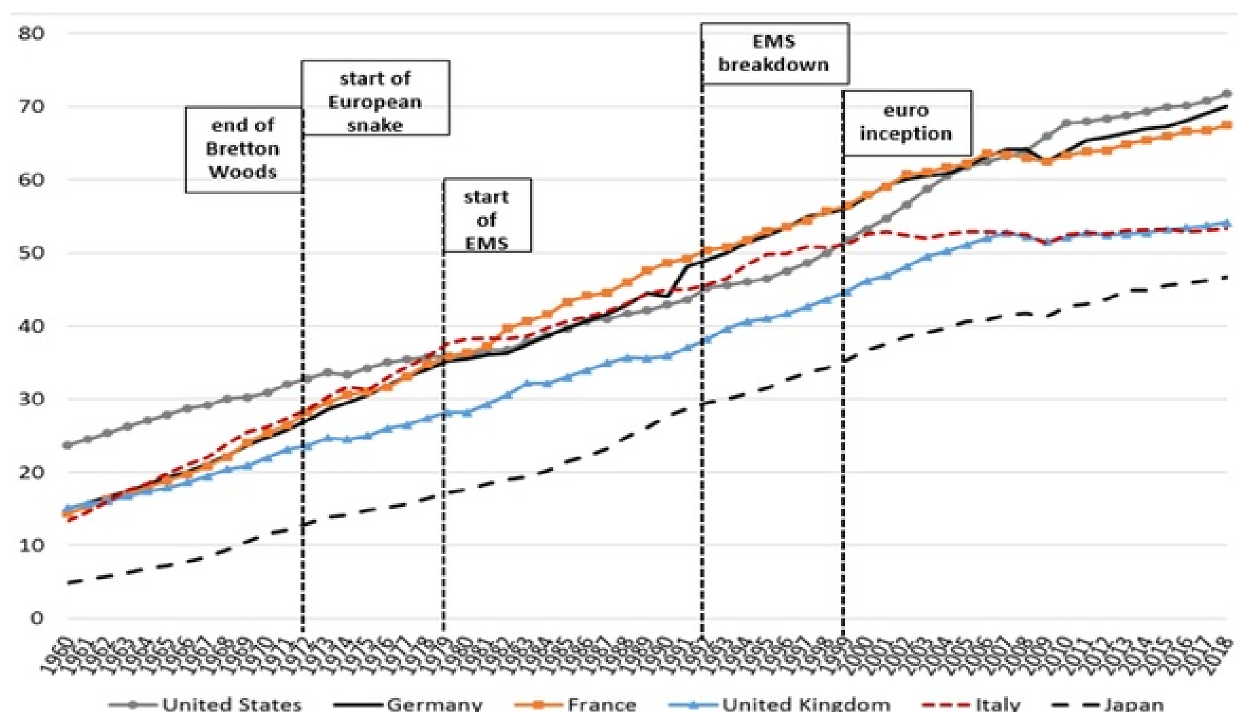
Source: BIS and European Commission; data for current account balance before 1971 from OECD; data for REER before 1964 from Bruegel.
Notes: REER is calculated as geometric weighted averages of bilateral exchange rates towards 27 trading partners worldwide adjusted by relative consumer prices.

Real wages and productivity

Figure 3 presents the long-term evolution of the levels of real labour productivity per hour in some industrial countries. As can be seen, Germany, France, and Italy were moving in concert and gaining ground against the US since the 1960s up until the early 1990s, with France, and in earlier years also Italy, sometimes outperforming Germany. The UK was generally lagging behind, despite the acceleration that followed the Thatcher years. After the mid-1990s, however, the pattern changed, with the US charging ahead and rising above the level of other countries, and Germany picking up speed to pull ahead of its European partners. While France lost little ground relative to Germany, Italy entered a period of stagnating productivity and descended to UK levels. Similar gains for Germany were observed relative to other euro area partners.

Widening productivity differentials with euro area and EU partners is only half of the story; the other half is a distinct deceleration of wages that allowed Germany to lower unit labour costs much more than all its European partners as well as the US. Germany's relative gain came in two waves: the first in the second half of the 1990s, the second in 2004-07 (i.e. after the Hartz reforms). Various factors were at work in the remarkable deceleration of wages since 1995 (Dustmann et al. 2014 , Carlin and Soskice 2009 , *The Economist* 2017). A major role was played by the decentralization of wage setting (also including hours and other aspects of working conditions) that took place in the second half of the 1990s whereby most wage contracts came progressively to be decided at company level. The success of this strategy cannot be fully understood without considering two further components of the policy set-up: the anti-inflationary policy of the Bundesbank and, later, of the ECB and disciplined budgetary policies (Iversen et al. 2016). Wage moderation in Germany has ensured that real productivity increases normally exceeded wage increases.

Figure 3 Real labour productivity per hour



Source: Conference Board.
Note: data are expressed in 2017 US$ (converted to 2017 price level with updated 2011 PPPs).

Savings, investment, and domestic demand

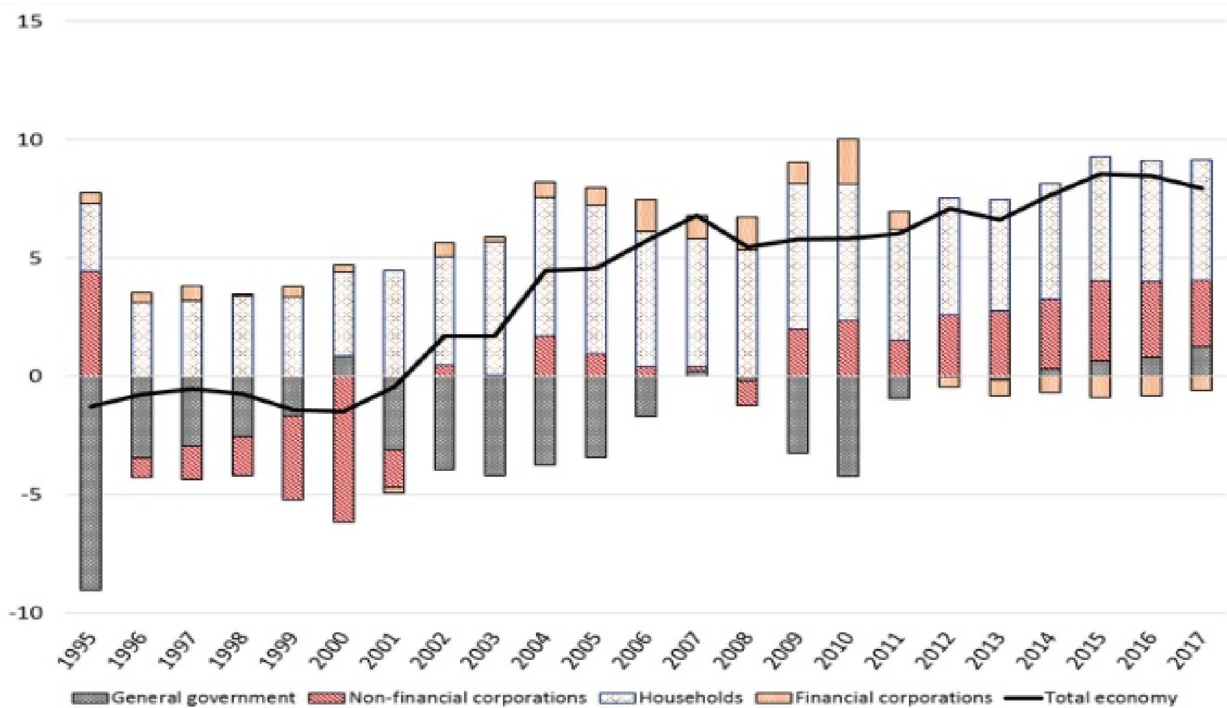
The current external account reflects a domestic imbalance between savings and investment. Figure 4 shows the sectoral net savings balances since the second half of the 1990s, together with the resulting evolution of the current external balance. In the early- and mid-1990s, Germany had a current external deficit, mainly resulting from a sizeable public sector deficit, which was due in turn to the costs of unification. Later in the decade, as the public sector deficit was receding, the corporate sector went into sizeable indebtedness to meet deteriorating profitability and rising costs. Since the inception of the euro, the large improvement in the current external balance is mainly due to increasing net savings by the corporate sector and the public sector. There is no evidence of a significant role for household savings.

The shift from a net debtor to a net creditor position of the public sector is of course due to discretionary policy decisions: while up until the 2008-09 financial crisis the public sector continued to provide support to domestic demand, in the ensuing years the priority shifted to reducing the public sector deficit to bring down the government debt. This improvement was achieved precisely in those years when the euro area was falling steeply into recession, aggravating the aggregate fall in demand and activity. Higher public and private investment would be highly beneficial to address a dearth of productive capital and badly needed infrastructures. And indeed, an important feature in the evolving net savings position is the rather dramatic fall in investment rates, amounting since the euro inception to about 2.2 percentage points of GDP.

Figure 5 may help bring some light to this matter. It shows, for each of six sub-periods dating back to the 1960s, the average yearly increase in real labour productivity, real labour compensation per hour, and domestic demand. As can be seen, in the earlier sub-periods real compensation per hour exceeded productivity increases while subsequently it always fell short of them up until the 2008-09 financial crisis. The proportionate gap between productivity increases and real labour compensation widens in 1999-08, which are the years of maximum wage restraint.

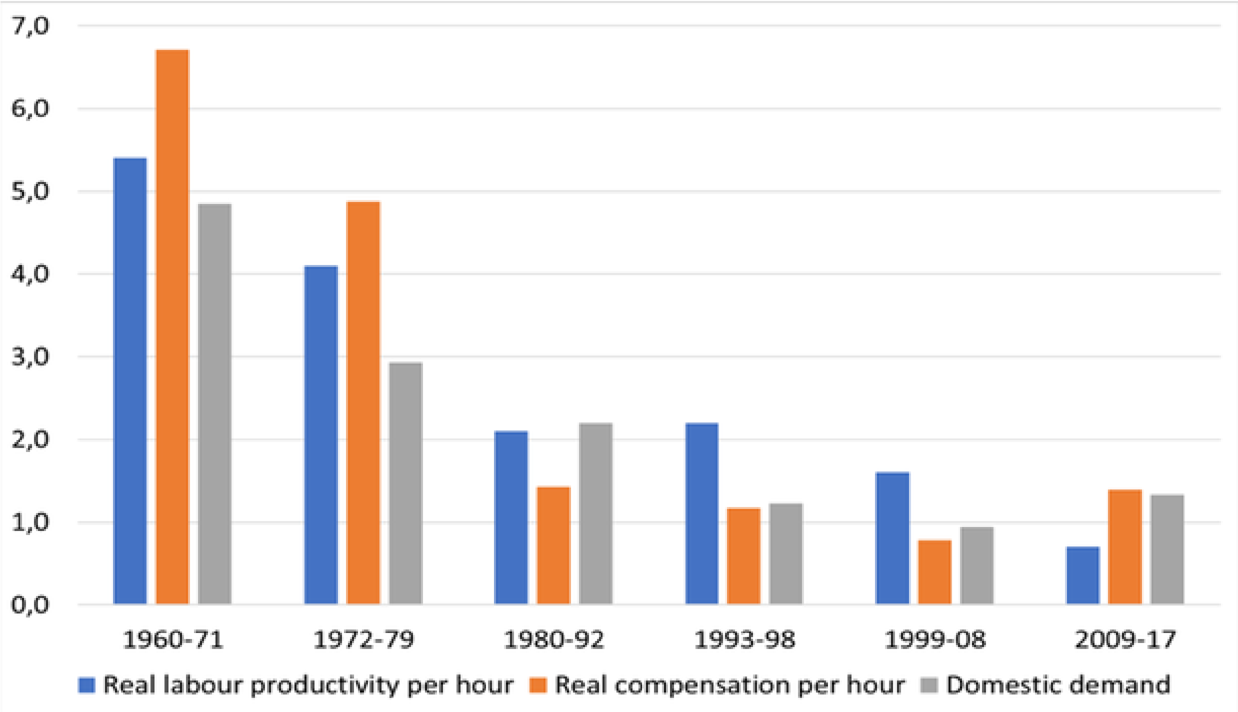
In 2009-17 productivity slowed below hourly compensation, reflecting the sharp fall of productivity in 2009 and its subsequent slow growth, while wage growth was recovering thanks to diminishing slack in the labour market. The waning productivity margins relative to labour compensation have likely increased pressure on the corporate sector to raise investment. This may confirm that wage restraint and high slack in the labour market have contributed to depressing private investment. Another interesting finding in Figure 5 is that the rate of growth of real domestic demand in the euro years appears strictly aligned to the rate of increase of labour compensation. This is not surprising, in an environment in which the public sector was increasingly retrenching and private investment was stagnating. However, it calls attention to the importance of wage developments in moderating the increase in domestic demand, thus leaving room for the expanding export sector. As shown in Micossi (2016), in euro countries where the relative prices of tradables continued to move in favour of Germany, low growth of wages and domestic demand in Germany has constrained wages and domestic demand growth in euro partner countries.

Figure 4 German net lending/net borrowing by sector (% of GDP)



Source: authors elaboration based on Eurostat and Deutsche Bundesbank data

Figure 5 German Domestic demand, labour productivity and real compensation per hour (average annual growth in periods)



Source: Ameco

Financial counterparts to external surpluses

In the early euro years, swelling imbalances between participating countries were financed mostly by intra-euro area capital flows through the purchase of government and financial institution securities, including by private investors and cross-border interbank lending (Chen et al. 2013), with a substantial involvement of German financial institutions. During the euro debt crisis in 2010-13, private cross-border financing collapsed and imbalances

were curtailed; much of what was left was financed through the ECB by means of extraordinary lending operations and Target2 balances (Micossi 2015). Afterwards, the tune changed. Germany's outward financial flows were dominated by net portfolio investments, which have come to represent close to 75% of the total. The growing net balance mostly reflects the decline of foreign portfolio investment in Germany, basically owing to sharply diminishing and even negative returns on German bonds (including notably the government Bunds, that during the great financial crisis of 2008-09 became a major haven for international investors).

The second, and related, feature in recent developments concerns the Target2 balances of the Bundesbank vis-à-vis the ECB, which has risen again to over €900 billion. Changes in these balances are recorded in the balance of payments under other investments; when a foreign investor sells German bonds and places the proceeds as a deposit with a German bank, these balances increase. Consequently, the net impact on the overall balance is small since any increase in Target balances, which is recorded as a capital outflow, corresponds to a parallel increase in the foreign liabilities of the banking system, which is recorded as a capital inflow (Busse and Gros 2017). As pointed out by De Grauwe et al. (2017), rising Target2 balances reflect to a significant extent the fact that the liquidity released by the ECB purchases of peripheral countries' government bonds is being used to acquire euro assets in Germany (or at least in the core countries). Thus, the risk of a sovereign crisis in a peripheral country that private investors are unwilling to bear is shifted onto the national central banks within the European System of Central Banks (ESCB); this is a clear indicator of persisting market fragmentation and the incomplete capital markets union.

The capital accumulated by Germany owing to its external surpluses does not contribute to reducing the risks of instability or currency redenomination that are still present in the euro area (Micossi 2017, ECB 2016), and neither does it contribute to raising the real investment rate within the euro area.

Conclusions

The euro has allowed Germany to maintain a strong competitive position for its exports within the euro area and has helped moderate the appreciation of its exchange rate vis-à-vis the main third-country currencies. Adjustment efforts by peripheral countries in the euro area have not dented the real depreciation of German tradables within the area. Moreover, the currency union has eliminated much of the pressure on Germany to adjust its gigantic external surplus, since capital inflows no longer affect its monetary base creation; the main cost has been low and even negative interest rates resulting from strong capital inflows, which have generated some strains on its banking and financial system. In sum, Germany has exploited the euro to transform its economy into a highly efficient export machine – with exports doubling their share of GDP since the inception of the euro – but this result has been achieved by squeezing the standard of living of workers at home and in its partner countries. This has contributed to weakening the political support for the euro amongst its members, while the risk is rising of a protectionist backlash from the major trading partners beyond the euro area.