FROM BRUSSELS TO BERLIN: A CRITICAL LOOK AT GERMAN CURRENT ACCOUNT SURPLUSES

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1. The initial question: Unusually high German current account surpluses—good or bad for whom?

German foreign trade is accustomed to success. For around fifty years, the German external trade balance has consistently shown a positive result. With very few exceptions, following German reunification, the trade in goods with foreign countries has only known surpluses. Meanwhile, the surplus, amounting to more than 8% in relation to the gross domestic product for 2016, has reached an unusually high level, even by German standards.

The constantly increasing German current account surpluses have engendered a controversial discussion on the effects of current account imbalances, which in turn is nothing new. In the last few years before the outbreak of the financial and economic crisis of 2008/09, for instance, the debate was focused mainly on the US current account deficits and China's high surpluses. However, the debate has recently intensified, especially with regard to the German role in securing stability and growth within the common euro area on the one hand, but also with regard to the German role in tandem with the most important industrialized nations.

Critics maintain that Germany has unreasonably high current account surpluses. A generally considered acceptable bandwidth would be between 2.5% and a maximum of 5%. The maximum for Germany is thus considered to be around 4.5%. This prompted the EU Commission to open a review procedure against Germany in November 2013. It was said that Germany, with its excessive current account surpluses, makes it more difficult for other European countries to reduce their deficits, thus jeopardizing the stability of the eurozone.

The discussion surrounding 'current account imbalances' raises two fundamental questions: first, there is no universally recognized agreement on what should constitute an excessive current account surplus or deficit and, second, in economic science, opinion is divided on the effects a country's current account surplus can exert on its trading partners.

Supporters of the 'savings-glut' hypothesis postulate that a country's current account surplus translates into savings for other countries, which lead to lower interest rates and make additional investments possible—but which also lead to excessive lending.

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Others argue that the German current account surplus may be attributed to insufficient domestic demand for imports vis-à-vis exports. As a result, the macroeconomic development in other countries will be constrained. Hence, economic policy must take corrective action. Germany has to reduce its surpluses if it does not want to jeopardize European cohesion and the accustomed world economic order with the US as the dominant nation.

On the other hand, perception inside Germany itself has an unequivocal, albeit completely different, take on the situation. Put bluntly, this boils down to the following arguments: the Germans have disciplined markets and superior products; they are also industrious and modest when it comes to consumption and spending their money. In short: it's hardly their fault that they are so successful. If other countries want to succeed, they must follow their example.

What, then, is the real answer to high surpluses and the heated debate over the attribution of responsibility that results? Is the dispute merely guided by envy and as such to be referred to social psychologists? Or does it present a real threat to the stability of an entire economic area?

2. Current account balances: The financial side and the real economy side

Current account balances show a financial side, which represents the balance mechanics of the national accounts. Domestic macroeconomic balances therefore generate corresponding current account balances in the case of ex-post differences between savings and investments. Surpluses are then reflected in savings overhangs vis-à-vis net investment. This gives rise to a supposition: namely, current account surpluses are a reflex to a structural savings surplus—possibly even a phenomenon of mature economies.

A current account surplus is thus matched by an equally large macroeconomic financial balance, which means that total domestic savings (S) exceed total domestic investment (I). At the same time, a current account surplus, taking into account the balance of capital transfers vis-à-vis other countries, can be regarded as an increase in the net financial assets of the German economy. Domestic savings therefore flow either into domestic investment or into changes in net financial assets, i.e. changes in net receivables vis-à-vis the rest of the world. Owing to this relationship, the current account balance is alternatively referred to in the literature as the net outflow of an economy. When looking for sources for the rise in the financial result, the corporate sector in particular stands out: it has had a financial surplus for more than ten years. This is rather unusual, in that the corporate sector is commonly considered to be a net debtor in an economy. In the context of circulation theory, financial deficits in the corporate sector thus normally find their equivalent in corresponding financial surpluses of private households. Financial surpluses in the corporate sector amount to retained earnings as a reflex to high export demand with simultaneous wage restraint in the years since the introduction of monetary union. It is from this that investments are financed.

If it is really the case that a savings glut is an expression of a mature economy, current account surpluses should not be solely a German issue, but a common problem of developed economies. That would considerably qualify the thesis that there is a lack of investment in Germany. It would thus not equate to a location weakness, but rather a to secular phenomenon of over-saving.

The other side of current account surpluses, the real economy, has its historical roots in Germany's economic resurgence after the Second World War. It was Germany's systematic embedding in the international division of labour that initially set the course for an export orientation in the area of high-quality consumer products—but, in turn, also for investment in capital goods. Should Germany really now be blamed for these historically rooted strengths? It surely cannot be blamed for partaking of the blessings created by the international division of labour. But it may well be accused jeopardizing the stability of the international economic community, especially within the euro area. What could be a possible catalogue of measures capable of stemming the historic trend of economizing and investing in a mature economy look like? Proposals to introduce a brake on the current account seem to offer a fruitful approach.

3. The shared destiny of debtor and creditor

Since the beginning of monetary union, Germany has been among the creditor nations; not just within the European Union, but also the major players in the global economy, notably the US and Asia. However, being a creditor involves considerable risks. Deficits, provided that the debt cannot be serviced from currency reserves, presuppose the willingness of lenders to finance them. With the outbreak of global financial crisis in 2008, borrowers were deprived of access to international capital markets, cutting them off from sources for funding their current account deficits. In such a situation, insolvency threatens. Even the US had to resort to borrowing to finance its deficits.

For its part, Germany was more strongly dependent on the development of the world economy than it would have liked. During the financial crisis, it experienced a significant blow to its exports. Germany had to face up to the painful fact that as a surplus country it depends on the solvency of its debtors. The German banking crisis was characterized above all by the bad debts owed by US mortgage banks. The upshot was that the taxpayers had to bail out the German banking system, which before the crisis had been engaged in crisis countries like Greece as a lender. Debtors and creditors are in the same boat.

When debtors and creditors in the global markets are bound together in a common destiny, what stance should a surplus economy like Germany adopt in the strategic debate on current account surpluses? Specifically: What should a surplus economy take responsibility for—and what not? What could be the goal of a responsible policy for managing current account balances? And, finally, which policy variables are available?

While it seems obvious that a debate on current account balances should not be directed against the market, at the same time it is clear that there must be rules to govern the institutional design of market activity and its consequences. First and foremost, in the absence of exchange rate adjustments via floating currencies within a common euro area, there must be an institutional framework for the regulation of external imbalances. Although a common exchange rate may be considered to contribute towards establishing foreign trade equilibrium, it has in fact led to a consolidation of existing imbalances. Germany has coped well with the increase in the euro exchange rate against the dollar, but not the southern eurozone countries.

The German current account surplus, together with the bail-out policy, was largely responsible for the euro more or less maintaining its exchange rate value during the financial crisis. The decline in current account deficits in the crisis countries of the eurozone that has meanwhile occurred is more due to a cyclical reduction in imports rather than to regained competitiveness. The heterogeneity of the member states has impaired the functioning of the euro exchange rate as a balancing instrument.

A regulatory mechanism for the economic strength of the individual member states, similar to that of the fiscal equalization scheme operated by the German *Länder*, is thus on the political agenda. More than had been expected, surplus and deficit countries are fatefully linked. More than ever before, it is less a matter of creditor protection than debtor protection; creditors must be interested in the long-term solvency of their debtors if they are not to risk losses on their foreign receivables.

It's also about the political costs of permanent imbalances. The financial crisis reveals the vicious circle of macroeconomic crisis, sovereign debt, and banking crisis. These are the breeding grounds for trade wars and economic isolationism—and thus for the potential collapse of a whole economic area. Trade on the basis of comparative cost advantages can only function successfully by creating a net welfare effect for all the participating economies. The international division of labour must be worthwhile for everyone, or it will not be sustainable.

4. A possible catalogue of measures to regulate current account surpluses

If we assume that the deeper cause not only of the German (!) current account surpluses can be attributed to the cyclical gap between S and I in the sense of S> I, then the following question must be answered: How can savings be reduced and how can investments be increased?

At first glance, monetary policy seems to play a strategic role in raising real interest rates. Whether it can bring about a reduction in savings, though, given that the currently prevailing real interest rates are at zero and savings exceed net investment, appears most improbable.

Of course, other policy measures are also conceivable, be they in the form of increased taxes on income and wealth in order to curb savings, or restrictions on saving for the future through a change in pension policy such as a later pensionable age—pensioners save less than employed persons—or possibly even the contrary: earlier retirement leads to a reduction in net savings as result of drawing on pension rights.

With regard to investments, the classic instruments come to mind, such as subsidies or tax relief on real capital formation, e.g. in the field of renewable energies, or public infrastructure investments in the field of education, transport, or communication technology.

5. Putting the brakes on the current account

Reducing the current account surplus over the course of macroeconomic financial accounting correspondingly entails the acceptance of budget deficits, and consequently government debt.

What does Germany stand to gain from putting the brakes on its current account surpluses? Germany has a genuinely strong interest in the continued existence of the eurozone. Bringing about a reduction in current account surpluses could prevent the breakup of the euro area. Under the conditions of prescribed austerity, surplus countries appear too strong and other countries see themselves as too weak in the common market. Centrifugal forces both in the strong as well as the weak economies could push for exit—the strong ones for fear of a transfer union, the weaker ones for fear of economic hegemony on the part of Germany.

When it actually comes to reducing the current account surplus, there is much to be said for expanding much needed public spending, especially for long-term infrastructure investments. Neglected schools and the poor state of roads and bridges send a clear message for urgent action. The same applies to public digitalization projects in order to make Germany fit for the age of ‘Industry 4.0’.