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Criticism of Germany's CA surpluses largely unfounded

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International criticism of Germany's current account (CA) surpluses has reached new heights. The German surplus, together with the Chinese surplus, is seen to be contributing to the massive global imbalances that have characterised recent global financial and economic developments. It is our view that most of these assertions may be politically motivated and are without intellectual merit. The discussion of whether surplus or deficit countries should adjust is invalid in a globalised world in which the vast majority of economies are market-based.

There is no evidence of unfair competitive advantage. Wages, for instance, have been growing roughly in line with productivity. True, wage growth was suppressed in the early 2000s to correct the post-unification excess. But, by the mid-2000s, Germany's competitiveness was primarily boosted by unsustainable wage growth elsewhere. Moreover, the euro is neither artificially low nor manipulated. While a deutschemark would probably trade higher, this is part and parcel of belonging to a monetary union, which is incidentally creating costs to the German economy e.g., currently via the ESM.

Imports are not particularly low. On the contrary, with an import share of 46% Germany is much more open than, for example, France (30%). Germany's import elasticity of 2.5 is one of the highest among developed economies.

Germany is not preventing peripheral adjustment in Europe nor would a policy-induced demand push be of much help. In fact, Germany's CA surplus with EMU has dropped to 2.2% of GDP from 4.4% in 2007. The unchanged total surplus can be traced to gains elsewhere. Even a stimulus that would boost German GDP by 1 percentage point (counterproductive for Germany on cyclical and debt sustainability grounds) would improve peripheral countries' current account positions by 0.1% of GDP at best.

One serious argument is that domestic demand was indeed weak between 2001 and 2005. Since then, however, private consumption has grown in line with productivity. The weakness in investment is lingering, but to a large extent this can be ascribed to the slack generated by the crisis. True, there is now pent-up demand for infrastructure investment after years of constrained public spending, but we do not think this capacity gap should be overstated. Finally, weakening demographics are hardly conducive to strong domestic demand.

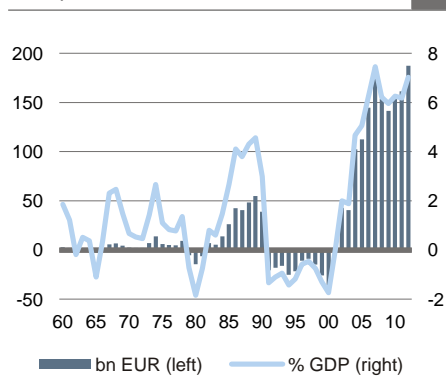
Another popular criticism highlights the inefficiency of Germany's foreign investment. It is true that Germany's capital exports have suffered valuation losses of EUR 450 bn. However, these losses, which mainly hit portfolio investments, were in line with benchmarks (MSCI World Index and US 10Y yields) and were in any case not a German idiosyncrasy. Greater losses as a percentage of GDP were seen in France, for instance.

Rather than focusing on how to shrink the German surplus, the issue lies with how to recycle these surpluses in a beneficial way for the EMU periphery. More German FDI would raise the productivity there and offset part of their investment weakness; all things in the interest of the broader European economy.



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German current account in most years in surplus



Sources: Deutsche Bundesbank, Federal Statistical Office

The criticism of Germany's current account surpluses, or how to make the buck stop in Germany

International criticism of Germany's current account surpluses recently reached new heights. The US Treasury's and the IMF's complaints were followed by an avalanche of op-eds from Keynesian (mainly Anglo-American) commentators. The EU has even started an investigation under its new macroeconomic imbalances framework.

Criticism alternately zeroes in on the current account (CuA) surpluses and the deficits in the capital account (CaA) resulting from large capital exports. Both are parts of the balance of payments, with the principles of double-entry book-keeping requiring that ex-post the surplus of the former has to be matched by a deficit in the latter (when the central bank's foreign exchange account is disregarded).

$$\text{CuA} + \text{CaA} = 0$$

CuA surpluses are the only way an economy as a whole can generate savings beyond domestic investment:

$$\text{CuA} = \text{S} - \text{I},$$

which obviously have to be invested abroad via capital exports. Although it is impossible on logical grounds to derive directions of causality from accounting identities, it is frequently done nonetheless – even to the extent that German capital exports are said to be “forcing” the target countries into excessive consumption.

Current account imbalances between two countries are a normal phenomenon in open economies. They may be due to cyclical (diverging income trends) or more structural factors, the (non-)availability of certain goods (oil), differing stages of economic development and/or demographic factors.

In the following, we analyse the main arguments frequently brought forward by the critics. Although these are intertwined given the accounting identity, we will first deal with those related to the current account and then with those dealing with the capital account. We find that – from an admittedly German perspective – most arguments do not hold on economic grounds. Rather, they seem to be motivated by attempts to put the adjustment costs for intra-EMU and, to a certain extent, global rebalancing on Germany's shoulders.

But let us first have a look at the facts:

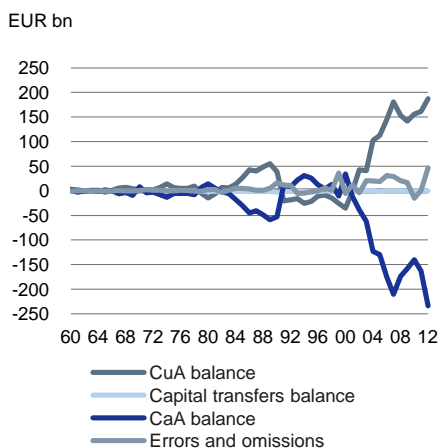
Fact 1: At 7% of GDP or EUR 187 bn Germany had one of the largest current account surpluses in the world in 2012. In 2013 a similar surplus is expected. Among the industrialised countries only Switzerland (11%), oil-exporting Norway (14%) and the Netherlands (10%) have larger surpluses.

Fact 2: The CuA surplus in 2012 was largely due to a trade surplus equal to 7.1% of GDP.

Fact 3: The CuA surpluses are matched by (roughly) equal deficits in the financial account, making Germany a large international creditor. Over time Germany has accumulated net assets abroad totalling EUR 1.2 tr, or around 44% of GDP in Q2 2013. Among comparable advanced economies only Japan (2012: 57%) and the Netherlands (55%) surpass that.

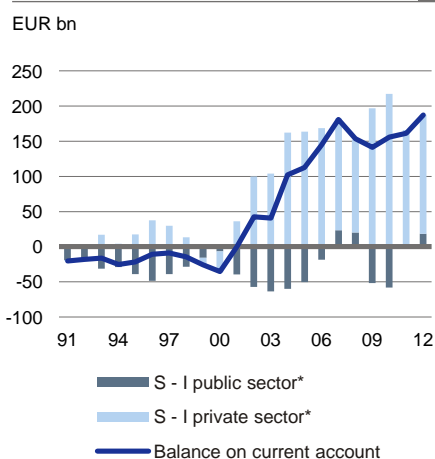
Fact 4: The German CuA surpluses have become more diversified. A break-down of the 2012 surplus shows that EMU accounted for 31%, the US for 19%, non-China Asia for 15% and non-EMU Europe and other Americas for 12%

Balance of payment by components



Source: Deutsche Bundesbank

Germany: Private and public sector financial balances & CA



*) Savings minus investment

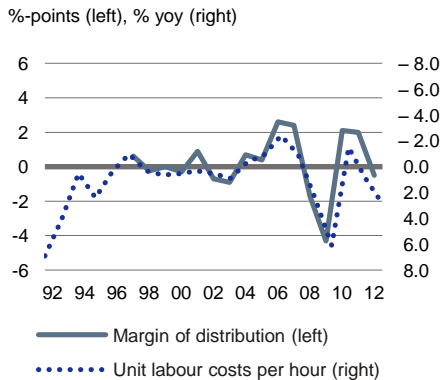
Sources: Federal Statistical Office, Deutsche Bank Research



Criticism of Germany's CA surpluses largely unfounded

Wage growth has been roughly in-line with productivity and inflation

4



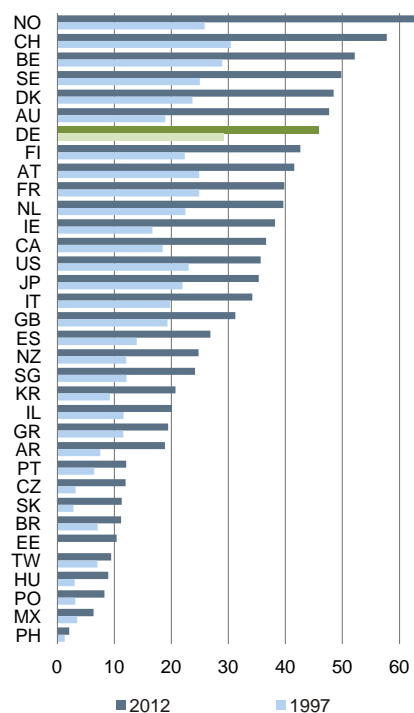
Margin of distribution (-) exhausted (+) not exhausted;
(Change of marginal labour productivity adjusted for
employment changes + GDP-deflator) - agreed wages per
hour

Sources: SVR, Federal Statistical Office

Hourly compensation costs

5

USD, August 2013

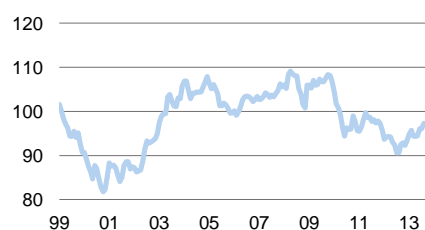


Source: U.S. Bureau of Labor Statistics

EUR: Real effective exchange rate

6

Vis-a-vis 40 trading partners, Index Q1 1999=100



Source: ECB

each. The current EMU share is almost the same as in 2002 – although it peaked at 62% in 2008. While Germany's deficit vis-à-vis China shrank substantially, surpluses with the rest of Asia rose strongly. The bilateral surplus with the US has fallen from 63% of the total (2002) to 19%.

Arguments in detail:

Germany lives at the expense of others, floods the world with its products

Argument: As a result of “unfair” German wage restraint real wages have stagnated for years, increasing German competitiveness substantially and thereby “exporting unemployment”.

No: Wages on the German labour market are determined by private contracts and not set by politicians. German unit labour costs (ULCs) remained broadly flat from the late 1990s to the mid-2000s, as **German wages rose roughly in line with productivity and the overall price level** – a benchmark suggested for example by the German Council of Economic Experts. Especially during the early to mid-2000s this meant low wage growth as productivity was lacklustre. This stands in stark contrast to several peripheral countries where real wages rose substantially faster than productivity, eroding their competitiveness (Spain's ULCs: +3% p.a.). In addition, German wage “restraint” has to be seen in the context of excessive wage increases in the buoyant post-unification years and 5 m unemployed in 2005 (11.1 % unemployment rate). Actually, since 2010 wage growth has been exceeding productivity growth, resulting in an average unit labour cost increase of 1% (2010-2012). **Since 2012, unit labour costs have risen by 2.6% (yoy), which is a reflection of the robust German labour market and one element of the market-based adjustment process.** In USD terms, German hourly compensation costs stood at USD 45.79 in 2012, which are among the world's highest (ranking 7th).

Germany enjoys an unfair benefit from the low euro

Argument: The surpluses would normally result in higher exchange rates which would dampen the competitiveness and therefore lower the current account surpluses. This is prevented as the EUR's exchange rate is dragged lower by the problem countries.

No: The euro is valued on the market and Germany cannot manipulate its value as it is not in charge. The (trade-weighted) euro is trading exactly at its long-term average; given still lacklustre EMU growth this can hardly be qualified as an excessively low exchange rate. Granted, if Germany still had its own exchange rate it would probably be higher, but it would also have been lower in the first half of the 2000s when Germany was the “sick man of Europe”. Within the eurozone an appreciation of the German currency can only materialise via an internal devaluation of the peripherals (via lower prices). Alternatively – as suggested by some of Germany's critics – German prices could increase substantially above the EMU average, thereby placing the adjustment costs on German consumers and savers.

Overall criticism aiming at German exports is not convincing. There is no evidence that Germany is manipulating its price competitiveness. Moreover, the



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German imports in line with global trade

7

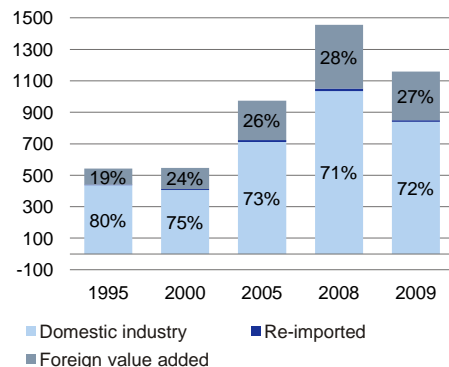


Sources: IMF, Deutsche Bank Research

Large share of German exports are imported intermediate goods

8

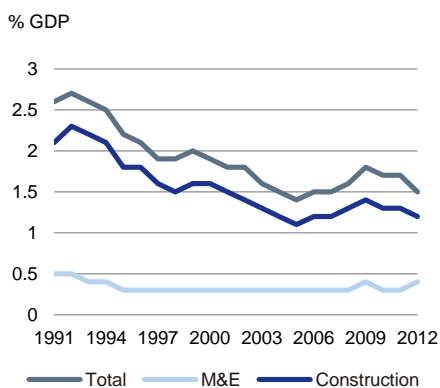
Share of foreign and domestic value-added in German exports, USD bn



Source: OECD-WTO TiVA database

Public investment

9



Source: Federal Statistical Office

success of German products is based on individual decisions taken by millions of consumers and corporate investors abroad, and has a lot to do with non-price parameters, such as quality, flexibility, service etc.

Germany is importing too little

Argument: Domestic demand in Germany has been too weak as i) consumers and ii) public and private investors have spent too little in Germany and thereby contributed to the import weakness.

No: Germany is not only one of the biggest global exporters but also one of the largest importers. Since the launch of the euro imports (goods & services) have risen on average by 5.2% p.a., exports by 6.3% and world trade by 5.5%. Exports accounted for 52% of GDP in 2012, and imports for 46%. This is the highest import share among large economies (US: 17%; France: 30%). In addition, at 2.5 Germany has one of the highest import elasticities among the larger industrial countries. This means that an increase in German growth of 1 % translates into 2.5% higher imports. Admittedly, an increasing share of these imports goes into German exports, i.e. not into domestic absorption. The share of foreign value added in German exports rose from 19% in 1995 to 28% in 2008. Thus, other countries benefited from the German export success.

- i. Between 2002 and 2012 real private consumption grew by 0.7%. Admittedly, this is weak growth in a historical and international comparison, but in line with the growth of real disposable income (0.6% p.a.). The sub-par growth is mainly due to the first half of that period when high unemployment, fiscal consolidation and the initially negative effect of the Hartz reforms were leaving their imprint. From 2006 onwards private consumption has expanded by a good 1% p.a., in line with productivity growth and despite a slightly shrinking population (-0.1% p.a.).
- ii. Private investment was indeed sluggish from 2002 to 2012, expanding by only 0.7% p.a. This can largely be attributed to weak construction investment (-0.2%), but investment in machinery & equipment (1.5%) was also below its long-term average of around 3%. Nevertheless, some special factors should not be overlooked. Following the bursting of the new economy bubble corporate balance-sheet consolidation caused a massive decline (2001-2003). In 2009 investments slumped by 24% due to the global recession and in 2012 uncertainty related to the euro crisis resulted in a renewed contraction (-4.5%). In "more normal" years investment spending actually showed solid growth. At any rate, private-sector investment is the result of individual decisions of German corporates, so it would be presumptuous to suggest that profit-maximising entities are deliberately not following promising investment opportunities.

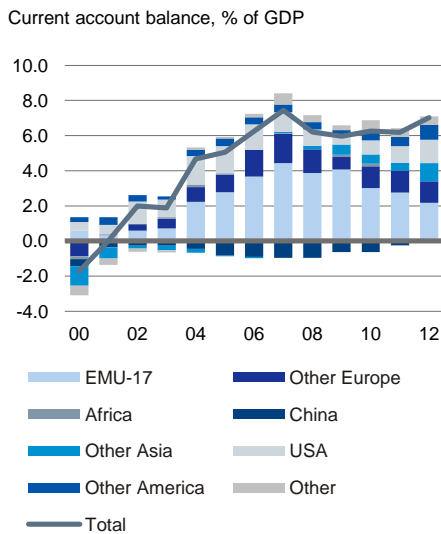
Therefore, the discussion (take, for example, the European Commission) has zeroed in on public investment, which shrank by 0.7% p.a. between 2002 and 2012. This again can be traced to shrinking construction investment (-1.8%). Public investment in M&E, which is probably more relevant with regard to its growth impact, expanded at 4.2% and hence more strongly than in many other countries. The fact that Germany's overall public investment/GDP ratio is below that of most comparable countries is largely due to the fact that Germany did not encounter a construction boom which resulted in a more muted price trend for infrastructure investment in Germany.

Still, Germany's share of public investment in GDP has fallen from 2 ¼% during the 1990s to 1.6% during the last 10 years. A major reason is



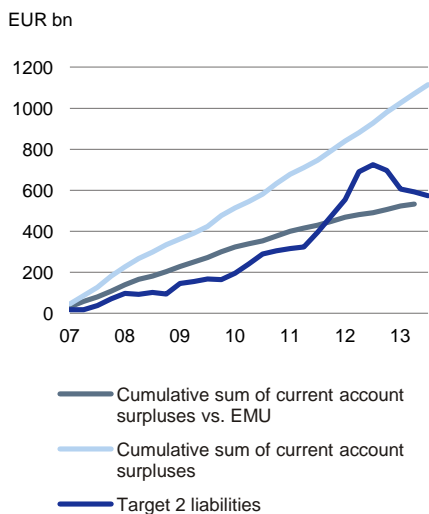
Criticism of Germany's CA surpluses largely unfounded

EMU share fell markedly in recent years 10



Source: Deutsche Bundesbank

Peripheral countries financed current account deficits vs. Germany via ECB 11



Sources: Deutsche Bundesbank, Deutsche Bank Research

massive public expenditures during the nineties to satisfy east Germany's pent-up demand, which has run its course. The eastern focus resulted in some neglect in the western parts of the country. The Council of Economic Experts recognises some additional demand of around EUR 4 bn p.a. but considers figures of EUR 100 bn or even more based on questionable estimation techniques or surveys as overblown. In addition, the experts point out that there is no clear evidence regarding the sustainable growth effects of public investments. Also saturation effects play a role for the low investment ratio. Finally, some reduction of the public capital stock might actually be quite rational given the shrinking population. A debt-financed public investment binge could also trigger a Ricardian response with ageing German taxpayers. On the contrary, there is ample evidence in peripheral countries that a deliberate increase in public investment spending encourages pork-barrel policies.

Higher German domestic demand reduces peripheral countries' adjustment costs

Argument: Measures to bolster Germany's domestic economy (expansionary fiscal policy, higher wages and investment spending) could help lift peripheral countries out of recession. This is basically the translation of the previous criticism (importing too little) into normative advice.

No: The effects of a German economic stimulus programme would have minimal spill-over effects into peripheral countries and would be counterproductive from a German cyclical and a longer-term sustainability perspective. Stimulus measures that increase German GDP by about 1% would improve the current account of the peripheral countries via increased imports and higher travel expenditures by only 0.1% of GDP at best.

Politically-induced wage increases – for example in the shape of a minimum wage – (outstripping productivity + inflation) would yield negative employment effects, especially in east Germany.

While measures aiming at boosting domestic demand would most likely be counterproductive, those targeting the supply side of the economy should certainly be implemented. An OECD simulation from 2009 suggests that Germany's labour productivity growth rate could be lifted by 1 percentage point per year (!) over a period of 10 years if Germany adopted the best regulation practice to be found internationally for each individual segment of its services sector. As the study admits that no country comes close to such an optimal position, the – admittedly impressive – benefits do certainly mark the absolute maximum of what could be achieved. The long-term effects on the current account depend on the extent to which these productivity gains are distributed on labour income. They might well lead in part to a further improvement of Germany's competitiveness.

Germany's current account surplus is preventing the periphery's adjustment

Argument: The pressure from German exports prevents a faster adjustment of peripheral imports and dampens their chances on third markets.

No: Germany's current account surplus with other EMU countries has adjusted materially since 2007, when it stood at 4.4% of GDP or more than half the total surplus of 7.4%. However, since then the surplus with EMU has halved to 2.2%

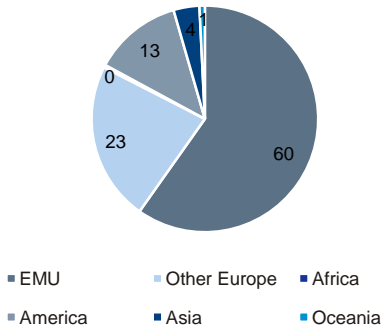


Criticism of Germany's CA surpluses largely unfounded

German investment abroad by region

12

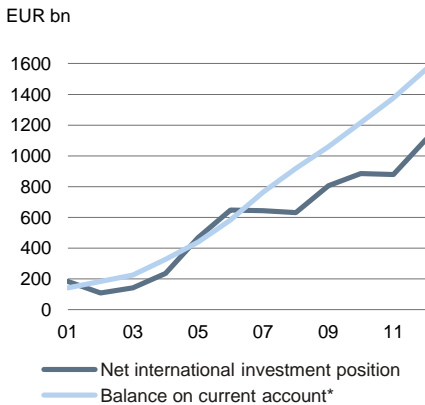
Cumulative sum of German investment abroad (balance) since Q1 2000 (EUR -4209 bn)



Sources: Deutsche Bundesbank, Deutsche Bank Research

Germany: Current account & net international investment position

13

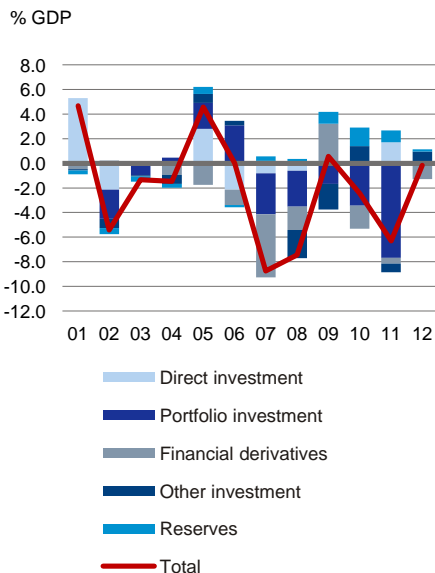


*) Cumulated since 1956

Sources: Deutsche Bundesbank, Federal Statistical Office

Germany: Valuation effects on net foreign assets

14



Sources: Deutsche Bundesbank, Deutsche Bank Research

of GDP in 2012 and has been largely financed by the ECB (Target2), while the overall surplus has remained roughly unchanged. Although a focus on bilateral balances can be misleading as it results to a large extent from structural factors it is worth noting that the German current account surplus with Spain has come down from over EUR 30 bn in 2007 to less than EUR 10 bn in 2012. The adjustment vs. EMU has come through lower German exports of goods (down 3%) to EMU as well as materially higher imports (up 11%) from EMU.

Excessive German savings forced peripherals into debt

This statement is invalid. The accounting identity implies that a German surplus must be reflected in someone else's deficit. But one cannot deduce any direction of causality from an identity. From a microeconomic perspective, a potential lender can hardly force someone else to borrow. Therefore, the reason for excessive peripheral borrowing can probably – at least in part – be found in an unsustainable macro-policy environment in those countries. However, from a macroeconomic perspective Germany's weak domestic demand between 2001 and 2005 helped generating the debt in the South by getting the ECB to pursue a very accommodative monetary policy which translated into negative real interest rates in the periphery.

Germany invests its surpluses in bad assets, adding to bubbles elsewhere (“stupid money”)

Yes, but: This argument seems to be backed by anecdotal evidence (US subprime, write-downs on peripheral bonds, automakers). On statistical grounds it is much harder to corroborate. Subtracting the accumulated German current account surpluses since 1956 (EUR 1,564 bn) from Germany's net external asset position (EUR 1,107 bn) reveals a difference of EUR 457 bn, which could be a proxy for Germany's capital losses. However, this rough calculation is based on different sources and influenced by different accounting rules, exchange rate fluctuations etc. The German contribution to housing bubbles in Spain, let alone in the US, is certainly negligible.

Closer analysis reveals that the valuation losses have mainly hit portfolio investments and have been largely accumulated since 2007 owing to the global financial crisis followed by the European sovereign debt crisis. This is actually of little surprise given that the euro area (60%) and the US (13%) have been major destinations for Germany's capital exports. A further breakdown into bonds and equities shows that the losses incurred were more or less in line with the development of global benchmarks (US 10Y yield or the MSCI). In addition, German investors' poor performance was no idiosyncrasy. Performing the same rough calculation for France yields even bigger losses.

At any rate, it is hard to understand why foreigners should blame Germans for buying their assets at considerably overpriced levels, given that they should benefit greatly from the transfer. If, by contrast, the money had – more wisely – been invested in Germany, this would not only have increased domestic demand but also German productivity further.

Finally, it is completely rational for an ageing society to invest its savings in younger and more dynamic economies, which of course entails certain risks. In this respect, successful German FDI in Eastern Europe which supported the regions catching-up to the West can serve as an example. If German surpluses

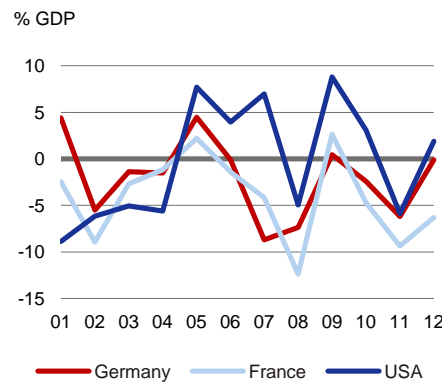


Criticism of Germany's CA surpluses largely unfounded

find their way as FDI in the Eurozone periphery – instead of financing excessive private and public consumption as in the past – this could not only offset some of the domestic investment weakness in these countries, and enhance their productivity but could also shift the focus of the discussion away from “how to shrink the German CA surplus”. This of course is predicated on further structural reforms there.

Valuation effects on net foreign assets

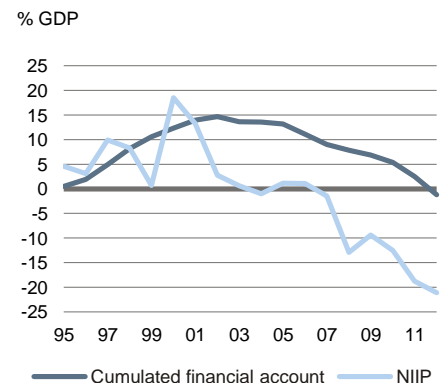
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Sources: BEA, IMF, Banque de France, Deutsche Bank Research

France: NIIP & cumulated financial account

16

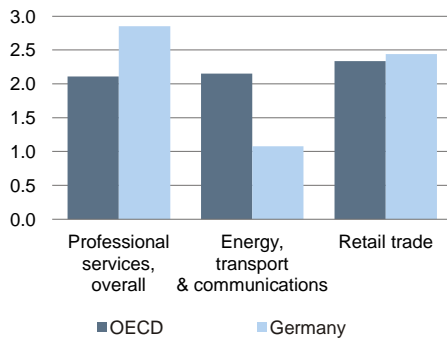


Sources: Banque de France, Deutsche Bank Research

Product market regulation

17

Scale from 0 to 6 reflecting increasing restrictiveness of regulation



Source: OECD

Conclusion

The arguments raised against Germany's current account surpluses are not overly convincing, in our view. As there is little evidence that Germany is manipulating relevant parameters, one should accept that the surpluses are the result of individual decisions of largely private agents in Germany and abroad. Politicians and commentators may be unhappy with the result, but they should not blame Germany. Rather, they ought to insist that the peripheral countries continue to improve their own competitiveness. Nonetheless, international critics will probably cheer at the redistributive measures found in the coalition agreement, although their impact on the current account will – even in the short run – probably be marginal. Unfortunately, more suitable supply-side measures for the services sector in particular have not been announced. Even worse, higher minimum wages and rising social security contributions will be a burden for the domestic economy in the medium term and hence weigh on import growth.

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Criticism of Germany's CA surpluses largely unfounded

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