EconPol POLICY REPORT

02
2017

July
Vol. 1

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Gabriel Felbermayr, Clemens Fuest and Timo Wollmershäuser

EUROPE
econPOL
European Network for Economic
and Fiscal Policy Research

headed by

EconPol POLICY REPORT
A publication of EconPol Europe
European Network of Economic and Fiscal Policy Research
Publisher and distributor: ifo Institute
Poschingerstr. 5, 81679 Munich, Germany
Telephone +49 89 9224-0, Telefax +49 89 9224-1462, email Abentung@ifo.de
Editors: Daniela Abentung, Clemens Fuest

EconPol Europe: www.econpol.eu

The German Current Account Surplus: Where Does It Come From, Is It Harmful and Should Germany Do Something about It?

Gabriel Felbermayr [c], Clemens Fuest [b] and Timo Wollmershäuser [c]

ifo Institute, Munich, July 14, 2017

Abstract

In the international economic policy debate Germany is criticized heavily for its current account surplus. This paper describes the factors that have led to the surplus and discusses the policy implications. The current account surplus is mainly a result of higher savings, driven by an ageing population. The claim that the German surplus causes economic damage either in Germany or in other countries is not well founded. But Germany faces growing political pressures related to the threat of protectionism, the risk that a growing creditor position may lead to political backlash, and the fact that European Macroeconomic Imbalances Procedures imply that current account surpluses should not exceed six percent of GDP. To reduce the surplus Germany should focus on a corporate tax reform to boost private investment.

[a] ifo Institute, Poschinger Str.5, 81679 Munich, Germany, felbermayr@ifo.de

[b] ifo Institute, Poschinger Str.5, 81679 Munich, Germany, fuest@ifo.de

[c] ifo Institute, Poschinger Str.5, 81679 Munich, Germany, wollmershaeuser@ifo.de

1 Introduction

Global macroeconomic imbalances have become a hot topic on the international policy agenda. Germany's current account balance is now in the spotlight after soaring from close to zero in 2001 to a surplus 8.5 percent of GDP in 2016. At around 261 billion euros Germany now boasts the highest single surplus in the world. Views on whether the German current account surplus is a problem are divided. In this short paper we describe the factors that have led to the current account surplus and discuss its policy implications.

The key results of our analysis are as follows:

1. The German current account surplus is not due to a decline in domestic investment. It is mainly a result of higher savings, driven by an ageing population.
2. The decline in the oil price in 2014 has further increased the surplus by 1.5 per cent of GDP. Declining prices for other imported goods have added another 0.5 per cent of GDP to the surplus.
3. Wage restraint is not a major factor driving the surplus. The share of wages in GDP fell until 2007 but has been growing since then.
4. The view that other countries are harmed by the German surplus is unconvincing. It is true that countries with unemployment and slack capacities would benefit from higher demand from Germany or anywhere else. But this would come at the price of higher public debt, undermining growth prospects and resilience in future crises. Moreover highly indebted countries could also stand to suffer if a decline in the German surplus were to boost interest rates.
5. Germany has no direct economic interest in reducing the surplus. There is no evidence of a general domestic investment gap in Germany. Saving more and investing abroad makes sense as a response to population ageing. But Germany faces growing political pressures related to the threat of protectionism and the fact that a growing creditor position may lead to political backlash. The European Macroeconomic Imbalances Procedures also include the rule that current account surpluses should not exceed six percent of GDP.
6. If the German government wants to reduce the surplus it should focus on a reform of the corporate income tax system to boost domestic private investment. This could be achieved through improved loss offset, accelerated depreciation and R&D tax credits.

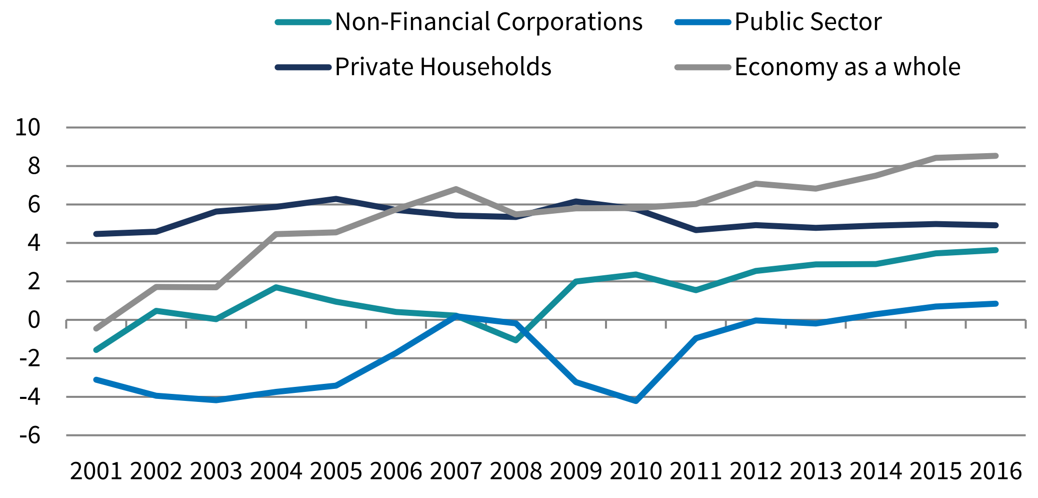
2 Why does Germany have such a large a current account surplus?

The current account surplus equals the difference between domestic savings and domestic investment. To understand Germany's current account surplus it is helpful to consider the development of its financial balance, i.e. the difference between savings and investment, in different sectors of the economy: the public sector, private households, non-financial firms and financial firms (primarily banks). Figures 1 and 2 illustrate how this difference has evolved in the period since 2001, when the German current account balance was close to zero.

In 2001 the German government posted a financial balance of -3.1 percent of GDP, while that of the non-financial companies amounted to -1.6 percent. This was financed by private household surplus savings, which were 4.5 percent of GDP, versus savings of close to zero by financial firms. The development in these balances between 2001 and 2016 is illustrated by figure 1.

Figure 1

Sectoral Financial Balances



Data: German Federal Statistical Office

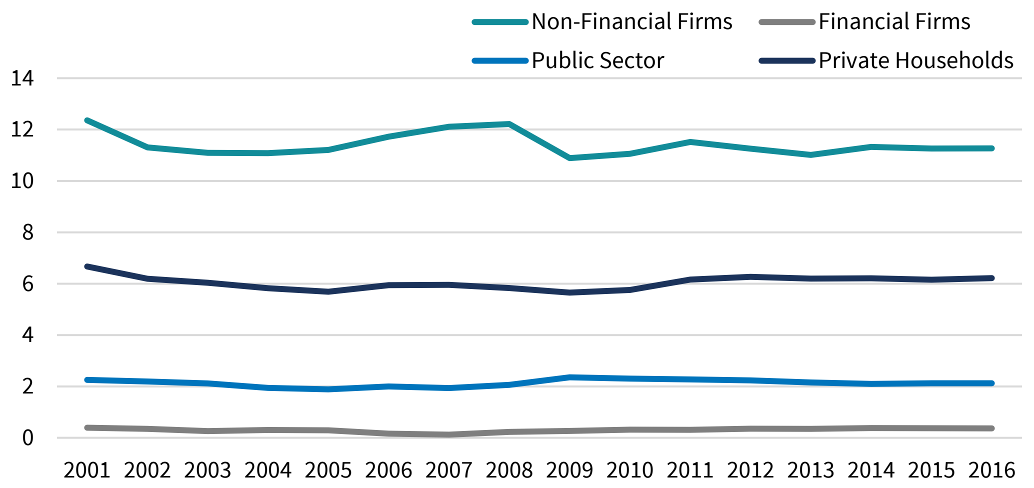
In 2016, two things were different: firstly, the government deficit vanished, increasing the financial balance by roughly four percent of GDP. Secondly, non-financial firms had a financial balance that was roughly five percentage points above that of 2001. This explains why the current account balance has improved by 9 percentage points, from -0.5 to +8.5 percent of GDP. The balances of private households and financial firms, by contrast, are not very different in 2016 from what they were in 2001.

3 What are the economic factors driving the current account surplus?

What are the economic forces driving these changes? According to a widespread view, the German current account surplus is the result of weak public and private investment. This is hard to reconcile with the fact that gross investment as a share of GDP was remarkably constant over the period when the current account surplus emerged. Figure 2 illustrates gross investment as a share of GDP in the different sectors of the economy and reveals that it has basically remained flat.

Figure 2

Gross fixed capital formation in Germany
(per cent of GDP)

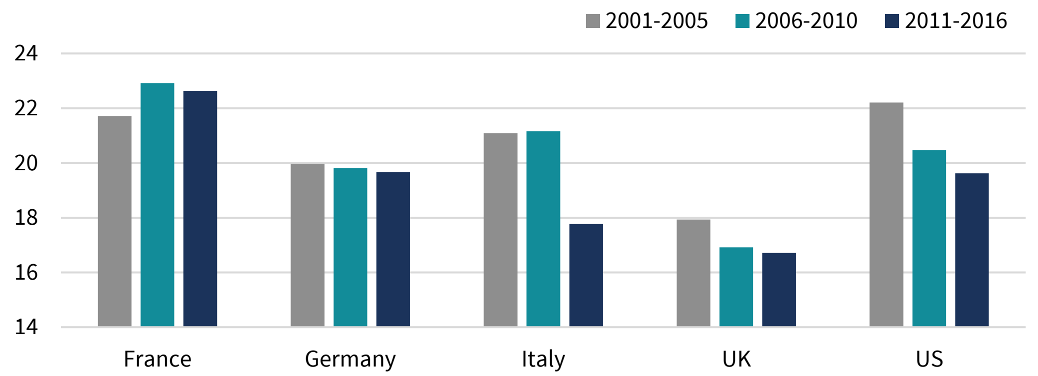


Data: German Federal Statistical Office

In the period between 2001 and 2016 depreciation increased by 0.8 percent of GDP, leading to a slight decline in net investment, but that does not explain Germany's soaring current account. Figure 3 compares the development of investment in Germany and other G7 countries. The bar chart shows that investment declined in Italy, UK and the US, but remained almost constant in Germany.

Figure 3

Investment
(per cent of GDP, yearly average)

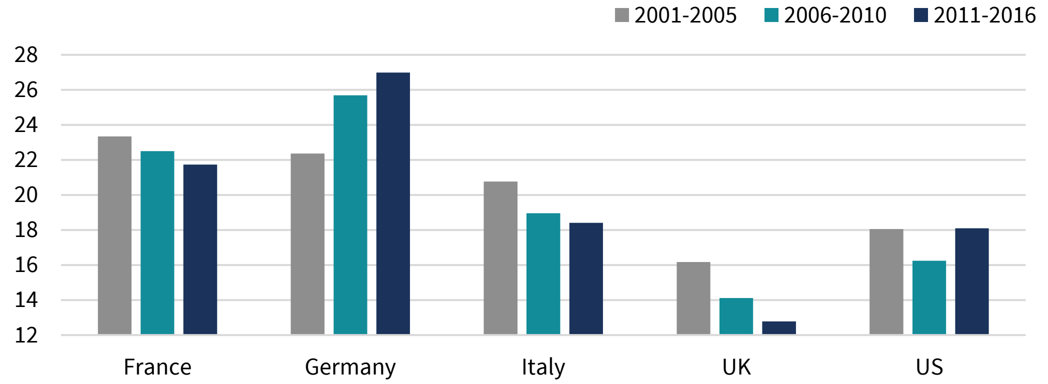


Data: IMF

Figure 4 illustrates the development of national savings, the sum of private and public savings. Savings increased considerably in Germany, but declined in most other countries. The German current account surplus is primarily a result of higher savings, not a decline in domestic investment. [1]

Figure 4

Savings
(per cent of GDP, yearly averages)



Data: IMF

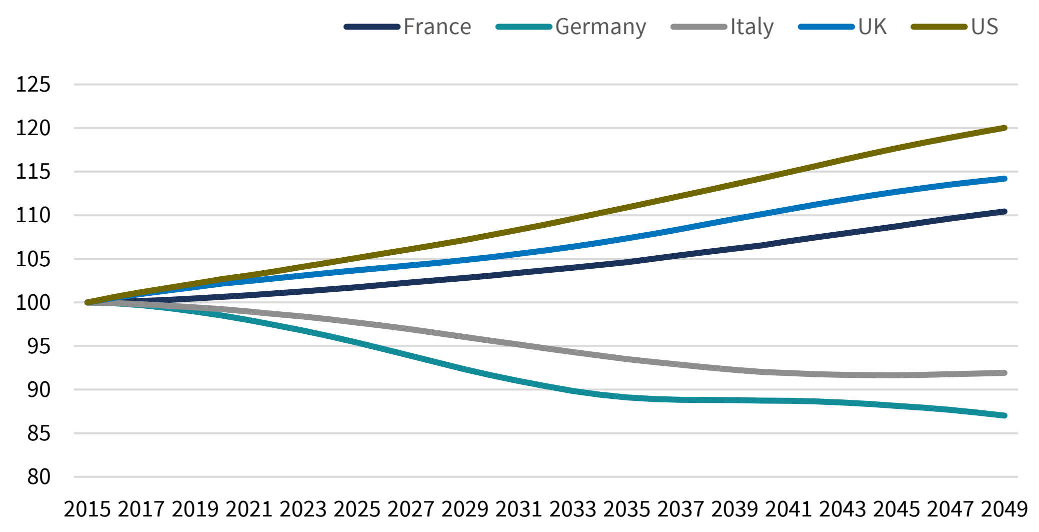
[1] Investment was higher in the 1990s, but that was a result of the transitional impact of German reunification.

Why have savings increased in Germany? The main reason is demographic change. In the early 2000s there was a growing awareness that the German public pension and health systems, based on pay-as-you-go financing, were extremely vulnerable to population ageing. Figure 5 shows that Germany is affected more strongly by population ageing than most other European countries. As a result, pension claims were reduced and various measures were taken to increase private saving for retirement. This also promoted a change in the public's attitudes towards public sector deficit financing and growing public debt. The debate over this issue led to the introduction of the 'debt brake' as part of the German constitution in 2009.

A popular argument in the debate over the current account surplus is that wage restraint (sometimes denounced as 'wage dumping') is an important factor. One variant of this argument is that low wages have boosted the 'competitiveness' of German companies. The trouble with this argument is that lower production costs do not necessarily lead to a higher current account surplus, as this requires an increase in savings over investment.

Figure 5

Labor Force Projection
(2015=100)



Data: ILO

Another variant of the wage restraint argument is based on the idea that wage earners save a smaller part of their income than capital owners. So if labour as a share of overall income declines, savings may increase. Figure 6 illustrates how wage income as a share of GDP has developed over time. It is true that this share declined until the mid-2000s, mainly due to rising unemployment. Since then the share of wage income has increased, as has the current account surplus. If the wage share had been a key determinant of the current account surplus, the latter should have declined between 2007 and 2016. Therefore the argument that a declining wage share can explain the growing current account surplus is flawed.

Figure 6

Wage Share
(compensation of employees in per cent of GDP)

Data: German Federal Statistical Office

Two other factors are more likely to be relevant for the increase in savings. Firstly, various tax reforms have been implemented including reductions in social insurance contributions financed by higher indirect taxes, and notably the standard value added tax (VAT) rate increase from 16 to 19 percent in 2006. This policy is sometimes referred to as 'fiscal devaluation'. The reform boosted profits in the export industry and is likely to have contributed to the increase in corporate savings. There were also two corporate tax reforms, in 2001 and 2008, that reduced the corporate tax rate and broadened the tax base. Overall, the reform reduced the tax burden on corporate profits and reduced incentives for debt relative to equity financing in German entities of multinational companies. Indeed, German companies have increased domestic equity financing considerably in recent years; another factor that boosted savings in the corporate sector.

Secondly, in recent years, Germany (like many other countries) has benefited from the decline in oil prices. It is plausible that most firms and households viewed the windfall gains from lower oil prices as a transitory effect, encouraging them to use most of the gain to increase savings. Between 2014 and 2016 the current account balance increased by roughly 2 percentage points because import prices fell relative to export prices; 1.5

percentage points were due to the fall in the oil price, the other 0.5 percentage points were a result of lower prices for other raw materials.

Moreover, monetary policy in the Eurozone is a major driver of Germany's current account surplus. The low euro exchange rate is a key factor that is raising exports and dampening imports. In addition, policies like the OMT programme are boosting capital flows to periphery countries in the Eurozone. This also raises the German current account surplus.

Finally, it is worth noting that foreign investment income (the net returns on foreign assets) itself is becoming an independent driver of the current account surplus. In 2016 this income was equal to 1.7 per cent of GDP.

4 Is the German current account surplus a problem?

According to the prevailing critique of the German current account surplus, the surplus is good for Germany, but bad for deficit countries. This view is based on the assumption that the world economy, and the Eurozone in particular, is in a recession that can only be overcome by stimulating demand. By absorbing demand generated in other countries Germany benefits because its economy grows, while other countries suffer from unused production capacities and unemployment. Paul Krugman sums it up as follows: 'We are still in a world ruled by in-adequate demand. […] By running inappropriate large surpluses, Germany is hurting growth and employment in the world at large.'[2]

It is plausible that countries with slack capacity would benefit from additional demand coming from Germany or anywhere else. There can be situations where generating demand leads to positive externalities. Since individual countries do not internalize the benefits of macroeconomic demand stimulation, they do too little. This applies to all countries. Does that tell us anything about the current situation of the Eurozone or Germany in particular? Claiming that Germany should do more is based on the view that countries with a current account surplus or low fiscal deficits should feel morally obliged to stimulate global demand. But asking that Germany should do more to help others is not the same as proving that Germany hurts growth and employment. All countries hesitate to pursue fiscal policies which are not in line with the national economic interest, not just Germany. In addition, using fiscal policy to stimulate demand now

[2] https://krugman.blogs.nytimes.com/2013/11/01/the-harm-germany-does/

would come at the price of higher public debt, undermining growth prospects and resilience in future crises. Moreover, there are other international spillovers. The critique of the German surplus overlooks the fact that supplying capital to the rest of the world may also give rise to significant positive spillovers. Most importantly, the extra supply of capital keeps interest rates low, which is beneficial to debtor countries.

Another, almost equally popular claim is that the current account surplus is bad for Germany itself. It has been argued that German companies and the public sector are investing too little in Germany, undermining Germany's economic future. The trouble with this argument is that there is no convincing evidence of an investment gap in Germany. As mentioned above, the current account surplus is not due to a decline in investment in Germany, but to an increase in savings. Given that demographic change in Germany will accelerate in the 2020s, it is perfectly rational for the private sector to use additional savings for investment abroad, rather than in Germany. For the public sector it is equally rational to cut investment in regions of the country where the population is declining. It is certainly true that maintenance has been neglected in some areas of Germany's infrastructure (as it has been in most other countries), but the idea that Germany would benefit from a massive boost in either private or public investment is unconvincing. If these investment opportunities existed, they would be realized. Access to capital is easy and public funds available for investment are not being fully used.

A variant of this argument claims that the surplus is harmful for Germany because capital is invested poorly and generates low rates of return. The implicit assumption is that domestic investment in Germany would yield higher returns, but for some reason does not take place. It is true that some German foreign assets, and particularly the growing TARGET 2 balances in the ECB system, generate low rates of return. But that is related to tensions in the Eurozone, which cannot be readily defused. Generally, however, both foreign and domestic investment decisions are taken in private capital markets and there is no reason to assume that these markets are biased towards foreign investment.

Yet another variant is that current account imbalances may give rise to future debt crises, as debtor countries accumulate excessive debt. This is hardy convincing because excessive debt may occur without current account imbalances, and large deficits of individual countries are a better predictor of debt crises than the surpluses of individual countries.

Overall, there are no convincing arguments suggesting that its current account surplus is harming Germany. For other countries the surplus in itself is not harmful either; in normal circumstances trade is mutually beneficial. It is, however, true that countries suffering from unemployment and a lack of demand for their products would benefit from more demand coming from Germany. At the same time, however, a decline in the

German current account surplus, i.e. a reduction of capital supply from Germany, would push up interest rates, something that will be less welcome in those countries.

5 Policy implications: what should Germany do?

Germany currently has no direct economic interest to stimulate domestic demand in order to reduce its current account surplus, but political pressures on it to do so are growing. There are three reasons why Germany may be forced to do more to rein in its surplus. Firstly, foreign governments may threaten to turn to protectionism. This is a negative sum game, but Germany depends more on international trade than other countries, which means that it has a stronger interest in defending free trade. Secondly, a growing creditor position relative to other countries may become a political problem by giving debtor countries a growing incentive to seek ways to avoiding servicing their liabilities. Creditors seldom attract sympathy. Thirdly, in the framework of the European Macroeconomic Imbalances Procedures Germany has accepted the rule that its current account surplus should not exceed 6 percent of GDP. Germany can hardly ask other countries to respect European fiscal rules while ignoring other regulations itself.

So if the German government wanted to bring down the surplus, what are its options? The first option would be to stimulate domestic investment and the second would be to boost consumption.

As explained above, there is no evidence of a general investment gap in Germany, but if something needs to be done to reduce the surplus, stimulating investment is preferable. Increasing public investment is difficult in the short term. Growing funds have been made available in recent years, but they are not being used. Moreover Germany's public investment accounts for just 2 percent of GDP. Even if this figure could be increased by 20 percent, for example, the impact on domestic demand would be just 0.4 per cent of GDP. A quantitatively more powerful option would be to boost private investment. This could be achieved through improved loss offset, accelerated depreciation and R&D tax credits.

Which instruments are available to raise consumption? A temporary cut in the value added tax rate (VAT) would boost spending, albeit only until the end of the reduction period. Then the effect would be reversed. A permanent cut in VAT or a lower income tax would have little impact because private households will react to the tax cut by saving more.[3] Low income households are often expected to save less in response to tax cuts but the evidence on this effect is ambiguous.[4] Another option would be to increase public consumption. Germany, for example, could increase its military spending and buy more foreign equipment. But overall increasing consumption is not compatible with the desire to save more to prepare for ageing.

It is sometimes suggested that Germany should increase wages to reduce its current account surplus. This is not a convincing proposal. Firstly, wages are set by unions and employers, not by the government. The government only sets the minimum wage. Increasing the minimum wage more aggressively would be risky because it would reduce employment opportunities for low skilled workers, an area of the workforce in which unemployment remains high. More generally, the impact of rising wages on the current account is ambiguous. If higher wages were to reduce employment, domestic demand may fall and the surplus could continue to grow. Whether wages are too low or too high should be judged in the light of labour market conditions. From that perspective German wage developments seem perfectly acceptable.

In any case, if Germany does yield to foreign pressures and takes steps to reduce its current account surplus, it should focus on reversible measures. The oil price may rise again, and as Germany's population ages and the baby boomer generation retires, the German current account surplus may soon be a thing of the past.

[3] A recent study of the German Ministry of the Economy finds that a permanent cut in the VAT rate by five percentage points, which would reduce the tax burden by 1.8 per cent of GDP, would only reduce the surplus by 0.25 per cent of GDP, see Schlaglichter der Wirtschaftspolitik 07/2017, p. 14.

[4] A study on tax rebates in the U.S. in 2008 shows that low income households on average saved a larger part of the rebate than higher income households, many of them paid back consumer credits, see M. Shapiro und J Slemrod: Did the 2008 tax rebates stimulate spending?, in: NBER Working Paper, Nr. 14753, 2009.

EconPol Europe

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