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Raising consumption in Germany would benefit German savers as well

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The German foreign current account surplus has reached record levels, averaging 8.1% of GDP over the last three years. It is much higher than the (already generous) threshold set by the European Commission (6.0%). As a result, ***the excessive German surpluses jeopardize the sustainability of European GDP growth*** *and even that of the European Union itself. Moreover,* ***they go to the detriment of German households themselves****, as shown by recent past experience.*

In particular, such high surpluses have ***penalized German consumers and savers*** *through at least two channels: (i) Germany's competitive gains, due to the strong productivity growth not counterbalanced by similar wage gains, have restrained household consumption growth (already slow). At the same time, they have deterred investments and weakened domestic demand relative to production, resulting in* ***excess savings*** *(the equivalent of the foreign current account surplus); (ii) excessive savings are inevitably transferred abroad (this is a merely accounting issue), building* ***credits to deficit countries****, which become unsustainable and generate crises in the long run, leading to* ***depreciation of accumulated foreign assets****; a bad deal for German savers.*

The last of these crises was the one of sovereign debt in the Eurozone, whose asymmetric management implied deflation and fall of domestic demand in peripheral countries. The German trade surplus with respect to the other European countries has decreased via both lower exports and imports. ***Thus, subdued German imports have contributed to the weakness of domestic demand in the Euro area as a whole****, accentuating the negative effects on EU investment and GDP. Consequently, the excessive German foreign current account surplus puts in danger the same* ***European Union's cohesion****.*

Peripheral countries *must push forward with* ***structural reforms*** *to gain competitiveness and promote growth. But the process would take too long and might be vulnerable to new shocks in* *the absence of a firm **German policy supporting wage and consumption growth**, boosting domestic demand and favoring higher inflation, even with expansionary budget measures; that would benefit **German households** themselves.*

*The **ECB policies** have sustained German foreign assets valuation, also through exceptional measures. With a robust recovery in the Eurozone underway, reassuring markets about the sustainability of foreign debt in peripheral countries, the start of monetary policy normalization gets closer. It is a **crucial phase that requires a renewed joint and symmetrical effort** towards sustainable growth, rebalancing economic fundamentals in all European countries.*

Large German surpluses to the detriment of German households themselves:…

The German current account balance has been positive since 2002, rising rapidly to 6.7% of GDP in 2007. After a modest correction at the beginning of the crisis, it has achieved a record level of 8.5% in 2015; edging down to **7.6% of GDP in 1H-2017**, according to Bundesbank seasonally adjusted data.

These levels are considered to be excessive even according to the European Commission parameters, which are more tolerant on the surplus side rather than in case of deficit: surpluses should not exceed 6% of GDP, on average, over the last three years, while deficits should not overcome 4%, as stated by the Six-pack rules.

The German foreign current account surplus will remain well above the 6% threshold for a long time: according to the IMF, the three-year average will still be equal to 7.5% of GDP in 2022. On the other side, current balances in other European countries that registered in the past deficits higher than the Six-pack threshold (like in Portugal, Ireland, Greece and Spain) or close to it (in Italy) all climbed up quickly, via reduction in domestic demand, competitive deflation, and other improvement in competitiveness.

As a result, **the asymmetric correction of the imbalances in foreign accounts has exacerbated and protracted the European recession**, as repeatedly remarked by CSC[1]. At the same time, the excessive and persistent German surpluses, unsustainable in the long run, **have damaged German consumers and savers as well**.

Current surpluses are, indeed, equivalent to credit transfers abroad, resulting in lower resources for domestic consumption and private and public investments, especially those in

[1] See CSC (December 2014), Area euro: correzione zoppa degli squilibri nei conti con l'estero, pp. 35-40, *Scenari economici* n.22 and Pignatti M. (January 2015), La Germania rende zoppa la correzione dei conti esteri dentro l'Area euro, *Nota dal CSC* n.15-3.

infrastructure; thus leading to **lower German GDP growth, with a loss estimated in 1p.p. per year over the last 20 years**[2]. In addition, the wealth accumulated by German residents in foreign assets has suffered significant valuation losses (before being supported by the ECB policies). Finally, the high unemployment rate in European peripheral countries (also due to foreign account imbalances) has pushed immigrants from non-EU countries into the German labor market (in full employment), causing strong **social tensions** in the German society, as shown by the increasing appeal of populist and nationalist parties in the last political elections.

Three arguments are mainly used by those who favour the German stance: i) the current account surplus is determined by the competitiveness of German goods; II) the trade surplus with other European countries, anyway, has shrunk relative to the past; iii) German savings have financed the debts in the peripheral countries, hence the latter have to bear the cost of rebalancing, resembling the fable of the ant and the grasshopper. However, these thesis overlook some fundamental macroeconomic principles.

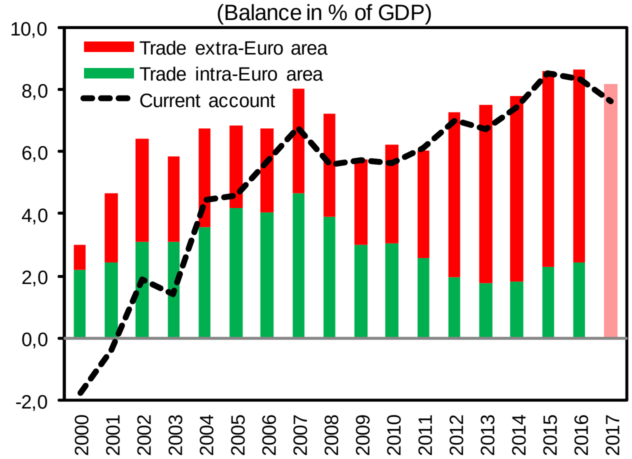
…too high savings slowed growth,…

First of all, it is true that trade balance is the major item in the current account, hence its variations lead in many cases the dynamics of the overall balance. In particular, German trade and current surpluses display similar dynamics and levels since 2009; while in the first 2000s the current account was also boosted by the rise in the balances of services and primary income (from labor and capital, chart 1).

Chart 1

German current accunt surplus at record levels

(Balance in % of GDP)



2017: 1H (seasonally adjusted balance towards the Rest of the World).
Source: CSC on Bundesbank and Eurostat data.

However, **net exports**, that are the difference between exports and imports, are what really matters. German competitive gains, mainly via **wage moderation policies**, supported exports and curbed imports, **penalizing household consumption**, already structurally low. During the crisis, weak domestic demand, in the absence of a significant fiscal stimulus, slowed down GDP dynamics even in Germany: lower demand implies lower production and investments, which in turn cut demand, and so on. Ultimately, a greater propensity to save can lead to lower GDP and savings, as stated by Keynes' paradox of thrift.

[2] See Ciocca P. (2017), La Germania: debitrice ieri, creditrice oggi, *in Germania/Europa*, *Due punti di vista*, Donzelli Editore.

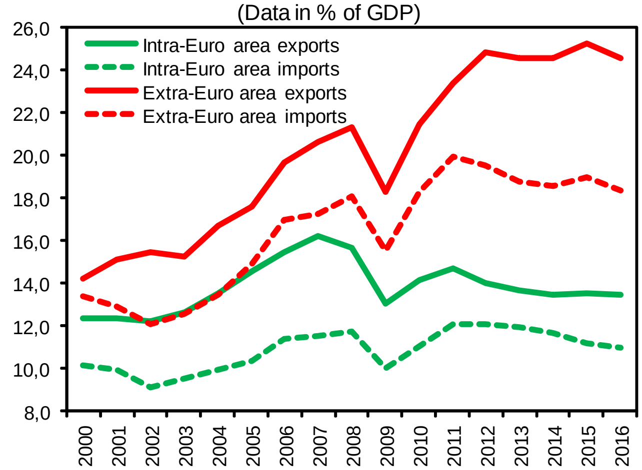
Indeed, in national accounts net exports are equal to excess savings over investment. Consistently, the increase in German net exports, as a percentage of GDP, has been associated with an increase in savings and a roughly stable investments; higher saving were due, in particular, to a decline in household final consumption of around 4 p.p. of GDP compared to the 2000s pre-crisis average (51.5% in 2016), while public consumption increased by 1 p.p. only (to 19.6%). In other words, **Germans gave up consumption**, and investment.

High savings are, in part, due to structural factors. The most significant one is the expected **population aging,** that, combined with the high share of medium and old-aged people, produces a strong motivation to save money for consumption in older age. However, these factors can only partially explain the current level of the German current account surplus. According to IMF estimates, in 2016 the current balance consistent with the medium-long term economic fundamentals was 4.5 p.p. of GDP lower than the actual one; globally only Singapore and Thailand have also experienced "substantially stronger" surpluses, that is more than 4 p.p. of GDP higher than the one consistent with fundamentals[3].

...lower intra-Euroarea trade reduced European demand…

Chart 2

German trade flows in the Eurozone is declining
(Data in % of GDP)



Source: CSC on Eurostat data.

Secondly, the **German trade surplus** indeed decreased with respect to the other Euro area countries, while it has expanded relative to non Eurozone countries. The German intra-Area surplus rebalancing has nevertheless been partial and stopped in recent years: from the 4.7% of GDP peak in 2007 it fell to 1.8% in 2013, rebounding to 2.5% in 2016. Besides, and mostly relevantly, the dynamics of the intra-Area balance from 2011 onwards results from a **fall in both trade flows, as a percentage of GDP**: a larger fall for exports than for imports in 2012-2013 (with a surplus drop) and vice versa in 2015-2016. On the contrary, with regards to the extra-Area dynamics, imports decreased while exports remained roughly stable (chart 2).

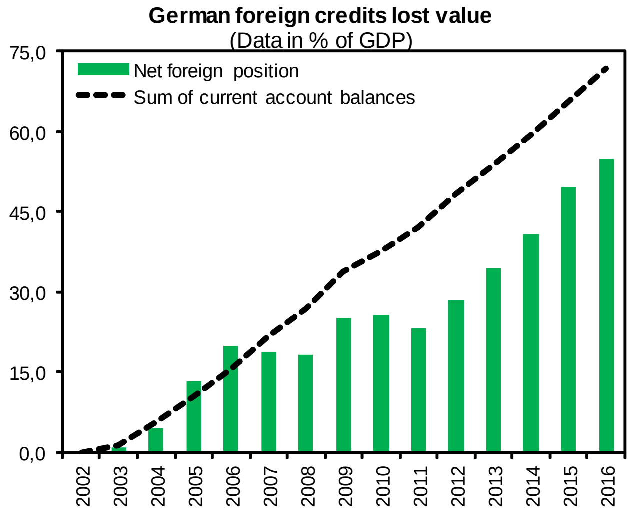
[3] See IMF (July 2017), 2017 External Report, *IMF Policy Paper*.

In other words, **the reduction in German imports has contributed to the general weakness of European domestic demand**, exacerbating the negative cycle of investment and GDP. In foreign trade acted an additional transmission channel, via international value chains: lower production of downstream firms, typically German, due to lower exports to the rest of the Eurozone, has resulted in lower demand for intermediate products of upstream firms, typically outside Germany; with a significant impact, given the high international fragmentation of production within Europe.

From a European point of view, the trade flows between the EU Member States represent part of domestic demand (both of final and intermediate products) and a vital element of the single market that, with its magnitude and the presence of sophisticated buyers with high purchasing power, is the pillar of European companies' competitiveness[4]. The German model of small open economy cannot be transferred on a continental scale.

… and German foreign assets lost value

Chart 3



Source: CSC on Eurostat data.

Finally, the German surpluses **have financed**, on an accounting basis, **other countries' deficits**, particularly those of European peripheral ones before the crisis. Thus German savers hold, directly or indirectly, net assets towards these countries (but also, for example, with the US). According to pro-German analysts, this financial connections have been artificially sustained by the ECB hyper-expansionary policies, which technically manifest themselves in the Target2 balances between national central banks, that pay zero interests; so that the burden of the grasshoppers' excesses in the European periphery falls unfairly on the German ant[5]. This metaphor, however, is misleading, as shown by the previous analysis. Beyond moral judgment, also in foreign account credit and debt are obviously two faces of the same coin; consequently, **if other economies get into a crisis**, there are negative consequences for the German one as well, in particular through the **devaluation of assets accumulated** in those economies.

[4] See CSC (June 2017), L'Europa a un bivio: integrazione o disaffezione, *Scenari economici* n. 29, chapter 2.
[5] See Sinn H.-W. (21 July 2017), *How to reduce Germany's surplus*, Project Syndicate.

The buildup by surplus countries of a positive net foreign position against those in deficit is unsustainable in the long run. In flexible exchange rate regimes, currency movements act as automatic stabilizers, with a relative appreciation of the currency of the surplus country, when the voluntary financing of the deficit ends. Otherwise, without economic policies' adjustments, markets start to doubt that deficit countries will repay their debts and their financial and real assets lose value. In both cases, net foreign assets of the surplus country tend to record negative valuation adjustments and therefore foreign investment is a bad deal for savers (as historical events underline).

In extreme cases a financial and/or currency crisis of the debtor country takes place, with a sharp drop in the net foreign position of the surplus country. This happened in the **European sovereign debt crisis** in 2010-2011 and, previously, in the financial crisis generated by US subprime mortgages (2007-2008). In those years, the German net foreign position suffered heavy negative valuation effects. In recent years, the value of German net assets has been supported by the ECB measures. Also thanks to the ECB unconventional monetary policies, after 2011 the German net foreign position has increased more rapidly than what implied by the cumulated current surpluses, given the assets value increases in peripheral countries. By the end of 2016 it was equal to 54.9% of GDP. However, it still shows the crisis effects, as it still is 17 p.p. of GDP below than the level obtained by cumulating all the current account surpluses starting from 2002 (the loss peaked at 20 p.p. in 2012; chart 3). In other words, **the German excess savings were partially lost**, so that German households not only gave up consumption and accepted lower wage growth than productivity gains, but also saw their efforts partially (and inevitably) vanish.

A symmetrical effort, for the benefits of all, is needed

The **stronger recovery** taking place **in the Eurozone** implies the beginning of monetary policy stabilization, also because it reassures markets about the sustainability of peripheral countries' foreign debt. It is a crucial phase that requires a **renewed symmetrical and joint effort** towards a sustainable rebalancing in the economic fundamentals of European countries. As Tommaso Padoa-Schioppa stated, the well-ordered house principle, saying that keeping your own house in order is a sufficient condition for the community to well operate, included in the European rules mainly by Germany's will, is not always true; instead, it is necessary to take into account common goods and externalities[6].

[6] See Padoa-Schioppa T. (2009), *La veduta corta*, Il Mulino.

Peripheral countries must proceed along the path of **structural reforms** in order to gain competitiveness and boost growth. Yet the path would still be too long and at risk of new shocks without effective **German policies favoring wage and consumption growth**, with a strong boost to domestic demand and higher inflation, including **expansionary budget measures.**

This would enable an adjustment along multiple directions: more imports and exports in Germany and in peripheral countries, hence higher European domestic demand, and a realignment of price competitiveness without deflationary pressures. That would benefit German households themselves, in terms of higher income growth, higher standard of living and more value to savings.