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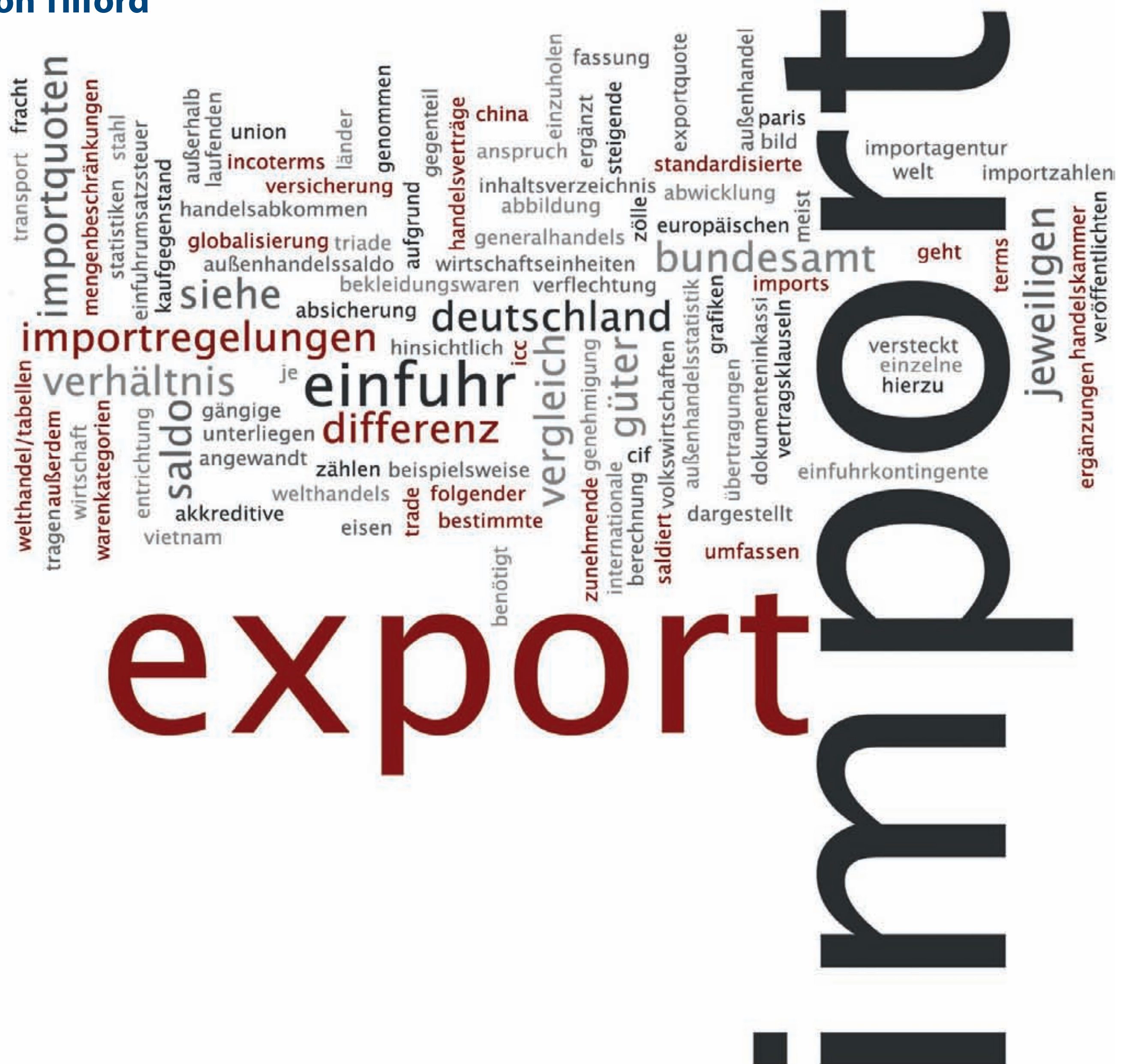
By Simon Tilford



CENTRE FOR EUROPEAN REFORM

German rebalancing: Waiting for Godot?

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★ German rebalancing is always about to happen but never does: the country's current account surplus hit a record 7.5 per cent of GDP in 2014. This is not in Germany's interests. The current account balance is the difference between a country's income and what it spends. A surplus therefore represents lower consumption and investment in Germany than otherwise would be the case. Moreover, Germany's surplus is also a formidable obstacle to sustained economic recovery in Europe.

★ The surplus reflects anaemic domestic demand, which grew at just 0.4 per cent a year between 2012 and 2014. A combination of real wages having barely grown for 15 years and high household savings means that private consumption has fallen as a share of GDP. This is a major reason why business investment is weak despite robust corporate profits. And the government is running a budget surplus. Germany has substituted external demand, in the form of additional net exports, for deficient demand at home.

★ The country's imbalances are not primarily the result of demographics, lack of competitiveness and loss of macroeconomic policy autonomy on joining the euro, or cheaper investment goods. Rather, they reflect political choices: the government's drive to balance the budget; reforms that undermined labour's bargaining power; a highly unequal distribution of wealth; and too much taxation of consumption and too little of corporate profits, wealth and property.

★ Aside from depressing living standards and productivity growth, Germany has lost almost a third of the savings that it has invested abroad since 1999; it is hard to believe that this money could not have been invested more productively at home. German rebalancing would also boost the eurozone economy, lift inflation and make it easier for other eurozone countries to service their debts, including those debts owed to Germany. This, in turn, would help reduce the global economy's excessive reliance on the US.

★ Germany's imbalances are too big to correct themselves. A number of policy steps would help to boost demand and reduce surplus savings: a big public investment programme and higher public sector wages; lower taxes on consumption and higher ones on corporate income, wealth and property; steps to encourage greater home ownership, and hence a more equal distribution of wealth and lower households savings; and unequivocal support for aggressive monetary stimulus by the ECB.

★ As the German government shows little inclination to take active steps to foster rebalancing, the European Commission should step up pressure on it to do so. At present, the Commission does not treat current account surpluses with the same seriousness as it treats deficits. And the German government does not take the Commission's tame warnings seriously.

Germany's striking imbalances

The German authorities and media regularly point to data allegedly showing rebalancing in progress.[1] Newspaper articles froth about German consumers rediscovering shopping, and the government intones that the economy is now being driven by domestic demand. But the data tell a different story. The country's current account surplus hit a record 7.5 per cent of GDP in 2014 (see Chart 1). Put another way, the gap between what the country produces and consumes is wider than ever (see Chart 2). At over €200 billion this was easily the biggest surplus in the world, bigger even than China's. Germany is in breach of the EU's excessive imbalances procedure (which requires member-states to restrict current account surpluses to no more than 6 per cent of GDP, and deficits to 4 per cent). German policy makers are proud of the country's export success, but a much smaller surplus would be in Germany's interests and those of its trade partners.

Europe is awash with talk of the need for structural reforms, but little attention is paid to the chronic imbalances in Germany's economy, which comprise perhaps the biggest structural problem of all. This needs to change for Germany's sake and for the sake of its trade partners. It is not in Germany's interest to run such a large surplus. It means that living standards and investment are lower in Germany than would otherwise be the case. Moreover, the country has lost almost a third of the money it has invested abroad over the last 15 years; it would have made much more sense to invest the money at home. At the same time, German imbalances represent a formidable obstacle to a sustainable economic recovery and escape from deflation in Europe. What explains Germany's trade surplus? Will rebalancing happen of its own accord? If not, what should the German government do about it? And what should the EU be doing about it?

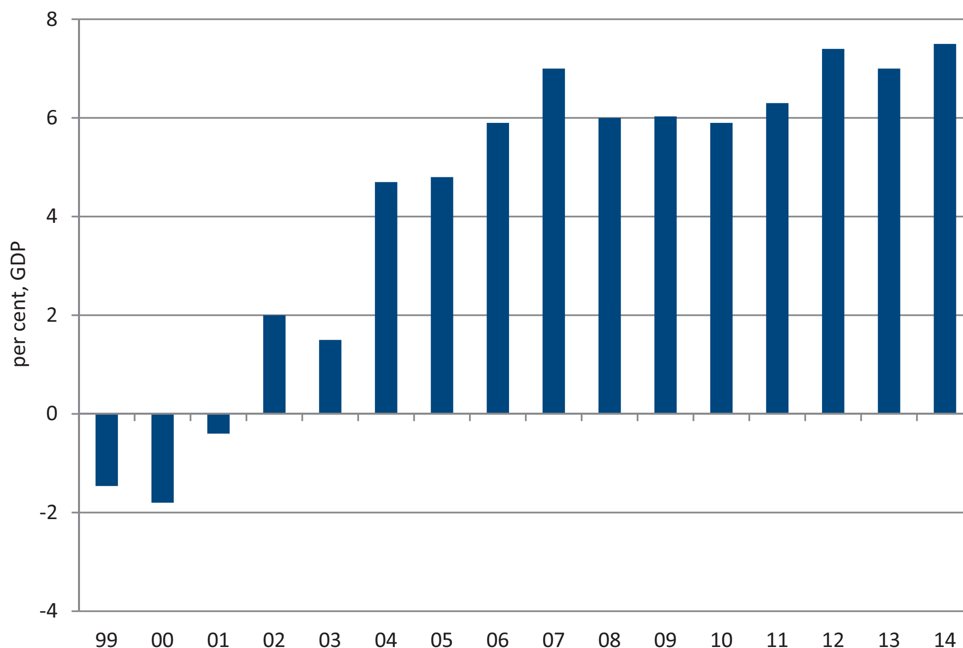

Chart 1: Germany's current account balance

Source: Haver

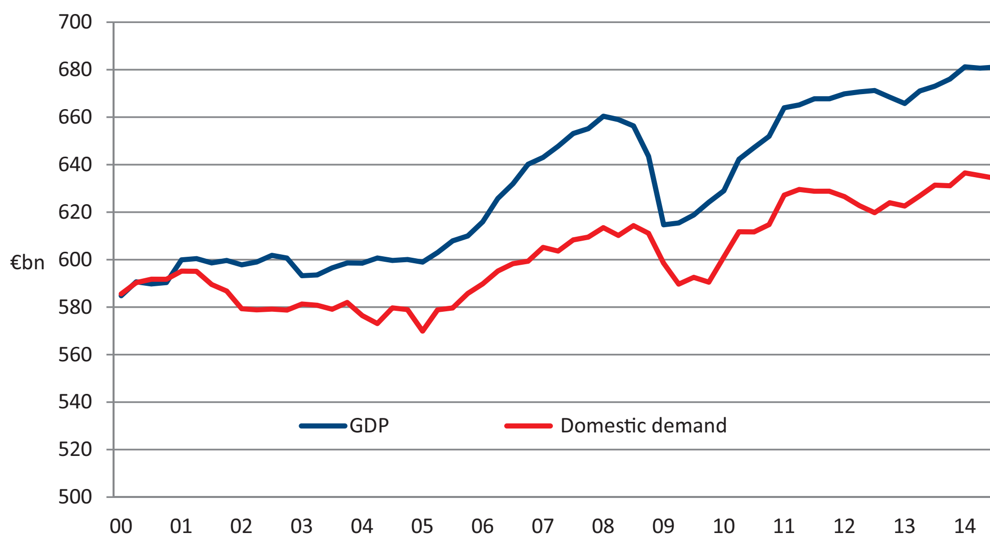

Chart 2: Germany, GDP and domestic demand

Source: Haver

1: Wolfgang Schäuble, IMFC Statement by IMF's International Monetary and Financial Committee on behalf of Germany, October 2014.

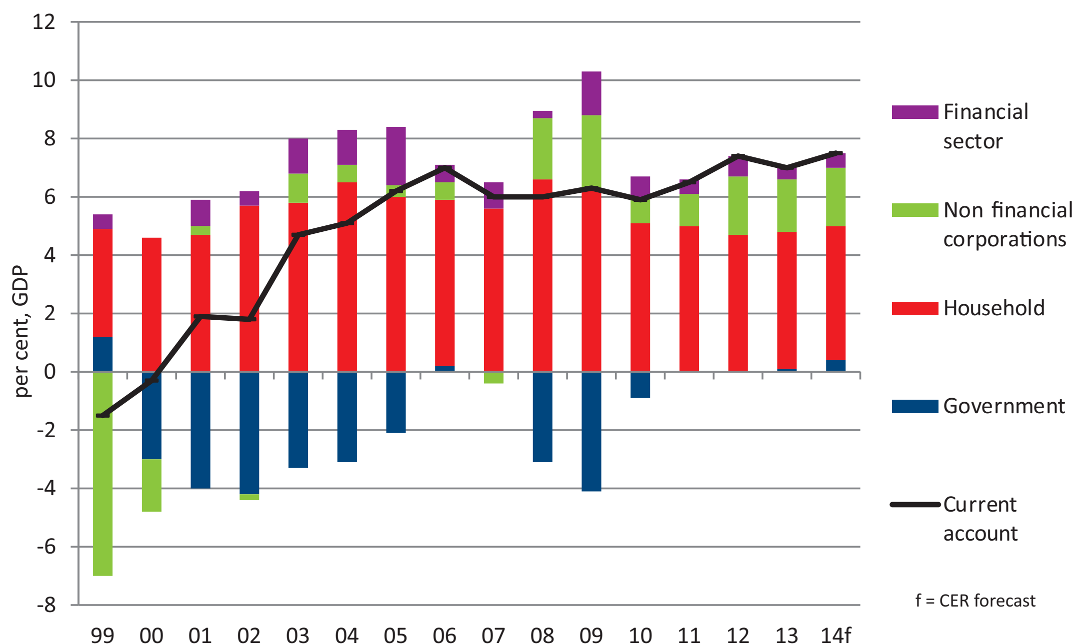

Chart 3: Current account and sectoral savings-investment balances

Source: IMF

How did Germany's economy become more imbalanced when it was supposed to be growing robustly and unemployment has been low? Because growth in domestic demand has been anaemic – averaging 0.4 per cent a year in 2012-14 – while economic growth averaged 0.8 per cent. The difference was accounted for by exports growing more rapidly than imports. Domestic demand did account for the lion's share of 2014's GDP growth of 1.6 per cent, but just because domestic demand is contributing more to growth than the external sector does not mean that the economy is rebalancing. First, domestic demand accounts for the overwhelming proportion of GDP, so it can be the principle driver of GDP growth even when expanding very weakly. Second, if net exports are positive – that is, exports are rising more rapidly than imports – the economy is still becoming more, not less, imbalanced. For the German economy to rebalance in any meaningful way, net exports will need to be negative for a prolonged period of time.

This will require the German government and private sector to save less and invest more. The reason is that in any economy, the sum of the savings surpluses or savings deficits of government, the private sector and the foreign balance has to equal zero. If the private sector balance is in surplus (that is, if households and firms are saving more than they are investing), then the government or foreigners must be borrowing – they must be in deficit. If both the private sector and the government are saving, as is the case in Germany, then other countries must be borrowing those surplus savings. In other words, they must be living beyond their means, something German policy-makers and economists like to criticise. Since it is a net saver, Germany has to 'import' demand from other countries which are running a current account deficit, and which are therefore borrowing money from Germany (see Chart 3).[2] Germany has substituted external demand, in the form of additional net exports, for deficient demand at home.

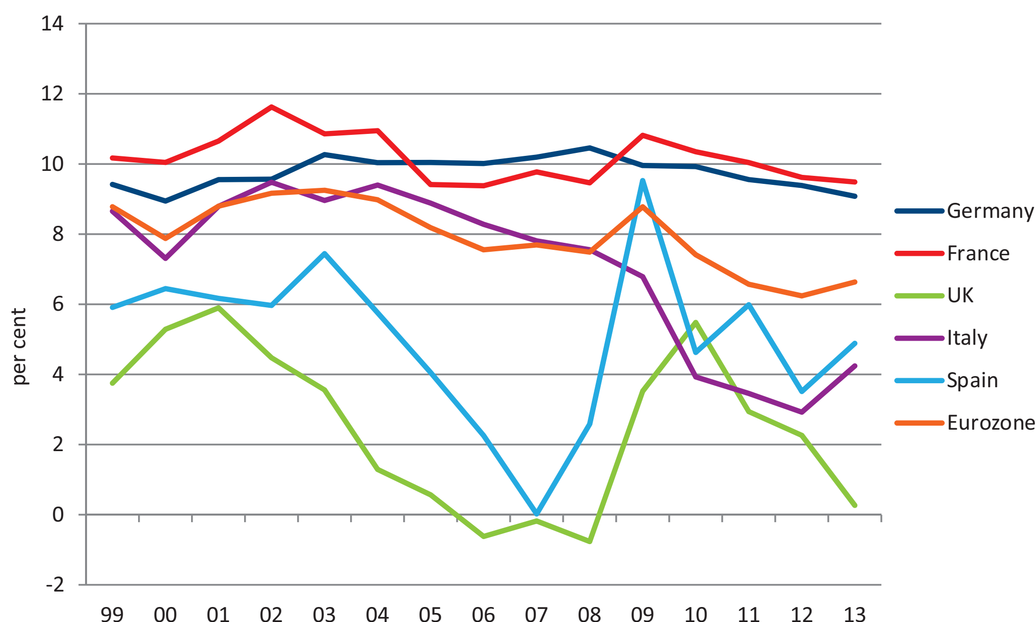

Chart 4: Household net savings as a proportion of net disposable income

Source: Ameco

2: Selim Elekdag, Faezeh Raei and Jerome Vandenbussche, 'Germany: Selected issues', IMF, June 2014.

German household savings are high but have started to ease down in recent years, so cannot explain the widening of the current account surplus (see Chart 4). However weak household spending is no doubt part of the explanation for the growth of the countrys external surplus. Real wages have been stagnant, leading to a decline in private consumption as a proportion of GDP (see Chart 5). This, in turn has contributed to a decline in business investment and hence a rising surplus by the corporate sector (see Chart 6).

Much as elsewhere, Germany's corporate sector has become a big net saver – a reversal of the normal order of things, as businesses should borrow to invest. However, unlike elsewhere in the developed world, Germany is not offsetting the weakness of private sector demand by running a large government budget deficit. That is, it is not countering excessive private sector savings with public sector dissaving. The reason why Germany is able to do this is because it is importing demand (equivalent to 7.5 percentage points of GDP in 2014) from the rest of the world.

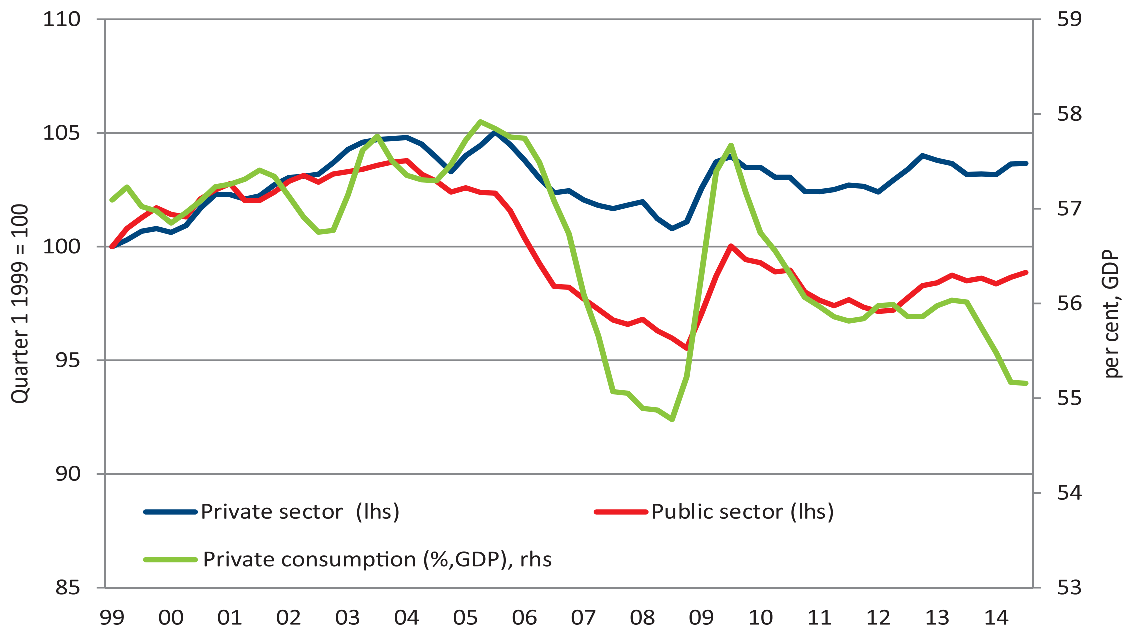

Chart 5:
Real wages and private consumption

Source: Haver

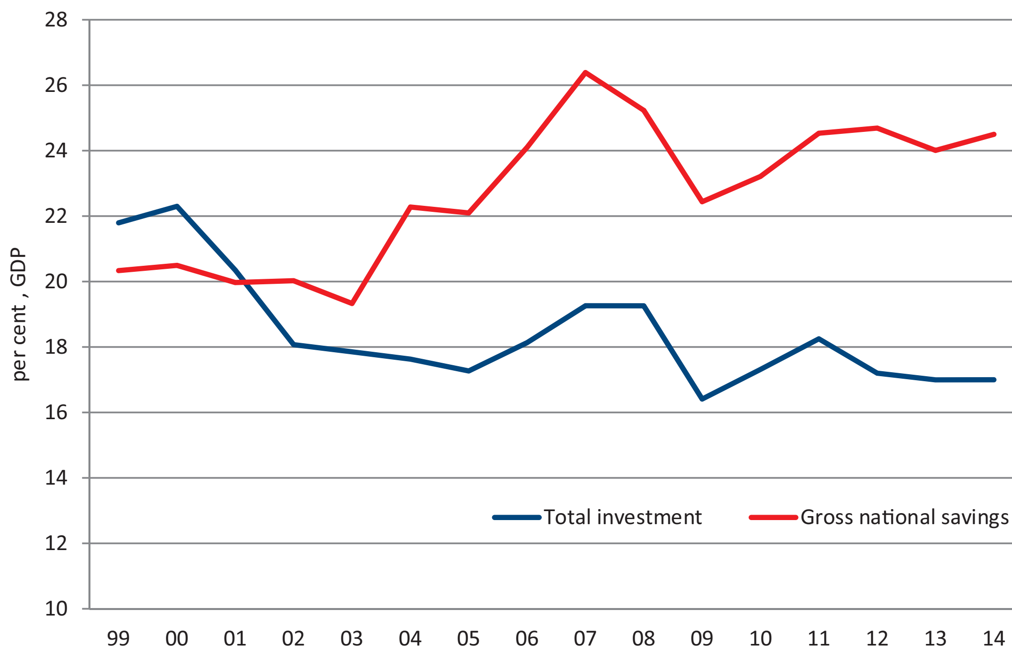

Chart 6:
Gross national savings and total investment

Source: German Federal Statistical Office, IMF, CER calculations

Why has Germany's economy become so unbalanced?

One explanation is demographics. Germany's population is ageing relatively quickly, and ageing populations tend to have a higher propensity to save than younger ones. The flipside of a high propensity to save is a lower propensity to consume and weak consumption undermines investment in the domestic economy. Moreover, a stagnant population reduces the need for investment in physical infrastructure and housing. The result is a surplus of savings over domestic investment and consumption.

There is less to this argument than is often attributed to it by many German policy-makers. First, Germany is not alone in experiencing an ageing population; most developed countries are experiencing this. Second, retirees should be consuming more, and in the process running down their savings, as is happening in Japan (a country that until recently had a very large current account surplus.) Moreover, in recent years, immigration into Germany has picked up strongly as people have moved there from the struggling south of the eurozone and from East and South-East Europe: in 2012-14 net immigration totalled around 1.2 million. One of the most congested road networks in Europe does not suggest that Germany suffers from a surfeit of physical infrastructure. Finally, an ageing population requires faster productivity growth so as to sustain a relatively larger non-active population, which in turn requires the government to work hard to remove obstacles to higher productivity growth. This is particularly true of a country like Germany with a pay-as-you-go pension system, as compared to a privately funded one. Germany's labour productivity performance is far from impressive: 0.7 per cent per year between 1998 and 2014. This requires more investment, not less.

Another reason for German imbalances is the decline in real wages. Real wages in the private sector are up just 4 per cent since the beginning 1999, whereas public sector wages actually fell over this period. A number of explanations are put forward for the stagnation of German real wages. One is that Germany entered the eurozone at an inflated real exchange rate and with a weak domestic economy. And after the recession in 2002-03, the government could not stimulate the economy through fiscal policy because of the Stability and Growth Pact (SGP) limiting governments to fiscal deficits of no more than 3 per cent of GDP. In addition, monetary policy was set by the ECB for the eurozone as a whole, not for Germany alone, which required lower interest rates. Domestic demand therefore stagnated, undermining labour's bargaining power and depressing wage settlements. This eventually priced labour back into work and is now leading to a recovery in real wages and hence consumption and investment.

This narrative is not without substance, but is problematic in a number of ways. First, it is far from clear that the D-Mark entered the eurozone at an overvalued rate. Germany's real effective exchange rate did rise following unification, peaking in 1995, but had fallen back by the time the euro was launched in 1999 (see Chart 7).[3] Interest rates might have been a bit lower in Germany in the early 2000s had the country retained the D-Mark, but it is unlikely this would have had much of an economic effect given the relative insensitivity of the German economy to small movements in official interest rates. Moreover, it is hard to see how the D-Mark could have been weaker than the euro was in the early years of the single currency: between its introduction at the beginning of 1999 and mid-2001 the euro lost over 25 per cent of its value against the dollar and did not recover that until the end of 2003. German fiscal policy was not as expansionary as it should have been in the early years of the euro, but neither was it that restrictive: Germany sensibly breached the SGP.

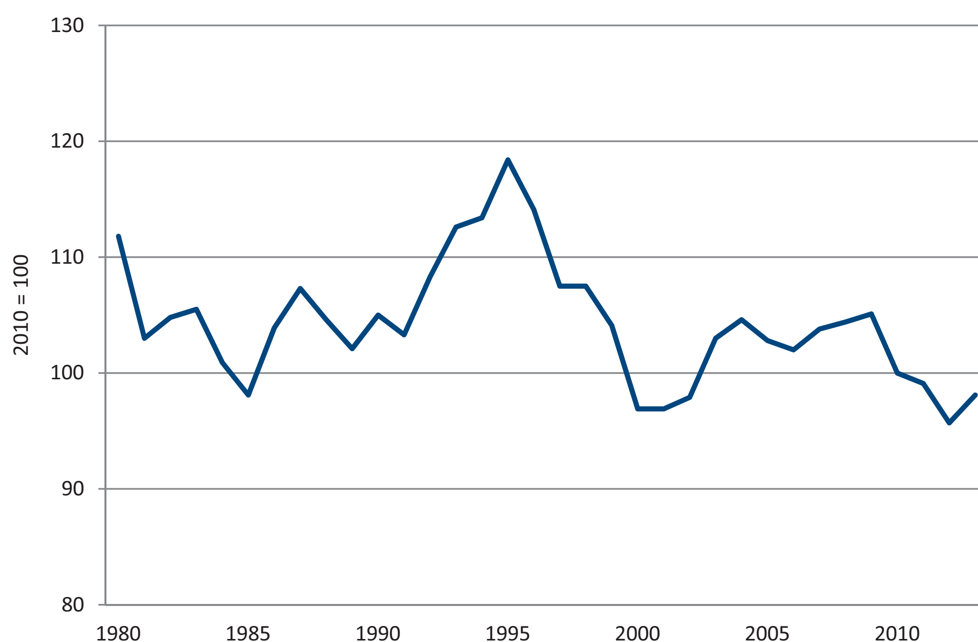

Chart 7: Germany's real effective exchange rate

Source: UNCTAD, Global Development Indicators

3: Simon Tilford, 'The eurozone's ruinous embrace of competitive devaluation', CER insight, March 2014.

The fall in real wages was certainly the result of a weakening of labour's bargaining power. But that appears to have had more to do with government policy than weak demand as a result of a lack of competitiveness. First, real wages in the public sector fell further than those in the private sector and have recovered by less. This was not out of a need to comply with the SGP – public sector wages fell even in years when the budget was in surplus. Second, the German business community and the media were successful in arguing that unless the country did something about its 'competitiveness crisis' brought on by excessively high wages and taxes on business, firms would have no choice but to invest elsewhere, especially in the new Eastern European members of the EU. This was one reason why the then SPD government introduced the Hartz IV reforms which reduced unemployment benefits and introduced sanctions to encourage the unemployed to take work. This made workers more risk averse and prepared to swap job security for wage restraint; it also led to the emergence of a large low-wage economy and increased the burden of indirect (or consumption) taxes relative to taxes on income, especially corporate income and profits. Despite private consumption accounting for a lower proportion of GDP, taxes on consumption have risen sharply as a proportion of total taxes (see Chart 8).

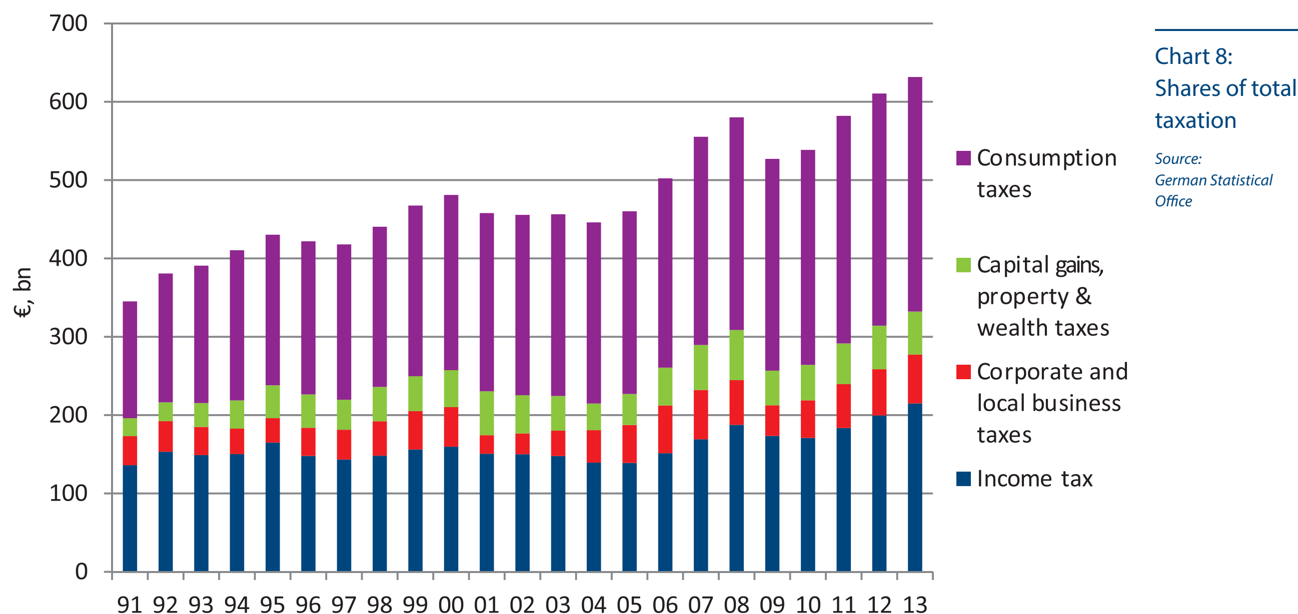

Chart 8: Shares of total taxation

Source: German Statistical Office

What has generally been portrayed in Germany as a necessary response to a loss of competitiveness was actually the result of policy-makers embracing rather simplistic supply-side economic thinking and succumbing to corporate lobbying for lower labour costs and taxes. There is little doubt that EU enlargement opened up a supply of cheap and relatively well-skilled labour for German companies. But it is also clear that German firms were the principal beneficiaries of enlargement, as German exports of capital goods and other machinery and equipment to the new member-states boomed. That is, enlargement undermined the bargaining power of some sections of the German labour force, while increasing the bargaining power of others. Moreover, nobody now claims that Germany faces a competitiveness problem and the benefits of enlargement are there for all to see: German unemployment is now low and the fiscal position is robust. But real wages, whether public or private, have not yet recovered in any meaningful way.

A third often-cited reason for the decline in German investment (and hence growth of the current account surplus) is declining relative prices of investment goods. The falling prices of certain types of machinery and equipment (especially computer hardware) could partly explain the decline in Germany's investment rate, but money spent on investment goods is only part of overall investment spending.[4] Moreover, if investment goods are getting cheaper, why are German firms not buying more of them and substituting them for labour, especially when interest rates are so low? As Christian Odendahl has shown, investment in Germany is lower than in comparably industrialised economies and investment in intangibles is especially low.[5] Another explanation for weakening investment is that German businesses are investing abroad, especially in Eastern Europe, rather than in Germany. But German firms are not especially avid investors abroad: their overseas investments are comparable to those of their counterparts in other developed economies. And FDI is not a one-way street: there is plenty of inward investment into Germany.

A more plausible explanation for the continued weakness of German investment is that firms are reluctant to invest when they are pessimistic about the outlook for private consumption in Germany. And the German government has steadily reduced public investment to the point where it is not high enough to replenish the existing capital stock (see Chart 9).

4: 'Deutscher Leistungsbilanz Uberschuss – Aktionismus nicht angebracht', Sachverständigenrat, 2013.

5: Christian Odendahl, 'More investment for Germany's sake', CER insight, June 2014.

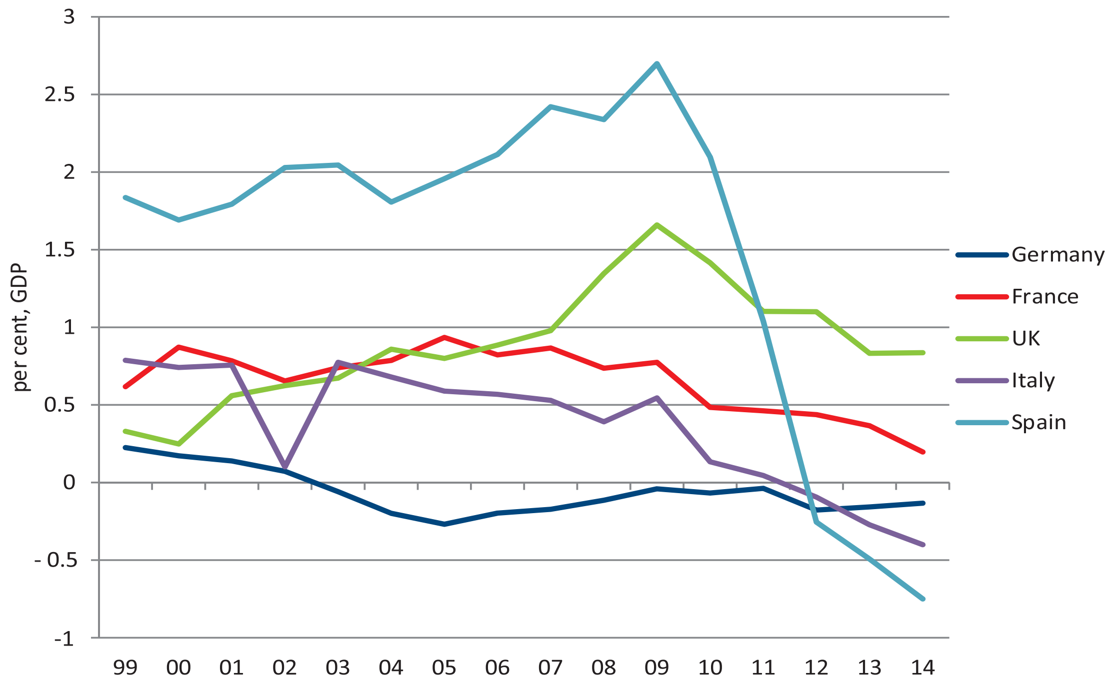

Chart 9: Net public investment

Source: Haver

German imbalances are a problem for itself and others

Germany's imbalances are a problem because they impose costs on both Germans and others. The current account surplus represents money that could have been consumed and invested at home. For the average German, the surplus represents lower disposable income than otherwise would have been the case and worse infrastructure and public services. Living well 'within their means' means German living standards are lower than they should be.

An often-repeated argument is that as an ageing society Germany needs to be running an external surplus so as to build up assets to support an ageing population. And that because of Germany's ageing population (and hence slow growing economy), savings can be invested more productively abroad. There may well be a case for an ageing society to run a small current account surplus, on the assumption that surplus savings can be invested abroad more productively than at home. But this is not happening in Germany's case. Chart 10 shows Germany's cumulative current account surpluses and its net international investment position (its total foreign assets less its total foreign liabilities). The country's foreign assets have risen much less rapidly than the accumulated current account surpluses, leading to massive accumulated losses: around €580 billion since 1999. Moreover, a sizeable chunk of the money that Germany invested in struggling eurozone economies will never be repaid, meaning that in reality the picture is even worse. These losses are partly the result of poor investment decisions by German banks, but also reflect the difficulties other countries face in finding productive uses for Germany's savings.

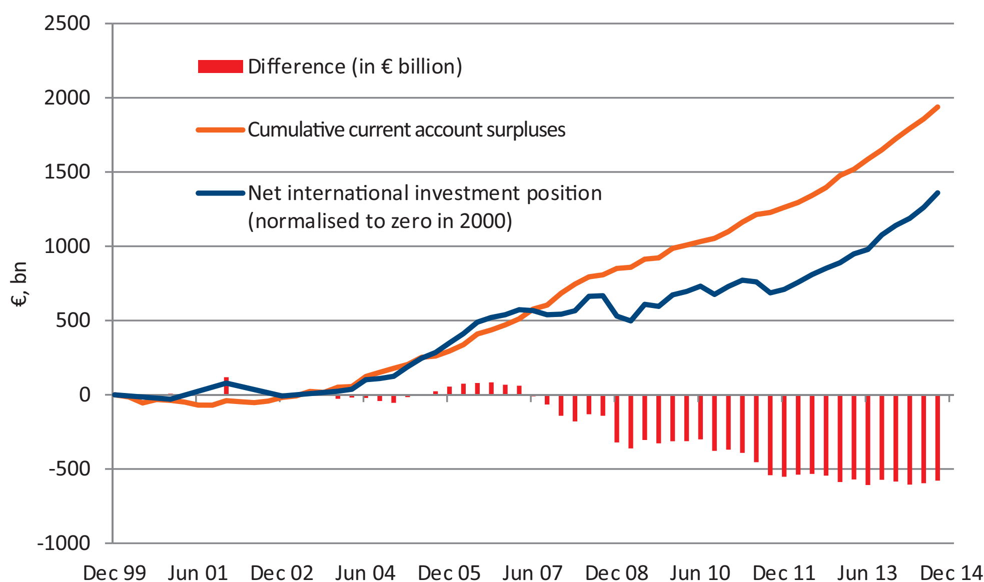

Chart 10: Cumulative current account surpluses and net international investment position

Source: Haver

Therefore, when foreigners call for Germany to reduce the surplus it should not be seen by Germans as a call to sacrifice their own interests for the common European good. On the contrary, it is in Germany's own interest to do this. It would make much more sense for the surplus to be invested at home.[6] But this requires the government to invest more and for employees to earn more (without which firms will not step up their investment).

What about the impact of Germany's current account surplus on its trade partners? The global economy is struggling with weak demand as a result of a surfeit of savings over profitable investment opportunities. Europe is the weakest spot in the global economy, and a major reason for that is Germany's savings surplus (strip out Germany, and the eurozone does not have a problem of excess savings). The eurozone's move into a large current account surplus since the financial crisis of 2008 (as Germany's surplus has grown and the deficits of other eurozone countries have narrowed) has left the world even more dangerously dependent on the US to sustain global growth.

Germany's surplus acts as a drag on an already weak eurozone economy and reinforces the deflationary pressures in the currency union. Depressed German consumption and investment make it harder for other members of the eurozone to rebalance their economies (close their trade deficits and run surpluses for a while in order to reduce their external indebtedness). At the same time, Germany's surplus makes it more difficult to bring about the necessary shifts in real exchange rates within the currency union. The reason is that the flipside of the German surplus is low inflation in Germany, which is the opposite of what the eurozone needs at present. If the deficit countries are to regain trade competitiveness (reduce their real exchange rates relative to Germany), they need lower inflation than in Germany. In short, they need the reverse of what happened in the early years of EMU. But if German inflation is very low, this requires the struggling eurozone countries to actually cut prices in order to bring about the required fall in their real exchange rates. Even if they succeed in doing this, the resulting deflation pushes up the burden of debt relative to income, imperilling their solvency. This is happening across the south of the eurozone.

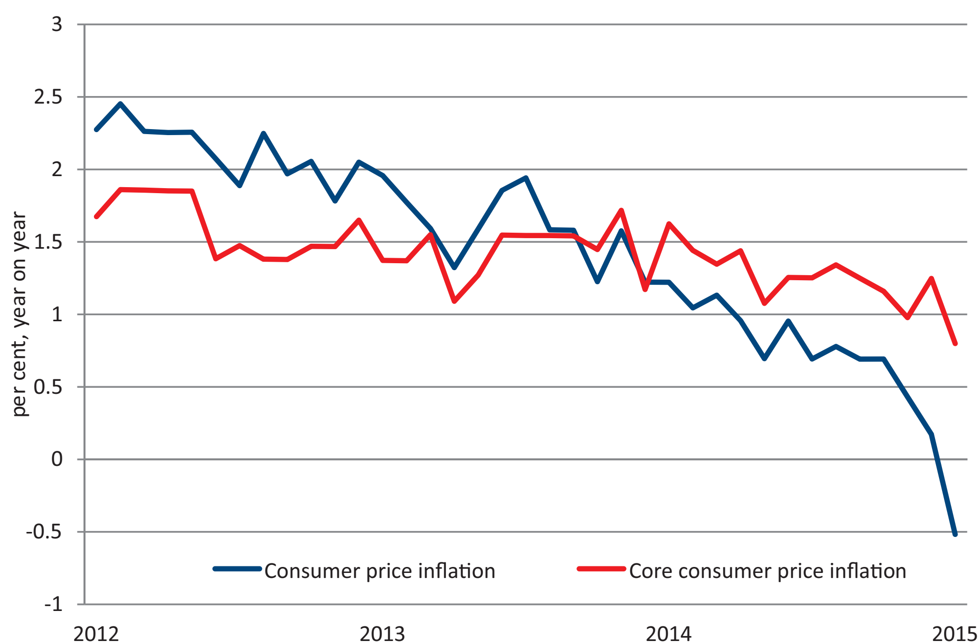

Chart 11: Consumer price inflation

Source: Haver

Will Germany's imbalances correct themselves?

Will the German economy rebalance without policy interventions? Real wage growth will accelerate quite sharply in 2015 largely as a result of the sharp decline in inflation brought about by the halving of the oil price and the introduction of a national minimum wage. The extent to which this will boost consumption will depend on whether German households spend the additional money rather than save. High levels of consumer confidence and improving job security suggest that they will spend it, bar a serious intensification of the eurozone crisis or another external shock. Combined with some employment growth, private consumption growth should accelerate providing a modest boost to business investment.

However, there are a number of reasons to doubt that the pick-up in real wage growth will be sustained. First, with inflation expectations falling, wage settlements are likely to start falling too. Indeed, there is tentative evidence that this is already happening, a trend that is likely to strengthen over the coming months.[7] Second, the German labour market is less tight than it appears.

6: Marcel Fratzcher, 'The German illusion', Collins, June 2014.

7: Allison Mandra, 'Is low inflation translating into lower wage growth in Germany already?', Bruegel, January 2015.

On top of the 2 million people still formally out of work, there has only been a limited fall in the number of people of working age outside the workforce (from 3.95 million in the third quarter of 2007 to 3.77 million in the third quarter of 2014), and a big rise in the number of part-time workers. Although total employment is up around 1 million (or 4 per cent) relative to its pre-crisis peak, full-time employment only recovered to pre-crisis levels in the third quarter of 2014; the growth in part-time jobs accounted for all of the rise in employment until this point. As a result, real wage growth in the non-unionised portion of the labour market is likely to remain pretty weak. Third, with the exception of one or two notable deals, such as the 3.4 per cent rise awarded in February 2015 to Germany's metal workers. Germany's major unions continue to accept modest wage rises.[8] For much of the last 15 years, they accepted wage settlements below the rate of productivity growth. But now they are reluctant to push for real wage settlements in excess of productivity growth, having apparently internalised the idea that real wage growth above that level would be damaging for competitiveness. This asymmetry is likely to continue holding back wage settlements in the unionised sector.

A weaker euro should boost German exports, especially if it succeeds in kick-starting big eurozone markets for German goods such as France and Italy. However, it is unclear that a weaker currency will boost demand in the German economy as a whole. While it should be positive for exports and investment in export-orientated sectors, it will hit household disposable incomes by making imported goods and services more expensive than they otherwise would have been. The net effect of a weaker euro on the amount of German firms' total spare capacity, and hence on their readiness to invest or increase wages, is therefore unlikely to be large. Indeed, what Germany really needs is a stronger real exchange rate, not a weaker one.

"There is no indication that the government is prepared to provide a fiscal stimulus."

What about a fiscal stimulus? With tax revenues rising robustly and the budget in surplus, the government is well-placed to award more generous wage settlements for public sector workers as well as boost investment. The government could boost spending by around 0.75 percent of GDP without breaching the country's so-called 'debt brake' (essentially a constitutionally-binding requirement to limit the structural budget deficit to just 0.35 per cent). However, there is no indication that the government is prepared to embark on even such a modest fiscal stimulus.

The policy interventions needed to correct the imbalances

There is little to indicate that the German economy is going to significantly rebalance, at least in the absence of policy interventions. These could take a number of forms. The first is a rethinking of fiscal policy. The government has the scope to impart a modest fiscal stimulus without even breaching its highly restrictive fiscal rules. But a bigger fiscal stimulus than this is required to make a significant dent in Germany's excess savings, and this would require a constitutional amendment. None of the mainstream political parties favours such a move, despite a compelling economic case.[9] The German government can currently borrow money over 10 years at just 0.3 per cent, which adjusted for expected inflation over this horizon means that it can borrow at negative interest rates. Basically, investors are willing to pay the German government to lend money to it, such is the dearth of profitable investment opportunities. The government can borrow money over 30 years at under 1 per cent. Instead of targeting a balanced budget, the German government could run a balanced budget on current spending, but borrow to cover public investment (say around 2 per cent of GDP). At the current very low interest rates such an investment programme would be likely to deliver a handsome return. A fiscal stimulus of 2 percentage points of GDP would no doubt lead to a tightening of the labour market, push up wages and encourage firms to substitute capital for labour. But this is exactly what Germany (and the rest of Europe) needs: higher German wages, a recovery in investment and higher inflation (see Chart 11).

Another policy shift that could help rebalance the German economy is a more progressive tax system. The increased dependence on value-added taxes is no doubt one reason for the weakness of private consumption. Indirect taxes are regressive: they hit those on lower incomes hardest, but it is these groups that have the highest propensity to consume and the lowest to save. Income taxes are more progressive, but the proportion of German taxes raised from this source has fallen. Wealth and property taxes are the most progressive forms of taxation, but are low in Germany (taxes on property are less than half the OECD average). Germany could also increase taxes on the corporate sector, which now has a high propensity to save. Corporate taxes in Germany account for a lower proportion of overall taxes than in any other OECD country except Estonia and Slovenia, and are not much more than

8: Frankfurter Allgemeine Zeitung, 'Metaller erhalten 3.4 Prozent mehr Lohn', February 24th, 2015.

9: Selim Elekdag and Dirk Muir, 'Das Public Kapital: How much would higher German public investment help Germany and the euro area?', IMF Working Paper No. 14/227, December 2014.

half the OECD average. This would not be in any way 'anti-business': a tax system which boosted consumption would benefit businesses and encourage them to invest. Indeed, higher corporate taxes in themselves could persuade them to invest more of their profits in order to avoid having to pay tax. However, it would involve the German government challenging the widely held belief that low corporate and wealth taxes lead to higher investment.

A more equal distribution of wealth could also help to deter excessive precautionary savings by households and hence boost consumption. The German wealth (as opposed to income) distribution is one of the most unequal in the world, more so even than in the UK or the US. One reason for this is that ownership of property is more concentrated in Germany than elsewhere in Europe or the US. Encouraging greater home ownership could help to address this, as well as ensuring that a greater proportion of the population shares in the wealth effects of recovering house prices. One way of doing this would be to liberalise the country's mortgage market to make it easier for those without much equity to get a mortgage. At present, borrowers typically need a very large deposit (around 30 per cent) in order to qualify. Despite warnings from the Bundesbank of a house price boom, there is no evidence of one. In real terms, prices remain well below their levels of 20 years ago, with the current price rises highly concentrated in a small number of population centres.

"A more equal distribution of wealth could deter households from saving so much."

Finally, the German authorities could openly support the ECB's strategy of quantitative easing and any further moves to provide monetary stimulus. This would help convince investors that the ECB is really serious about doing all it takes to increase inflation in the eurozone. Quantitative easing works by increasing the amount of cash in the financial system: the central bank essentially 'creates' money and uses it to buy bonds from investors such as banks or pension funds. Like lowering interest rates, this is supposed to encourage banks to make more loans and hence to stimulate consumption and investment. The banks buy assets to replace the ones they have sold to the central bank, which lowers asset prices and interest rates, which in turn boosts consumption and investment. If investors really come to believe that the ECB will keep buying assets until inflation rises back to target, this could impart a powerful boost to domestic demand in Germany. Similarly, if German savers were convinced that official interest rates would remain very low indefinitely (or even turn negative), they might increase spending rather than stomaching nominal falls in the value of their savings.

Conclusion

The German economy has not rebalanced – its 2014 current account surplus hit an all-time record as a proportion of GDP. Nor is the German economy about to rebalance significantly. Real wage growth will accelerate in 2015 as a result of falling commodities prices, but will not put a significant dent in the country's surplus. For this to happen the government will need to embark on a series of policy interventions. A fiscal stimulus is the most obvious way of soaking up some of the country's surplus savings, and Germany has plenty of fiscal space to provide one. A more progressive tax system would also help: Germany relies too much on consumption taxes, whereas corporate income, wealth and property are undertaxed. Financial liberalisation to encourage greater home ownership could also help to address Germany's highly unequal distribution of wealth, lowering households' precautionary savings in the process. Finally, the German authorities could openly back aggressive monetary easing by the ECB, including its programme of quantitative easing. There is no sign of any inflationary pressure in Germany and the awareness that interest rates will remain very low for a prolonged period of time could deter German households from saving so much.

As the German government shows little inclination to take active steps to foster rebalancing, the European Commission should step up pressure on it to do so. At present, the Commission does not treat current account surpluses with the same seriousness as it treats deficits, to a large extent because of German pressure to set asymmetric rules. And the German government does not take the Commission's tame warnings seriously. This is unacceptable. German imbalances have a deleterious effect on both Germany and on its trade partners. They reflect structural (and distributional) problems in the German economy, which holds back investment and hence productivity growth, and depresses German and European living standards. German rebalancing would boost the eurozone economy as a whole and lift inflation, making it easier for indebted eurozone countries to service their debt, including those which they owe to Germany. It would be a win-win for all concerned.

Simon Tilford
Deputy director, Centre for European Reform

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