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Surmounting the German Surplus

PARIS – Germany's large and persistent current-account surplus was scarcely mentioned in a recent electoral debate between Chancellor Angela Merkel and Martin Schulz of the Social Democratic Party. That may not have bothered Germans; but for many outside of Germany, it was deeply troubling, as Germany's external surplus has been roiling political debate in many countries for several years.

Leading the charge against Germany's huge trade surpluses, no surprise, is the arch-protectionist Donald Trump, who accuses Germany of pursuing mercantilist policies that severely harm the United States' economy. And many European leaders – including some within a European Commission often said to be in Germany's back pocket – have similarly blamed Germany for much of the economic distress in the eurozone over the past decade.

Germany's critics argue that its surplus reflects a perverse obsession with fiscal prudence, which has not only constrained demand in Germany, but also

imposed a decade of austerity on the rest of Europe. But such criticism has not gone unanswered: many German economists have responded with forceful defenses of their country's policies, though often using arguments that baffle their fellow economists.

These exchanges have, at times, become very emotional, given that they hark back to some of the darkest episodes in European history. After World War I, Germany was a major debtor, facing huge repayments to pay for war reparations. Fortunately, in recent years, *Project Syndicate* commentators have looked past the heated rhetoric to offer dispassionate, informed analyses of the causes and effects of the German surplus. Taken together, their insights help to bring clarity to one of Europe's most fraught policy disputes.

Deutschland über alles?

One reason Germany's surplus has proved so divisive is that it often defies simple explanations.As Charles Wyplosz of the Graduate Institute of International Studies in Geneva notes, "Economists have made a specialty of disagreeing about the causes and policy implications of large external imbalances." Current-account imbalances can reflect a host of varying factors, which can differ from country to country; and, complicating matters further, many countries' current accounts have changed significantly just in the past decade.

In Europe, for example, many countries that had large deficits before the 2007 financial crisis – including Greece, Ireland, Italy, Portugal, and Spain – have since experienced spectacular turnarounds. The Baltic countries went from having deficits of over 15% of GDP in 2007 to surpluses in 2016. And the United States has halved its deficit since 2007, while China has reduced its surplus by almost ten percentage points of GDP. But while "China's current-account surplus shrinks," Harvard's Carmen Reinhart observes, "Germany's is climbing to record levels," surpassing 8% of GDP in 2016 – the largest in the world in dollar terms.

Trump has attributed Germany's growing surplus to "currency manipulation" – a truly bizarre claim, given that Germany, as part of the eurozone, does not have its own currency to manipulate. In fact, as the University of Munich's Hans-Werner Sinn points out, one of the actual causes of "the euro's undervaluation lies within the country over which President Trump presides." In recent decades, says Sinn, the US financial industry has offered "international investors a potpourri of alluring products" that have pushed up the value of the dollar relative to the euro, making it harder for US manufacturers to compete. Or, as Wyplosz observes, "it takes two to tango. For every risky borrower, there is a careless lender ready to dip and twirl."

Even more to the point, as Sinn argued in July, Germany's surplus cannot be reduced without first understanding "why excess capital is flowing from Germany to the rest of the world." The German surplus, he points out, is in many ways just a reflection of "deficits in other countries, not least the United States, which accounts for about one third of the value of current-account deficits worldwide."

Historically, this has also been a problem within the eurozone. "The introduction of the euro," Sinn writes, "dramatically improved the creditworthiness of southern European countries." But it also created a false "sense of security," which allowed for capital – much of it from Germany – to flood into southern Europe. That capital sustained a deficit-fueled economic boom in those countries prior to 2008; and now that it has disappeared, so have those countries' current-account deficits.

Fiscal Superlatives

But while it takes two to tango, only one partner can lead. As Philippe Legrain of the London School of Economics' European Institute argues, "Germany's immense current-account surplus – the excess savings generated by suppressing wages to subsidize exports – has been both a cause of the eurozone crisis and an obstacle to resolving it." Legrain contends that, after fueling a bubble in the eurozone periphery, Germany, owing to its "depressed

domestic demand," is now "exporting deflation" and "deepening the eurozone's debt woes."

Still, this does not tell us if Germany's surplus is the result of deliberate policies. After all, as Christoph M. Schmidt, the chairman of the German Council of Economic Experts, reminds us, "International trade is not a zero-sum game." Just as "a surplus is not necessarily a cause for celebration," nor is a deficit "a straightforward indication" of what Trump would deem "a bad deal." Schmidt urges restraint against ideological interpretations of a country's current account, which he describes as merely an abstract reflection of "the outcomes of myriad private deals, from which the parties involved expect to reap benefits."

Moreover, Reinhart and Daniel Gros of the Center for European Policy Studies in Brussels both demonstrate that Germany is hardly the only country to run large surpluses consistently in recent years. In fact, according to Gros, "*All* northern European countries with a Germanic language are running a current-account surplus," including the Netherlands, Switzerland, Sweden, and Norway, each of whose surpluses, relative to GDP, exceeded that of Germany at the time. Gros hints that critics who do not also accuse these countries of "mercantilist policies" and competitive wage restraint are applying a double standard.

On the other hand, Germany's surplus has indeed been persistent, dating back to 2002. And the deficits that it ran in the 1990s largely reflected the enormous fiscal expansion that accompanied the reunification of East and West Germany – a one-time event. As Wyplosz notes, "all current-account imbalances are not created equal." In addition to business cycles, Harvard's Kenneth Rogoff explains, "the difference between what a country exports and imports" also depends on "demographics, investment opportunities, and economic diversification."

Thus, surpluses in other advanced economies do not necessarily invalidate the claim that Germany's own current account reflects mercantilist policies. Very

different factors could be contributing to the current account balances just among northern European countries, to say nothing of those in Asia and elsewhere.

Prudence and Prejudice

In the case of Germany, as in any surplus country, savings may be too high, but investment also may be too low. And while both factors reflect the behavior of individual households, firms, or the government, large surpluses, more often than not, are a result of high saving rates among households in aging societies. That would certainly describe Germany. "By 2035," Allianz SE Chief Economist Michael Heise reports, "Germany will have more than 21 million inhabitants over the age of 67; half of them will be over 80 by 2050."

In this context, "Germany has a high savings rate for good reason," says Barry Eichengreen of the University of California, Berkeley. "Its sensible people are sensibly saving for retirement." Although "they are accumulating assets now," Eichengreen argues, they will inevitably "de-accumulate them later, when old-age dependency ratios are higher." This implies that, in the meantime, some measures to boost domestic demand may fall short. For example, while the government could cut taxes, as Merkel has proposed, Eichengreen cautions that, "there is no guarantee that German households, being voracious savers themselves, will spend the additional income."

Moreover, German households' high savings rate has been stable for quite some time, whereas the German surplus has continued to increase. This has led some critics to chastise the German government for its recurring fiscal surpluses. And yet Rogoff warns that this is another area of debate that "has too often been informed more by ideology than facts." In reality, he argues, "larger German fiscal deficits would hardly have been a decisive factor in Europe" in recent years. Citing research by the International Monetary Fund, he shows that "the demand spillovers from German fiscal policy to Europe are likely to be modest, particularly in the eurozone's troubled countries, like Greece and Portugal."

Still, as Heise noted back in 2014, there is “a lot that the [German] government could do about investment, which has fallen by almost four percentage points of GDP since 2000, to just over 17% in 2013.” This remains true today. The government need not worry about crowding out private investment, given that interest rates are historically low. And, as Eichengreen suggests, now is as good a time as any for Germany to increase public spending on its “massive unmet needs in health care, education, and communication and transportation infrastructure.”

The German Model

Of course, even if fiscal policies can rebalance Germany’s current account *vis-à-vis* Europe or the rest of the world in the short term, the question of why Germany has accumulated such surpluses remains. Many commentators have pointed to deeper structural features of the so-called German model of industrial competitiveness, which is based on fiscal prudence and labor-market reforms that began in the early 2000s.

But Marcel Fratzscher of DIW Berlin cautions against focusing too much on Germany’s industrial might, because one must not assume that “a country’s current-account balance reflects the competitiveness of its exports,” rather than one or more of the other factors mentioned above. Fratzscher does not consider Germany’s export competitiveness to be a root cause of its surplus, and instead points to “protectionist policies” that have impeded productivity and wage growth in the country’s non-tradable services sector. In addition to neglected investment projects, especially in “municipalities, which are responsible for half of all public investment,” he laments that spending to upgrade the country’s “aging capital stock has been weakened by many German companies’ desire to invest abroad.”

Similarly, Heise sees a clear need for the government to step in to improve conditions for corporate investment at home. This could be accomplished with “simpler and more investment-friendly taxation, improved incentives for business start-ups and R&D, less bureaucracy and red tape, and no further

energy-cost increases." And, as Rogoff observes, "there are still extensive impediments to competition in the service and retail sectors" across northern European countries. With these removed, "consumption of all goods, including imports," would increase.

These critiques are in keeping with those offered by former Indian Reserve Bank Governor Raghuram Rajan in his 2010 book *Fault Lines*, in which he described the German economy as "oddly misshapen, much like someone who exercises the limbs on one side of the body." According to Rajan, Germany's "superefficient manufacturing sector" has operated "side by side with a moribund services sector," creating a persistent "focus on foreign demand" even when domestic demand is "dormant."

Changing the Equation

But what incentives does Germany have to change its regimen and reduce its surplus? From an economic-policy standpoint, there are at least three reasons why it should do so. First, smaller current-account imbalances could help the rest of the eurozone, and the global economy generally. As Eichengreen explains, southern Europe "needs to export more, but can only do so if someone else, like the largest northern European economy, imports more."

But Gros might push back on this argument. "The peripheral eurozone countries account for only about 10% of German imports," he wrote in December 2013, "compared to almost 40% for the other surplus countries in [the Netherlands, Switzerland, Sweden, and Norway]." Given this disparity, "[s]tronger domestic demand in Germany would thus benefit these other surplus countries (with low unemployment) four times more than the peripheral countries (with much higher unemployment)."

Of course, a second reason for Germany to reduce its surplus is self-interest. Saving less would allow for increased public and private investment to boost productivity over the long term. As the financial columnist Federico Fubini points out, despite the strength of its exports, Germany is actually the eurozone's "third-weakest performer" in terms of *per capita* GDP growth.

Worse still, it may now be experiencing its "slowest stretch of growth in total factor productivity in three decades."

Eichengreen also sees many areas where the so-called "world's strongest economy" could improve, pointing out that, "there are exactly zero German universities in the top 50 globally." And, beyond education, Germany could do far more to "boost living standards, ameliorate concerns about inequality," and address other economic weaknesses, all with "well-targeted public investment."

A third reason for Germany to reduce its surplus may be the most straightforward of all: European Union rules require it. Member states are obliged to make adjustments when their current-account surplus exceeds 6% of GDP.

Politics First

This points to the political side of the issue, which Clemens Fuest, the director of the Ifo Institute in Munich, regards as more relevant than the economics of Germany's external balance. Fuest rejects claims that "Germany is hurting itself by exporting too much and investing too little at home," and that its surplus "withholds demand from the rest of the world." Because there is "no compelling economic reason for Germany to do anything differently," he concludes that if the government does "change course," it will be "primarily for political reasons."

For example, he suspects that Germany will make economic concessions to advance other goals, given its "strong interest in international cooperation in many areas, from immigration to energy security." This seems especially likely under Merkel, who would regard "a 'Germany first' approach, akin to US President Donald Trump's 'America First' strategy" as "counterproductive."

Germany also has an interest in managing its public image in Europe. Fuest notes that its "creditor position *vis-à-vis* other countries" does not afford it much sympathy, and "may lead to political conflicts, because the debtors have

incentives to avoid repayment." For similar reasons, it is in Germany's interest not to be seen to be violating EU macroeconomic rules, lest other countries choose to do the same.

More broadly, how Germany manages its surplus could decide the fate of European integration itself. Former German Foreign Minister Joschka Fischer hopes that, after the federal election this month, the German government will finally "take the plunge and pursue a more robust economic policy." Otherwise, he warns, it could end up ceding "the stage to nationalists who would destroy the EU."

Fischer concedes that "Germany has made valid arguments in defense of its fiscal and external surpluses." But, for him, that does not change the fact that "its current economic model has failed to stimulate enough growth in the eurozone to stabilize the single currency." And this, in turn, has fueled anti-European populist movements in Germany, Italy, France, and elsewhere.

In Europe's Name

Germany is often described as the *de facto* leader of Europe. But most *Project Syndicate* commentators tend to agree that its large and persistent surplus sets a poor example for others to follow. To Harvard's Dani Rodrik, "The real heroes of the world economy – the role models that others should emulate – are countries that have done relatively well while running only small external imbalances." To be sure, countries such as "Austria, Canada, the Philippines, Lesotho, and Uruguay cannot match the world's growth champions, because they do not over-borrow or sustain a mercantilist economic model," Rodrik notes. "But without them, the global economy would be even less manageable than it already is."

At the same time, most commentators agree that the German surplus defies simple explanation. It is a problem with no single cause, and thus no easy solutions. But regardless of who or what is to blame, it is a problem that Germany will soon have to address one way or another – for Europe's sake, and for its own.

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