

The Drivers of Current Account Surplus in Germany and the Politics of Rebalancing in the Eurozone

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Illustration Source: Mountain High Maps/Shawn Venish

ABSTRACT

Current account deficits have caught the public's attention as they have contributed to the European debt crisis. However, surpluses also constitute an issue as a deficit in any country must be financed through a surplus in another country. In 2013, Germany, now the world's largest surplus economy, registered a record high US\$273 billion surplus. This paper looks at what accounts for Germany's surplus, revealing that the major driving factors include strong global demand for quality German exports, domestic wage restraint, an undervalued single currency, high domestic savings rate and interest rate convergence in the euro area. This paper echoes the US Treasury's view that a persistent German surplus makes it harder for the eurozone as a whole and the southern peripheral economies in particular to recover from the current financial crisis by imposing a Europe-wide "deflationary bias" through pushing up the exchange rate of the euro, exporting feeble German inflation and projecting its ultra-tight macroeconomic policies onto crisis economies. This paper contends that Germany's trade surplus is likely to endure as Germany and other eurozone countries uphold diverging views on the nature of the surplus engage in a blame-game amidst a sluggish rebalancing process. Prizing the surplus as a reflection of hard work and economic competitiveness, German authorities urge their southern eurozone colleagues to undertake bold structural reforms to correct the imbalance, while the hand-tied governments in crisis-stricken economies call on Germany to do its "homework" by boosting German demands for European goods and services.

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THE DRIVERS OF CURRENT ACCOUNT SURPLUS IN GERMANY AND THE POLITICS OF REBALANCING IN THE EUROZONE¹

JI XIANBAI JASON²

1. Introduction

In 2013, Germany ran a current account surplus of €206 billion (\$273 billion)³, or 7.4% of gross domestic product (GDP). It has leapfrogged China as the world's largest surplus economy since 2012 in nominal terms (US Treasury Department 2013). This record high surplus in the history of modern Germany, greater than 6% – a surplus ceiling specified in the European Union's Macroeconomic Imbalance Procedure – by a significant margin, was achieved against the background of a sluggish Europe-wide economic recovery from the financial and sovereign debt crises that swept across the prosperous continent in 2009.

This unprecedented current account surplus unleashed a vast sea of denunciations. In October 2013, the US Department of the Treasury (2013) issued a report starkly condemning Germany as a threat to the global economy. *The Wall Street Journal* called Germany the new trade-surplus "boogeyman" haunting Europe (Talley 2014). The International Monetary Fund (IMF) was quick to

¹ An earlier version of this paper was presented at the 2015 European Union Centre Asia-Pacific Research Workshop jointly organised by Yeungnam University EU Centre and Jeju National University's Law and Policy Research Institute in Jeju Province, Republic of Korea, on 5-7 February 2015. The paper was awarded the Grand Prix Best Presentation Award.

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³ Germany's current account surplus is likely to have hit a new record of \$285 billion in 2014 (Reuters 2015).

join in the criticism, rebuking Germany for delaying European economic revitalisation (Parkin and Donahue 2013). Taking a more dispassionate stance, the European Union (EU) released an in-depth review suggesting that "[a]lthough the current account surpluses do not raise risks similar to large deficits, the size and persistence of the current account surplus in Germany deserve close attention" (European Commission 2014).

This paper seeks to address the following three intriguing questions: What are the drivers of Germany's high level of current account surplus? Whether, and how, has the national surplus amassed by Germany imposes a systemic strain on the eurozone economy? And why is the imbalance not successfully tackled given the close policy coordination in the EU?

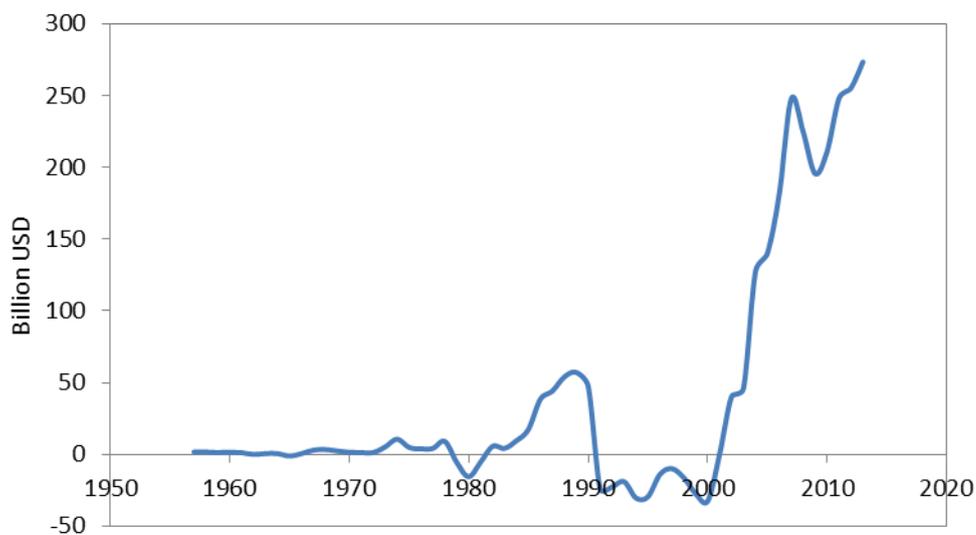
This paper is organised as follows: Section 2 presents an overview of Germany's current account balance. Section 3 dissects the surplus and identifies five major drivers – strong international demand for German capital goods, domestic wage restraint, undervalued single currency, high domestic savings rate and interest rate convergence towards German rate in the eurozone – that account for the increasing surplus. Section 4 elaborates on the spill-over effect of the German surplus on the eurozone economy and makes the observation that, due to a sharp divergence of views regarding the nature of the surplus between Chancellor Angela Merkel's government and their EU counterparts, a symmetrical, synchronised rebalancing adjustment requiring concerted efforts from both surplus and deficit economies is difficult to realise in the short term. These findings will be summarised in the concluding remarks of Section 5.

2. Germany's current account balance

There are two ways to define and therefore understand current account balance. Current account balance can be defined as the difference between exports and imports of goods and services⁴ (Krugman, Obstfeld, and Melitz 2012). A current account surplus, also known as trade surplus, implies an excess of exports over imports. Since in an open economy the total inflow of funds that is not used for domestic purposes flows outbound to accumulate claims on foreign assets (Deutsche Bundesbank 2014); the current account balance, also referred as net foreign investment in this context, equates to the difference between domestic savings and investment.

after World War II before the account dipped into the negative territory in the 1980s. The deficit soon gave way to a sustained period of surplus and it was not until the reunification of Germany which necessitated reconstructions of massive scale in the former East Germany that the figure plunged into the red for another decade (Ma and McCauley 2013; Deutsche Bundesbank 2014). After economic restructuring and several policy reforms the figure oscillated back into surplus in the 2000s. The introduction of the common currency, the euro, in 1999 boosted Germany's ballooning surplus further. The figure surged to \$247.7 billion in 2007 before the crisis hit but it soon bounced back and reached a historical high of \$273.4 billion in 2013. It deserves attention that Germany maintained a

Figure 1 Current account balance of Germany



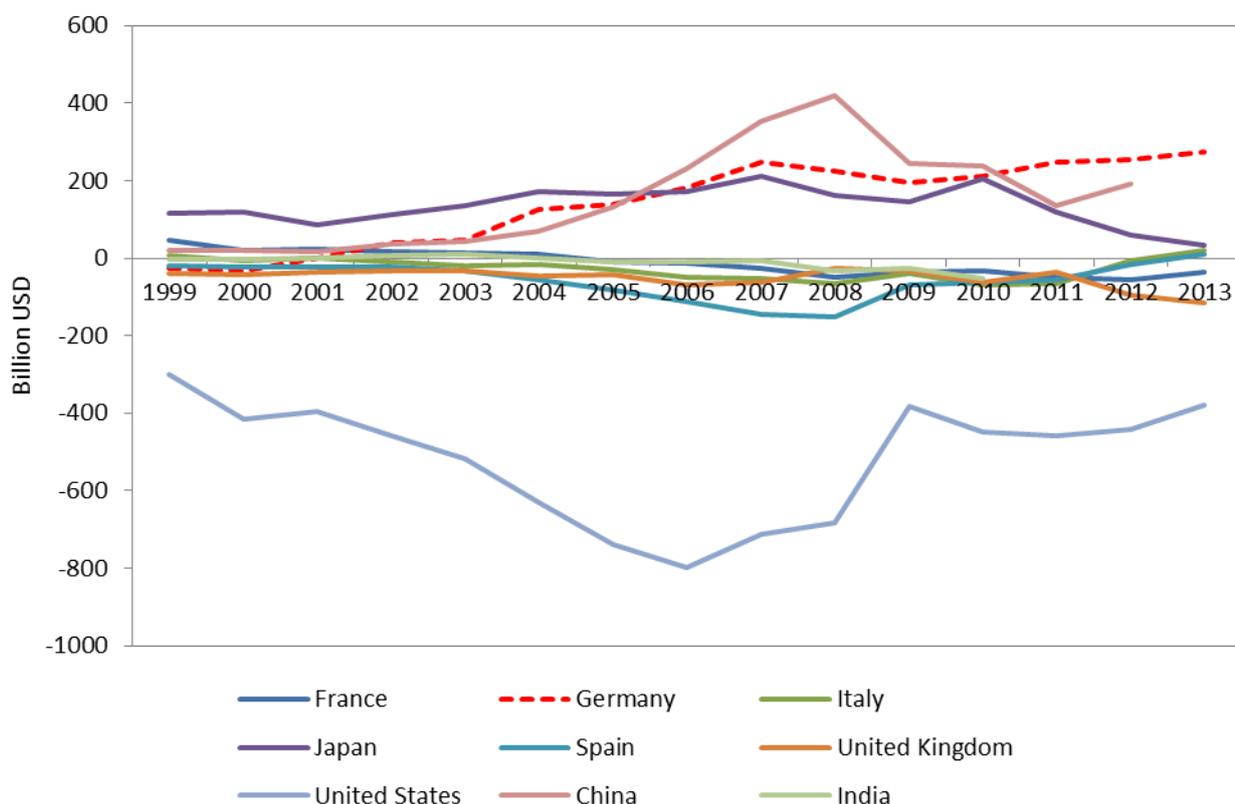
Source: OECD

Historically speaking, current account deficits have been fairly rare in Germany; instead surpluses have been the norm of Germany's external account (Figure 1). Germany ran a balanced current account for approximately four decades

positive current account balance throughout the global and European financial crises, leaving it under attack that "Germany's anaemic pace of domestic demand growth and dependence on exports have hampered rebalancing at a time when many other euro-area countries have been under severe pressure to curb demand and compress imports in order to promote adjustment" (US Treasury Department 2013).

⁴ Current account balance is also defined as the balance of trade in goods and services plus income and current transfer payments (Stutely 2010a). In the case of Germany, the latter two components are negligible vis-à-vis trade balance; therefore no definitional discussion is necessary in this paper.

Figure 2 Current account balance of selected economies



Source: OECD

Put in the global context, Germany's current account surplus is also extraordinary (Figure 2) given the fact that most of the industrialised economies, notably the US, run current account deficits. In addition, unlike Germany, nearly all major surplus economies have their external surplus shrunk significantly in the aftermath of the financial crises. The previous forerunner of the global trade surplus race and hitherto the sole comparable economy in terms of the magnitude of external surplus is China⁵. China's trade surplus was above 10% of GDP in 2007 and reached \$420.6 billion in 2008. However, China's surplus has been substantially trimmed down. In 2013, it was narrowed to just 2% of GDP primarily thanks to its proactive economic rebalancing policies aiming at exploiting the huge potential of its domestic consumers' market. Germany's current account

surplus transcends that of China and is more than three times larger than China's as a share of national GDP (6.9% versus 2.0%) now. Germany has continued to cling on to its export industry while China has begun an attempt to adjust its export-led development model to ameliorate over-dependence on increasingly volatile overseas markets when the swings of demand and instance of economic crisis have increased.

3. Main drivers of Germany's surplus

In explaining the origin of an economy's trade surplus, the traditional school of thought – mercantilism – prescribes that the surplus country in question must have resorted to market-distorting measures to protect import-competing domestic industries and/or subsidise export-competing sectors. In contemporary international economics, a common instrument of (neo) mercantilist policy is an actively managed currency in which the value is kept below market

⁵ A more detailed comparative study of Germany's and China's current account surpluses can be found in Ma and McCauley (2013).

determined rate to make their exports competitive. However, Germany, as a member of the Eurozone, no longer has the autonomy to devalue its currency as the monetary authority now lies with the European Central Bank. Germany is also known for its dedication to free market economic ideologies (Prestowitz 2012). Questions therefore arise as to what drives Germany's large and persistent trade surplus? If Germany indeed pursues some form of (neo) mercantilist policies, what does mercantilism with German characteristics consist of?

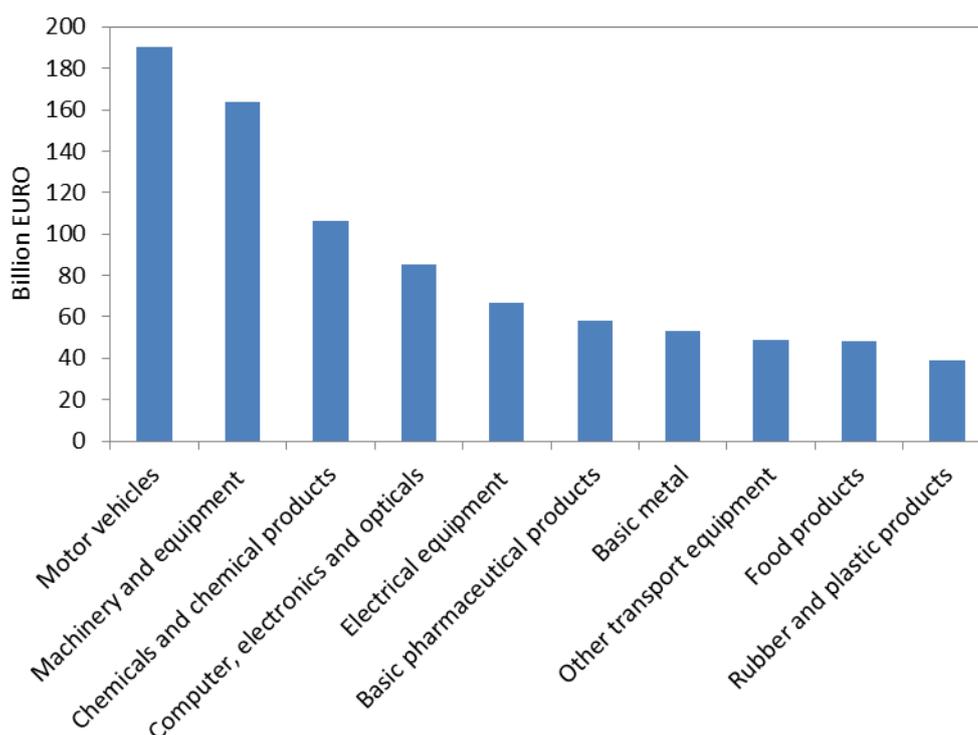
According to the definition of current account balance – the difference between exports and imports and that between domestic savings and investment, five factors are proposed to explain why German exports exceed imports and why savings outpace investment in a chronic manner, especially after the launch of the euro. They are, namely, strong international demand for German capital goods leading to strong exports; domestic wage restraint that enhances export

competitiveness and suppresses consumption; an undervalued single currency that gives Germany an edge in international markets; high domestic savings rates; and last but not least, interest rate convergence towards low German rate in the eurozone that has facilitated the outflow of German savings into the southern European economies. Each of these five factors will be discussed in detail in the remainder of this section.

3.1 Strong international demand for German goods

Deutsche Bundesbank, Germany's central bank, reconciled in its 2013 Annual Report that a significant portion of its trade surplus is attributable to imbalances in cross-border merchandise trade, which amount to an average level of 6.75% of GDP over the past decade (Deutsche Bundesbank 2014). While imports have been growing at a relatively modest speed, there is a continuous surge in German exports, and this is one of the underlying reasons for Germany's ever expanding external surplus.

Figure 3 German export by types of goods in 2013

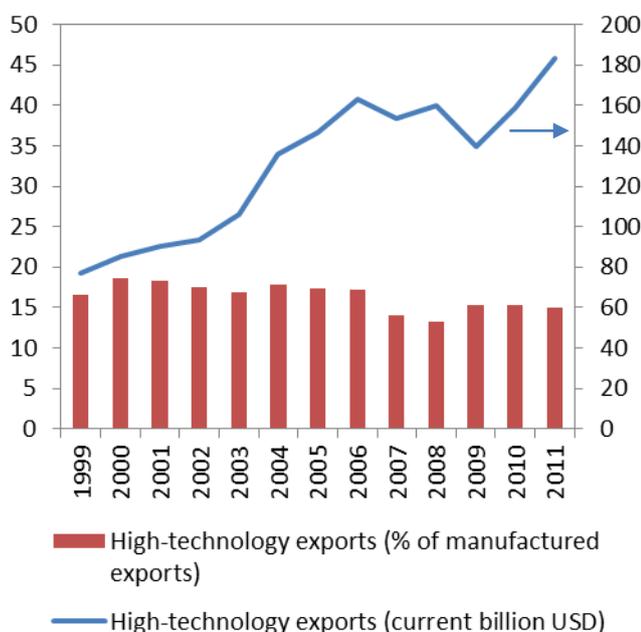


Source: Statistisches Bundesamt

On the aggregate level, Germany mainly exports finished capital goods which are highly attractive to economies in their growth phase (Figure 3). Furthermore, approximately one third of Germany's exports are intermediate goods contributing to the operation of transnational supply chains and regional production networks in Asia and Eastern Europe. Therefore semi-finished German goods are also fervently sought after (German Council of Economic Experts 2014; Schuknecht 2014). Sector-wise, Germany's high-end sector, which generated a total value of €55 billion and its luxury goods worth more than €32 billion in 2012 (MEISTERKREIS-Branchenmonitor 2013), is the spearhead of Germany's booming exports. Thanks to their world-renowned craftsmanship, coupled with "a constant stream of technical innovations and modern, timeless design", German products are world leading, with limited substitutes of matching quality and appeal in various industries such as motor vehicles (and

brands, Mercedes, BMW⁶ and Volkswagen's Audi collectively enjoying 70% market share, whereas the Japanese brands have just 10% (Economist 2014a). Another pillar of Germany's industrial potency is the capital goods manufacturing sector which is heavily dominated by the *Mittelstand* (the "Middle Class") enterprises, notably the companies that design and assemble sophisticated machine tools that developing economies need as they seek to develop indigenous manufacturing capabilities and climb up the value chain (Rattner 2011). Between 1999 and 2011, the volume of high-tech German exports escalated from \$77.2 billion to \$183.4 billion and the share of exports with advanced technologies (16.4% on average) remained stable and high compared to other major exporting economies (Figure 4). Between 2000 and 2011, the volume of German export increased by 70% while the value index soared upwards by more than 167% (Figure 5).

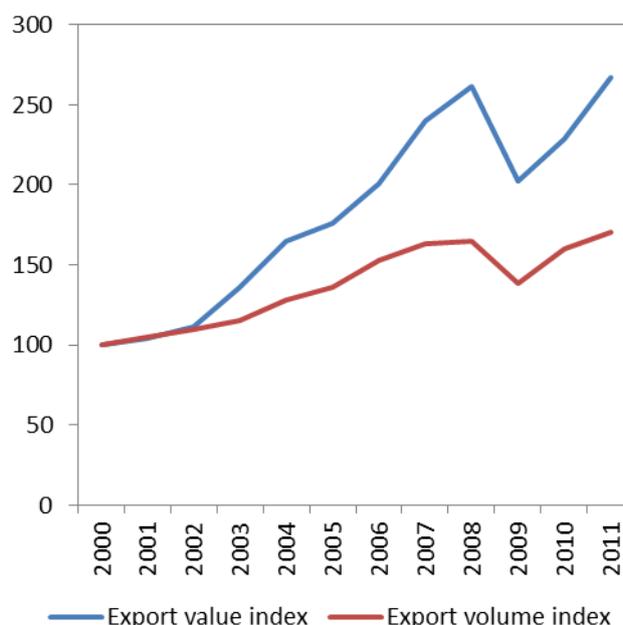
Figure 4 The volume and share of high-technology exports



Source: World Bank

other transport equipment) and super yachts (MEISTERKREIS-Branchenmonitor 2013). In the luxury car industry, for example, three German

Figure 5 German export value and volume index (2000=100)



⁶ BMW made unprecedented sales in 2013 and the record was again lifted by 7.2% in 2014, reaching over 120,000 vehicles worldwide (BMW 2015).

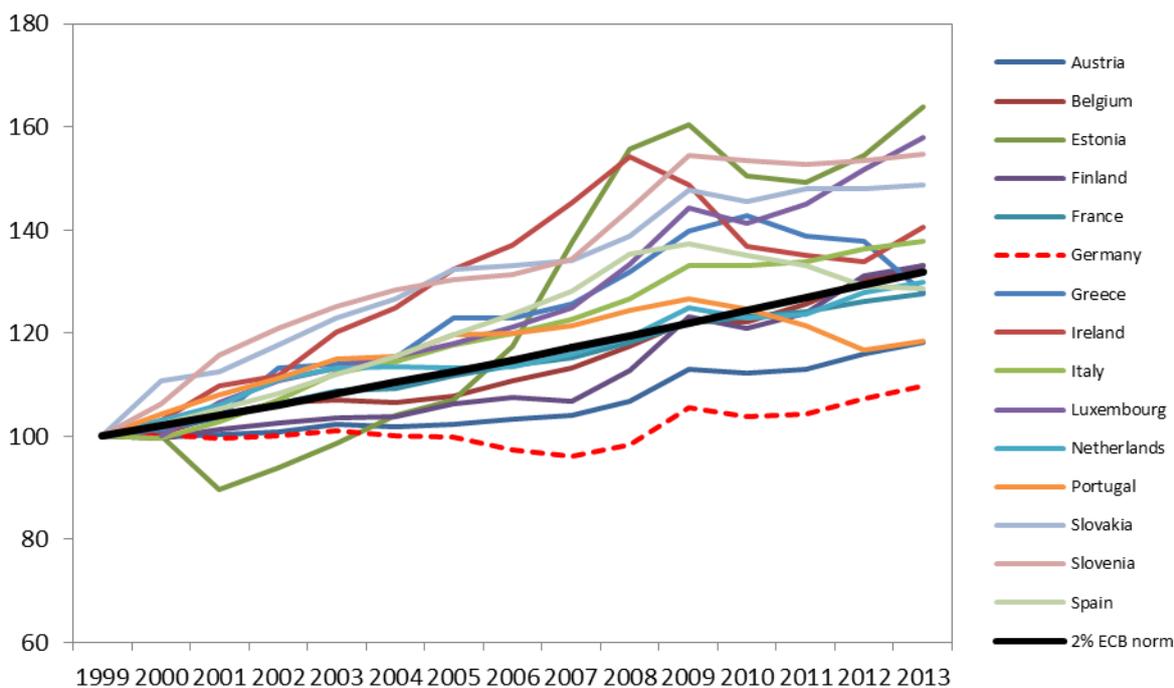
If “Made in China” is a guarantee of low price, “Made in Germany” is a warranty of high quality. On that account, Germany’s surpluses are accumulated not only through exporting goods of ever greater quantity, but also through selling goods of ever higher quality. Given the fact that the most avid importers of German goods are among the emerging and less developed economies – for example, the share of German exports to China rose from 1% in 1999 to 6% in 2013 (German Council of Economic Experts 2014) – the current account surplus also reflects the “new normal” of international economic development whereby the development of lower-income economies outpaced that of developed economies.

3.2 Domestic wage restraints

The “enviable global edge” (Rattner 2011) German exporters possess is also underpinned by a favourable domestic cost structure which is characterised by wage increment lagging behind productivity improvement.

Due to the soaring wage across the spectrum of German economy after the reunification, labour union leaders in the late 1990s agreed to suppress the wage increase rate below the growth of productivity (Flassbeck 2007; Ma and McCauley 2013). This largely voluntary wage restraint was complimented by a series of government-led labour market reforms, the so-called Schröder Agenda 2010, that attempted to cut down the then rocketing unemployment rate (Economist 2013a). The Hartz reforms, the core of the reform package, revolutionised the low end job market and curtailed state-sponsored jobless benefits substantially. It got rid of payroll taxes on earnings of less than €400 a month, giving rise to the creation of part-time, mini-jobs with miserable wages (Economist 2013a; Krebs and Scheffel 2013). The knock-on effects of the reform forced labour union to accept years of tight wage constraint in return for job security and economic prosperity. As of 2008, the wage share in Germany’s national income had been cut to a half-century low of 64.5%. The number of full-time workers on low

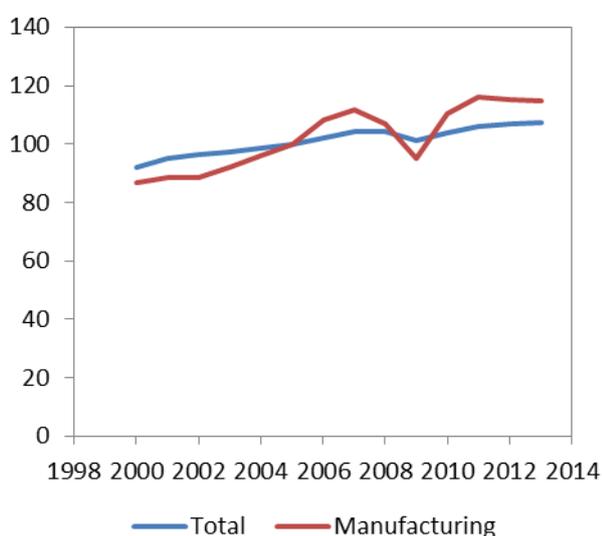
Figure 6 Nominal unit labour costs under the euro for the whole economy (1999=100)



Source: OECD, author’s calculations.

wages⁷ - often defined as less than two thirds of middle income - rose by 13.5% to 4.3 million between 2005 and 2010 (Marsh and Hansen 2012). Since the conversion to the euro, German workers' wages have been augmented by merely 0.62% per annum on average in nominal terms, leaving them virtually unchanged in real terms. Unsurprisingly, German unit labour costs (ULCs) fell sharply vis-à-vis those in other eurozone countries. This lengthy wage moderation even departed from Germany's pre-Maastricht norm of 2% annual increase in labour wages (Figure 6).

Figure 7 Value-added index (2005=100)



Source: OECD

Wage restraint is especially evident in Germany's internationally exposed manufacturing sector, in part because of the threat of off-shoring production networks to neighbouring lower cost countries from multinational corporations (Dustmann, Fitzenberger, Schoenberg, and Spitz-Oener 2014). Although German manufacturers have been creating more value than the whole economy, the ULC index fell below that of the

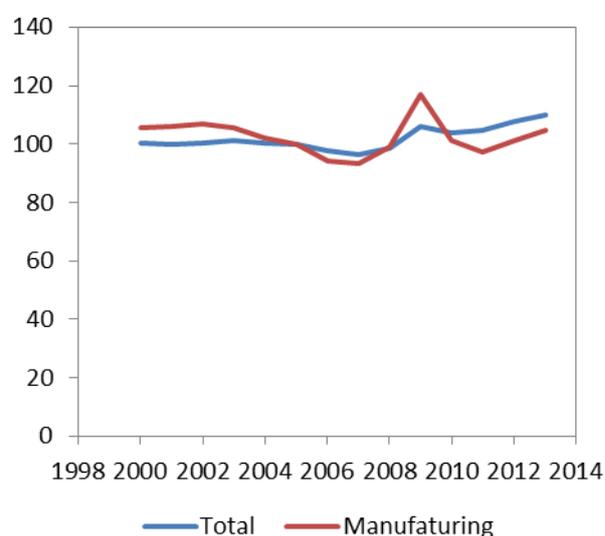
⁷ From 2015 onwards, Germany adopts a compulsory, statutory wage floor of €8.50 (\$11.61) an hour. This is the country's first national minimum wage approved by the German Parliament. Its effect on Germany's current account surplus remains to be seen.

whole economy with the notable exception being the economic turmoil years in 2008-09 (Figures 7 & 8). Low wages in Germany further strengthened the competitiveness of Germany's manufactured exports but at the same time weakened the Germans' financial capacity to consume imported foreign goods. As such, the diverging effect is an important contributing driver of the trade surplus.

3.3 Undervalued euro for Germany

In theory, balance of payment disequilibria can be corrected by movement in exchange rate. The

Figure 8 Unit labour cost index (2005=100)



Source: OECD

currency of a trade surplus economy will appreciate since the demand for its currency will outstrip the supply of it, thus eroding the competitiveness of its exports in international markets. Conversely, the currency of a deficit economy is set to depreciate and drives down the prices of its exports. Either way is envisioned to neutralise the imbalances between exports and imports. Therefore, before sharing a common currency with Germany, European economies running sizable trade deficits routinely devalued their currencies against the Deutsche Mark to boost their economic competitiveness and restore trade balance (Tilford 2010).

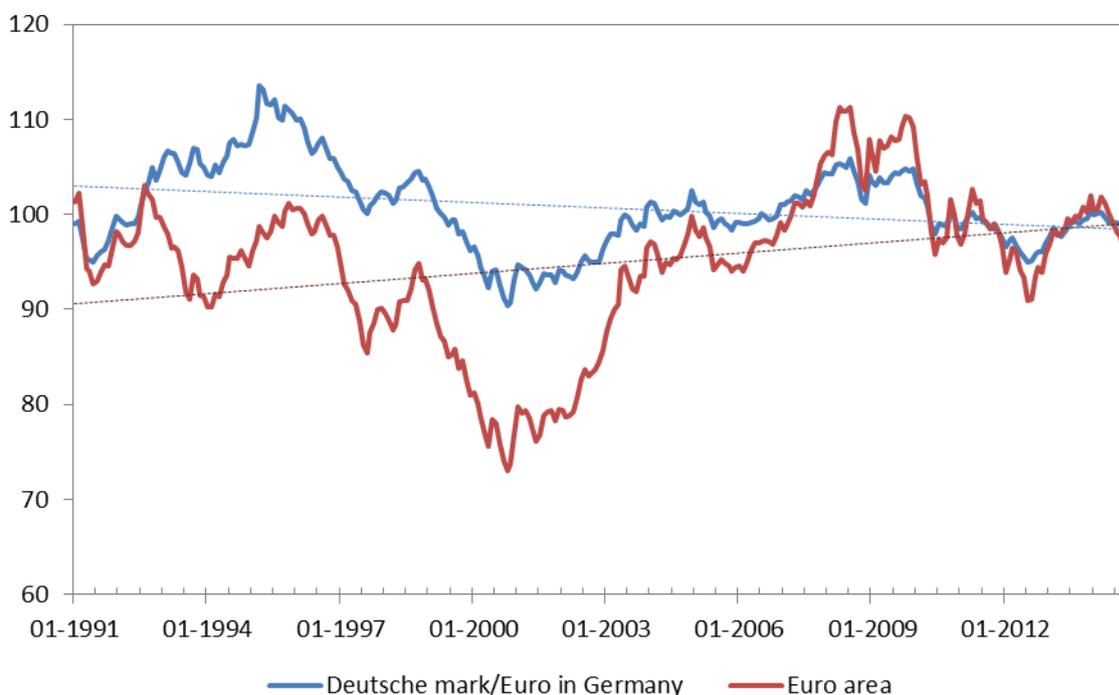
Such automatic adjustment mechanism, however, is gone as Germany gave up its Deutsche Mark and adopted the euro in 1999. Germany, along with the other EU economies joining the euro area, had surrendered their monetary autonomy to the independent, supranational European Central Bank (ECB) located in Frankfurt. Ever since, the value of the currency German exporters use to price their goods and services in international markets is determined by the homogenised market fundamentals in the eurozone as a whole, rather than the economic dynamics within its sovereign geographic boundaries.

The Eurozone's overall feeble economic performance and the implosive sovereign debt crises have kept the exchange rate of the euro far below what the Deutsche Mark would be worth

value (Figure 9)⁸. It is estimated that if Germany abandoned the euro, its national currency would immediately appreciate by more than one third (Rattner 2011).

On 22 January 2015, the ECB finally overcame its once resolute resistance to unconventional monetary policies – more specifically the quantitative easing (QE) scheme championed by the US Federal Reserve and the Bank of Japan – to launch an aggressive €60 billion per month bond-buying programme with the goal of injecting a minimum of €1.1 trillion into the chronically frail economy in the euro area. The announcement made by Mario Draghi, President of the ECB, sent the euro to an 11-year low against the US dollar and the euro has hitherto lost 6% of its value in 2015⁹ (BBC 2015).

Figure 9 Effective exchange rate (2010=100)



Source: Bank of International Settlement

today if it still existed (Rattner 2011). Germany's consumer price index-adjusted real exchange rate crawly depreciates after the inception of the euro in spite of a general upward trend of the euro

⁸ Reach exchange rates are the relative costs or prices expressed in a common currency, taking into account of inflation, that measure the international competitiveness of goods and services produced in a country (Stutely 2010b).

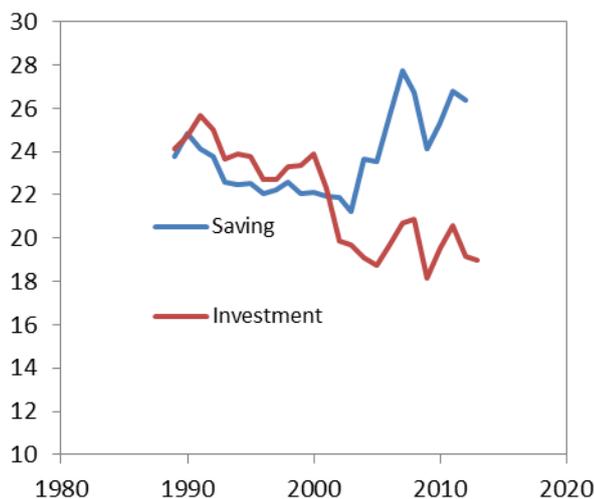
⁹ At the time of writing (27 January 2015), EUR 1 = USD 1.1244. The exchange rate hit record low of EUR 1 = USD 1.1198 on 23 January 2015, the day after Mario Draghi's announcement.

This unwittingly undervalued trading currency grants Germany a tremendous advantage over other economies with their own, most likely more expensive currencies, by making already cherished German goods artificially cheap in international markets. The latest episode of euro debasement will simply redirect Europe's internal imbalances outwards instead of scaling down Germany's external surplus as the loose monetary policy only acts to push Germany's competitiveness even further.

3.4 High domestic savings rate

The current account equates to the country's net lending to foreigners. Savings and investment in Germany are not correlated, contrary to what orthodox macroeconomic theory would have predicted – gross savings as a share of GDP is exceptionally high in Germany by advanced economy standard (Figure 10) while gross capital formation rate has been declining steadily, falling

Figure 10 Gross saving and investment (% GDP) in Germany



Source: World Bank

from 24% in 1989 to 19% in 2013 (Figure 10). This widening saving-investment gap is also at the heart of Germany's large-scale current account surplus. It is worrying to critics that the figure is likely to be

beefed up further if the past trend can be extrapolated.

On the side of the saving glut, research suggests that there is a high saving (and concomitantly low investment) propensity among German households (Kollmann, Ratto, Roeger, Veld, and Vogel 2014). This led *The Economist* (2014b) magazine to cry out that "German savers are a strange lot; they shun stocks, bonds and houses, instead parking over €2 trillion in ordinary savings accounts." Three structural factors – ageing demographic trend, cultural hostility to presumably speculative investment and low homeownership – provide credible elucidations to the eccentric German households saving behaviours.

To begin with, the high savings rate reflects German households' concerns about a rapidly ageing population (Huefner and Koske 2010; IMF 2014; Kollmann et al. 2014). The average life expectancy of Germans has been lifted from 75 in 1990 by 6 years to 81 in 2012 while the total fertility rate in Germany (1.4 births per woman) has been below the natural "replacement level" (roughly 2.1 births per woman)¹⁰ for decades. Hence it is projected that the German working population will shrink from 44.7 million (55% of total population) in 2011 to 35.4 million (48%) whereas the elder cohorts who are unlikely to support themselves through economic activities will increase from 17.2 million (21%) to 23.6 million (32%) by 2040-41 (Wong 2013). The foreseeable higher labour force dependency ratio¹¹ entails lower future per-capita pension entitlements in a "Pay-As-You-Go"¹² pension

¹⁰ A level required to at least sustain the current population size (Ji 2014).

¹¹ The dependency ratio is an age-population ratio of those typically not in the labour force and those in.

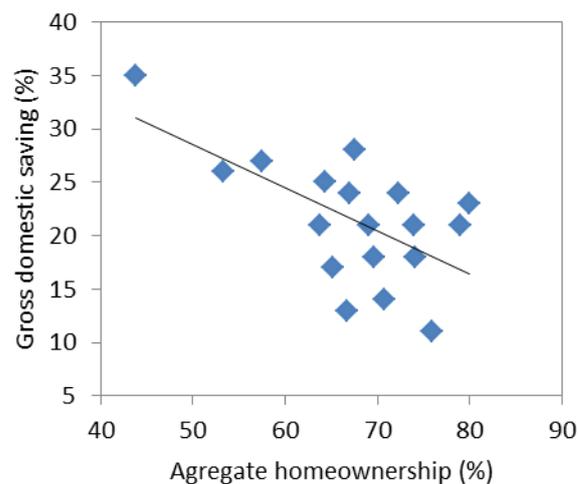
¹² A retirement scheme where the plan beneficiaries decide how much they want to contribute either by having the

system, understandably providing an incentive to increase household savings (IMF 2014; Kollmann et al. 2014).

Secondly, Germany is a risk-averse, frugal society, prizing the virtues of saving and generally denouncing investments as speculative, gambling activities. In a 2011 poll conducted for the Federal Association of German Banks, less than 10% Germans surveyed mentioned “building wealth”, 60% of respondents said “security”, and as low as 15% vocally prioritised “returns”, when asked about the most crucial criterion for an investment (Economist 2013b). The survey results are in conformity with the generalised public perception that “banks are simply flogging high-commission products” and trading in stock and property markets is a form of shameful, opportunistic gambling (Economist 2013b, 2014b).

Germans' firmly embedded economic caution has roots in the catastrophic war eras and the hyperinflation in the Weimar Republic of the 1920s (Stevens 2011). Nowadays Germans take ever more pride in their thrifty philosophy of not to live beyond their means. Younger generations are frequently indoctrinated by their parents to buy what they can afford and pay with the money they have. That attitude is so far-reaching that makes Germany a sag market for credit card companies as the word ‘credit’ is perceived to be negative in German culture (Stevens 2011). According to the Euromonitor International, a market intelligence firm, a typical American makes transactions worth \$4,236 in credit card a year, in stark contrast with the German figure of \$158 a year (Foxbusiness 2011). A side effect of the credit card phobia is that debit cards, online bank transfers and PayPal are far more common in Germany than credit cards, implying what most Germans want is “a

Figure 11 Homeownership and savings rate in selected OECD countries in 2012



Source: Table 1, World Bank

payment tool, not a credit tool” (Foxbusiness 2011; Stevens 2011).

Another cultural factor that leads to high savings rate and debilitated domestic investment in Germany is the low homeownership (Table 1). On the flip side, a higher propensity of owning a property will in all likelihood deplete savings and boost household investment (Figure 11). Germany’s homeownership rate (52.6% in 2013) ranks among the lowest in the developed world (Stevens 2015). Germany’s rental-dominated real estate market goes all the way back to the grievous experiences of the post-World War II era when the vast majority of new housing units in the war-torn Germany were rentals without incurring ownership. Nowadays, Germany’s renter-friendly housing policy, cheap rental (Phillips 2014) and the absence of tax relief on debt financing cost of homeownership (Kirkegaard 2014) collectively disincentivise Germans to buy and own houses. There is no such culture as “my home is my castle” in Germany. It is reasonably probable that this trend will endure as 93% Germans declared satisfaction with the current housing situation according to the OECD Better Life Index 2013 (Phillips 2014). The upward shift in the age

specified amount regularly deducted from their pay check or by contributing the desired amount in a lump sum.

structure of the German demographics and a downward slip towards a smaller household size will continue to dampen the already anaemic demand for homeownership in Germany. Germans thus save the funds that would have been used to purchase property.

Table 1. Aggregate homeownership rates in selected OECD countries

	Circa 1990s ¹	2004 ²	2012 ²
Australia	71.4	69.5	67.0
Austria	46.3	51.6	57.5
Belgium	67.7	71.7 ³	72.3
Canada	61.3	68.9	69.0
Denmark	51.0	51.6	64.3
Finland	65.4	66.0	73.9
France	55.3	54.8 ³	63.7
Germany	36.3	41.0	53.3
Greece	83.1	73.2	75.9
Ireland	79.6	81.4 ³	69.6
Italy	64.2	67.9	74.1
Luxembourg	71.6	69.3	70.8
Mexico	77.2	70.7	80.0
Netherlands	47.5	55.4 ³	67.5
Spain	77.8	83.2	78.9
Switzerland	33.1	38.4	43.8
United Kingdom	67.5	70.7	66.7
United States	66.2	68.7	65.2

1. 1987 for Austria, 1990 for Spain, 1991 for Italy, 1992 for Denmark and Switzerland, 1994 for Canada, France, Germany, Mexico and the Netherlands, 1995 for Australia, Belgium, Finland, Greece and Ireland, 1997 for Luxembourg and United States.

2. 2003 and 2011 for Australia, 2007 for Germany, 2007 and 2013 for United States, 2011 for Canada, 2009 for Mexico,

3. The data is particularly dated for Belgium (2000), France (2000), Ireland (2000) and the Netherlands (1999).

Sources: OECD, Luxembourg Income Study (LIS), GSOEP and the American Housing Survey, Statista, US Census Bureau, Eurostat, Statistics Canada,

High savings rate is not the sole culprit - weak domestic investment is also to blame. Public investment undertaken by various levels of German governments fell from 6% of GDP in 1970 to the current level of 2% (Economist 2015). Underinvestment in infrastructure is ubiquitous – 40% of bridges in Germany are in “critical condition” and capital stock of German machineries stay flat in real terms since 2008 (Economist 2015). At the same time, German non-financial corporates (NFCs), instead of offsetting slender government and household investment, are reluctant to invest as well. Although the

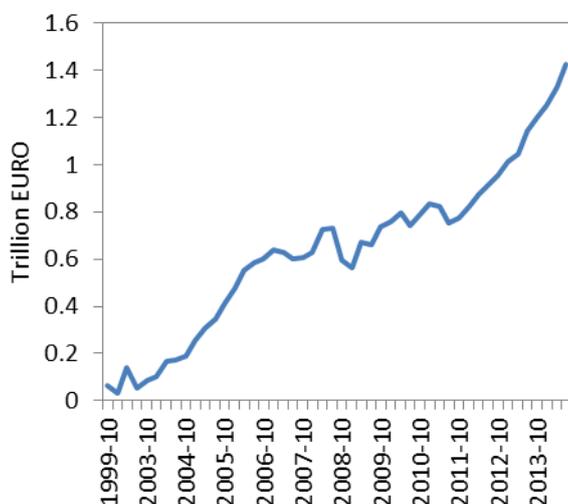
structure of labour market in Germany shifts the distribution away from wages and towards corporate profits (Ma and McCauley 2013), German NFCs are more inclined to park their revenue overseas in part to finance foreign affiliates (IMF 2014). Investors also cite their concern over the “uncertainty and nervousness over the future” of the euro, economic downturn and lukewarm business climate in Europe, as well as anxieties over discouraging German government policies such as the simultaneous exit from fossil fuels and nuclear energy, dubbed the “energy transition”, that render new investment less profitable in light of hiking utility bills (Economist 2015)¹³ to back their overseas investment decisions.

In sum, all these factors aforementioned – a rising share of the population that is entering a life phase which is characterised by a higher tendency to save, risk-aversion attitudes and cultural suspicion towards investment, frugal lifestyle, low homeownership, domestic wage moderation, investment decline – are behind the progressively expanding saving-investment gap that eventuate in the current account surplus Germany finds itself in.

¹³ Other reasons include the emerging global trend that corporates tend to hold extra cash either to hedge against sudden interruption of cash flow (Bates, Kahle, and Stulz 2009) or to fund research and development activities that are difficult to obtain external financing (IMF 2014) after the financial crises. In this regard, German companies are of no exception.

3.5 Interest rate convergence in the eurozone

Figure 12 Germany's international investment position



Source: Deutsche Bundesbank

The adoption of the euro permitted the deployment of the excessive German savings within the euro area without exchange rate risk (Ma and McCauley 2013). German banks and other institutional investors faced a drastically different investment environment prior to the euro as they were unable to take long foreign exchange positions. German economy as a whole also had trouble in recycling surplus that was in excess of 4% of GDP – ultimately it was up to a periodically revaluated Deutsche Mark to pare down the surplus (Gros and Mayer 2012). Failing to ascertain profitable investment opportunities in homeland, German capital fled abroad to the US, Central and Eastern Europe and eurozone's peripheral economies. German economy is one of the healthiest in the world notwithstanding, “[e]verywhere else gold appeared to shine more brightly than in Germany,” and “[e]ven small interest rate differences prompted investors to invest abroad the new capital provided by German savers” (Sinn 2011). Between 2002 and 2010, a total of €1.05 trillion¹⁴ German savings had been

intermediated to finance foreign consumption and investment, dwarfing the amount invested domestically (€554 billion) (Sinn 2011). The steady efflux of German savings makes Germany's international balance sheet one of the largest in the world. In October 1999, Germany's international investment position – an approximate cumulative sum of the current account – was €63.7 billion and this figure shot up to €1.42 trillion, or 39.2% of GDP, by July 2014 (Figure 12).

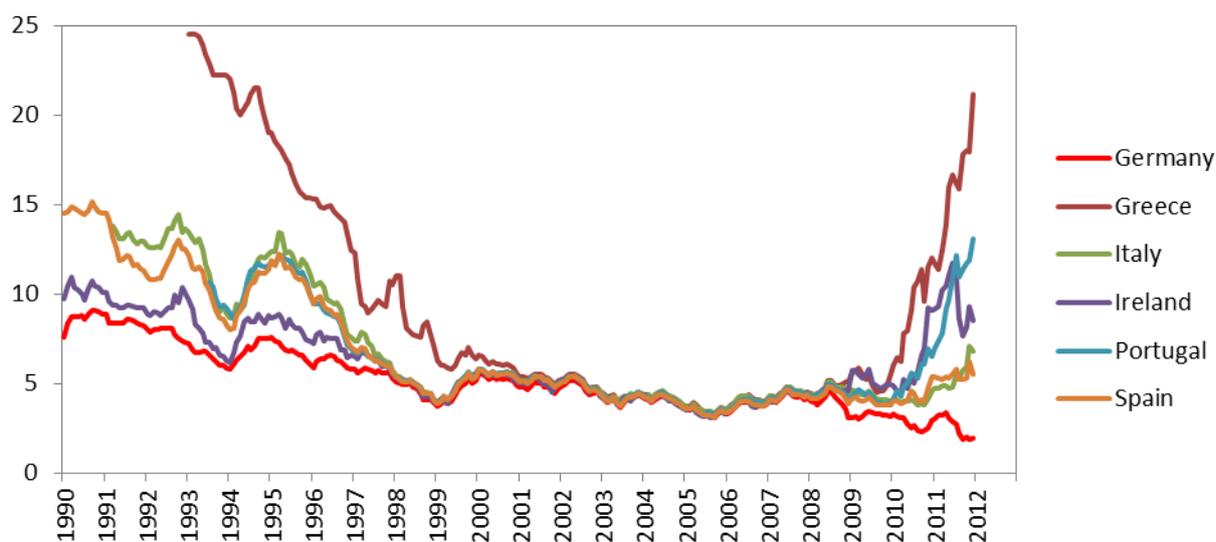
With the accession of GIIPS (Greece, Ireland, Italy, Portugal and Spain) into the monetary union, their nominal interest rates, or the cost of borrowing, rapidly gravitated towards the German rate (Figure 13). Moral hazard was pervasive – financial markets performed poor due diligence and practically treated public bonds and private liabilities issued by GIIPS economies in the same way as if they were issued by Germany.

Over the last decades, higher inflation rates in the southern deficit countries than in the northern surplus countries have been noted (Steinherr 2013) as a result of the income convergence in the euro area. Lower German inflation dictated that the German real interest rate was higher than that of the rest of eurozone economies, exacerbating the capital flight and the resultant current account surplus. In contrast, high inflation rate in the South drove their real interest rate into negative territory. Governments that used to be charged high risk premium found themselves immersed in capital floods and a “credit bonanza” but, unfortunately, they abused their favourable debtor positions – which was underpinned by the competitiveness of the German economy rather than that of their own – and created an unsustainable credit-financed boom. Private individuals used the cheap credit to buy property, low-skilled workers got well-paid

¹⁴ €356 billion were exported by Bundesbank under the framework of TARGET through Eurosystem. Other financial

exports amounted to €470 billion and net foreign direct investment was €227 billion.

Figure 13 GIIPS and German government bond rates (%)



Source: European Central Bank Statistical Data Warehouse, Federal Reserve Bank of St. Louis

leading to a wave of immigration (Sinn 2011). Imprudent governments exploited the ease of financing to raise the salaries of overblown public sector employees (Sinn 2011) and fund projects that make no economic sense. For example, Greek government borrowed excessively to build roads to nowhere, upgrade its urban transport infrastructure and build extravagant sports facilities, which were invariably deserted shortly afterwards, in the leading up to the 2004 Athens Summer Olympic Games.

To sum up, Germany's current account surplus and eurozone peripheries' deficit are two sides of the same coin. The launch of the euro facilitated the mobilisation of excessive German savings into other eurozone countries in a foreign exchange risk-free manner; the nominal interest rate convergence accelerated the capital outflow and contributed to Germany's swelling current account surplus. On the flip side, GIIPS misappropriated their well-disposed eurozone privileges and responded to the lowered borrowing cost by uplifting their consumption and investment, resulting in massive unsustainable current account deficits.

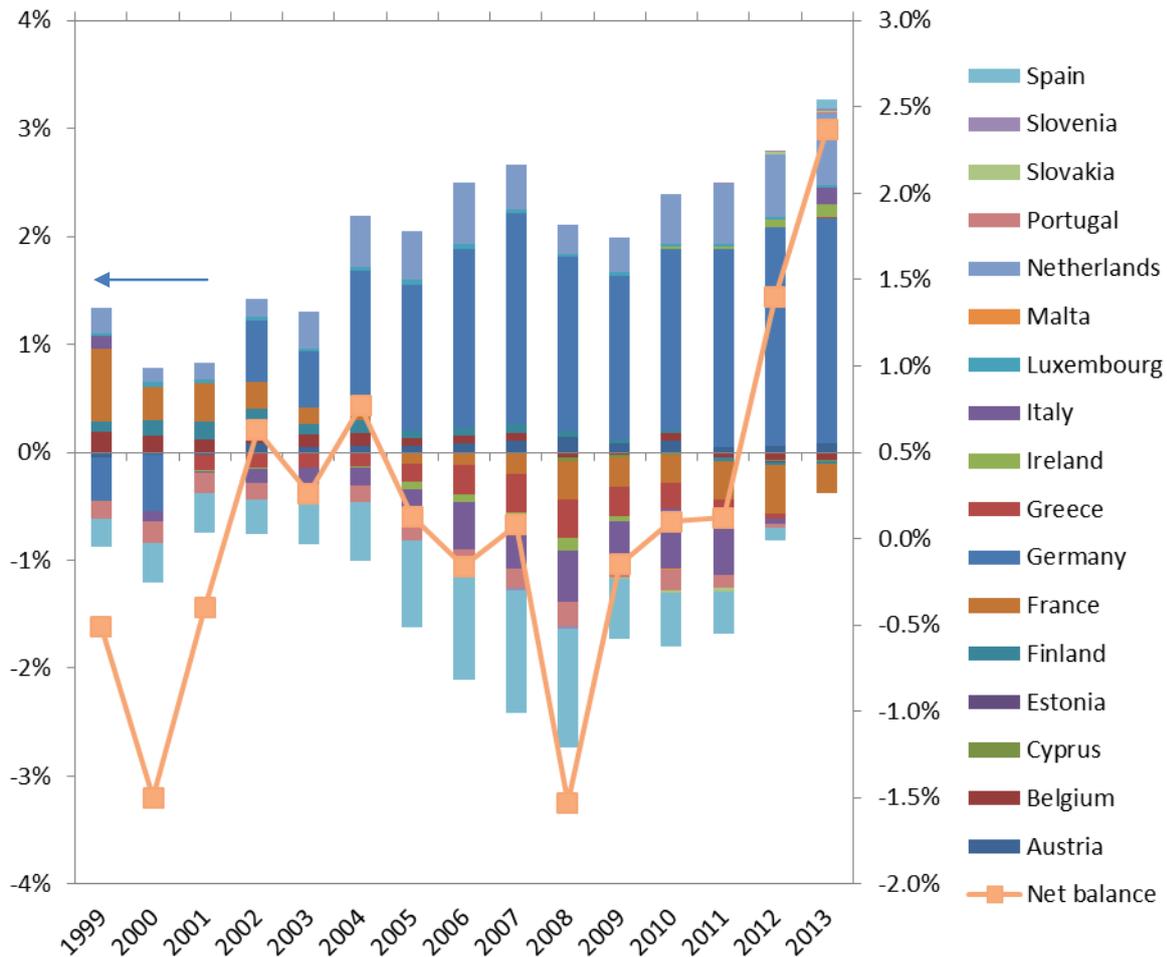
4. Spill-over effect and ideational disputes over Germany's surplus

There is little doubt over the existence and the astonishing size of Germany's current account surplus. There are, however, fundamentally diverging views in Europe regarding the nature of the surplus, its spill-over effect on the European economic recovery and the appropriate policy prescriptions to correct it.

4.1 Spill over effect of Germany's surplus

The US Treasury (2013) accused Germany of devastating their European compatriots by creating "a deflationary bias for the euro area". Basically there are three pathways through which Germany's strong external positions exert "deflationary" pressures on the eurozone as a whole, dimming the recovery prospect of the euro peripheries in particular and that of the EU in general.

Figure 14 Current account balance in eurozone



Source: OECD, European Central Bank Statistical Data Warehouse

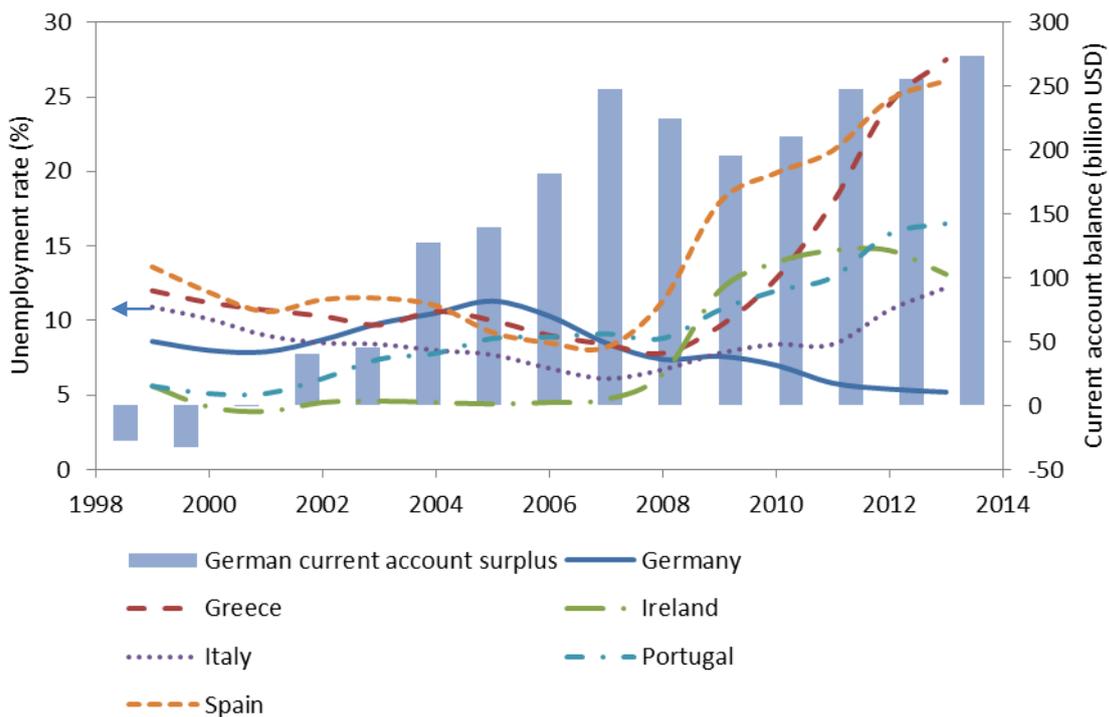
The first is by pushing up the value of the euro through creating a current account surplus in the euro area (Springford and Tilford 2014). Before the euro crisis, the current account surplus in Germany was largely countervailed by the deficits in the south (partly because the deficits in the south was financed by German savings in the first place as detailed above), making the overall current account in eurozone just about balanced (Figure 14). However, with the narrowing of deficits in GIIPS,¹⁵ the current account balance of eurozone had been driven up, primarily by German

surplus, to a respectable +2.4% of GDP in 2013.¹⁶ An economy that has a surplus will experience upward pressure on the value of its currency. But a stronger euro waters down the competitiveness of all European exports, deters foreign demand and lowers the prices of imported goods and services. The compositional disparities in the export profiles of Germany and those of the southern peripheries have made the apportionment of the currency appreciation burden skewed in favour of the former – the demand for Germany’s quality capital goods is relatively rigid and non-price factors tend to stabilise the demand fluctuations in the face of an appreciated euro, while a sizable share of

¹⁵ Greece reduced deficit from -7.4% to 0.5% of national GDP between 2005 and 2013. Over the same period, Italy balanced its current account from -1.6% to 1.0%, Ireland from -3.4% to 6.2%, Portugal from -10.0% to 0.5%, and Spain from -7.2% to 0.8%.

¹⁶ As such, it may be inappropriate to call the European debt crisis as Europe as a whole did not have significant external debt problem, but an internal imbalance.

Figure 15 The correlation between German surplus and unemployment rate in GIIPS economies



Source: OECD

exports¹⁷ from southern eurozone member states are more price sensitive. As a consequence, their exporters are disproportionately hurt vis-à-vis German counterparts by the strengthened euro. All these reinforce the deflationary trend in the eurozone since investors roll back on investing, leading companies to cut back on production, which in turn leads to lower output and lower income.

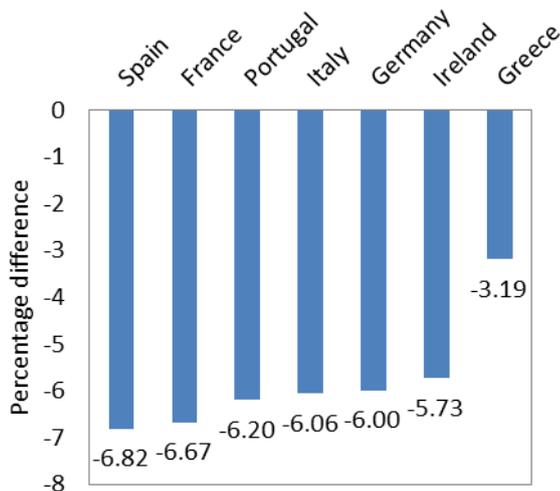
Secondly, Germany’s surplus may hinder the eurozone recovery through exporting its ailing inflation, thereby pulling its neighbours down. A low inflation in Germany implies weak domestic demand for European goods and services, leaving those troubled economies reliant on external

demand to stimulate growth. European crisis economies have to, on the one hand, cope with a rising euro that renders their products less attractive in international markets and, on the other hand, work very hard to open up and exploit new extra-regional markets. Even in those markets afield, their efforts are undercut by keen German exporters who display superior price and quality differentials. The inveterately low wage in Germany makes regaining competitiveness for the southern peripheries a distant hope – GIIPS exporters have to cut wages significantly to a level that is below the already low German wage benchmark (Figure 6). This is why German manufacturers win business contracts and German workers take away jobs. Empirical data suggest that Germany’s surplus drives down German unemployment rate but is positively correlated with the jobless rates in the GIIPS (Figure15) – for the latter, it does not make much difference whether Germany is doing this maliciously or with the best of intentions, it is just doing it all the same (Krugman 2013b). But the wage cut is a double-

¹⁷ Such as the animal products in Ireland and the luxurious fashion products of Italy. Worse, according to the former Venezuela Minister of Planning Hausmann (2015), Greece produces very little of what the world wants to consume. It mainly exports fruits, olive oil, raw cotton, tobacco, and some refined petroleum products. Greek industry produces no machines, electronics, or chemicals. Of every \$10 of world trade in information technology, Greece accounts for \$0.01.

edged sword as it also can throw the economy into death spirals by making debts harder to pay back (O'Brien 2013).

Figure 16 Austerity has hurt European exports, 2011-2013



Source: O'Brien (2013)

In a similar vein, Germany projects its ultra-tight macroeconomic discipline and self-inflicted austerity on other eurozone crisis members. In fairness, monetary and fiscal discipline is certainly a virtue in good times while it could well be a curse during economic crisis and hardship. Germany voluntarily pursues strict fiscal austerity despite its net creditor position. It insistently refrains from providing Keynesian-style stimulus to bolster domestic consumption and investment when it can borrow at literally zero cost. In doing so, Germany contributes to the credit squeeze in Europe and imposes its contractionary policies on crisis economies that are in desperate need of more accommodating policies. The continent-wide austerity impacted negatively the demand for each other's exports – even German exports would have been up by 6% had there been no widespread adoption of austerity measures (Figure 16) – and thus stifled growth. On the aggregate level, it is estimated that 20% of Germany's cost of austerity measures and fiscal consolidation spills over onto its neighbours and Greek and Spanish GDP were

18% and 9.7% lower than they would have been, respectively (O'Brien 2013; Veld 2013). It further demonstrates that the deficit adjustment in the south is predominantly realised by depressed economic activities rather than recouped competitiveness (Krugman 2013a). By historical analogy, it seems that Berlin is repeating the mistakes of the IMF in mishandling the 1997-98 Asian financial crisis – the IMF prescribed austerity when expansionary policy instruments would have helped the affected countries' spent their way out of recession.

4.2 Disputes over the surplus and politics of blame

A persistently large German current account surplus is making the European economy suffer and it is clear that something has gone dreadfully wrong.¹⁸ Why is Germany – a country in most cases acts as a responsible power in the community – so reluctant to tackle the seemingly palpable economic disequilibrium? Why is the adjustment process in the eurozone taking place at a glacial speed? I would argue that this impasse is due to the a parlous perceptual gap that is opening up between Germany and the “sinking rest” over the nature of the surplus and the contentious disputes over the roles surplus and deficit economies are obliged to play respectively in the painful adjustment process. After all, an effective rebalancing demands governments in both creditor and debtor countries to deflect the trajectory of their existing macroeconomic policies, aligning the national policy objectives with the economic conditions abroad. Citizens from the two camps also need to be persuaded to deviate from their familiar way of life that they have been accustomed to in the past decade.

From the German perspective, criticism on its strong external position is “incomprehensible”, as

¹⁸ Comments from an EU diplomat during the workshop requesting anonymity.

the German finance ministry spokesman has put it, hence “[t]here are no imbalances in Germany which require a correction of our growth-friendly economic and fiscal policy”. It is utterly justifiable for the Germans to feel a strong notion of injustice since in their eyes Germany’s huge current account surplus is hard-won thanks to a combination of self-sacrificing mentality, industrious work ethics, sophisticated quality capital goods and prudent life philosophy, thus reflecting the competitiveness of their economy, the resilience of their national character and the overall strength of their country at large. The euro peripheries are teetering along the brink of disaster precisely because they do not master the qualities Germans do and the southern Europeans, the “leeches, selfish and corrupt” Greek¹⁹ (Schofield 2015) in particular, are so appeased to work little, retire early and enjoy a cup of coffee that is financed by tireless German taxpayers. Meanwhile, it is equally understandable that the German government is furious at the irony that the disapproval came from an infamously macro-imprudent country, the US, which itself has run current account deficits for more than three decades. Policymakers alike in Berlin pronounce that Germany has no reason to apologise for its surplus as stacking foreign reserves in the Bundesbank’s vault is the result of free market process and not of a consciously distorted public policy (Pisani-Ferry 2013; Kirkegaard 2014).

In conformity with this belief, Germany argues that the critics are barking up the wrong tree concerning the surplus rebalancing – an artificially weakened German economy, Europe’s sole growth engine, serves no one’s interest and only acts to deepen the recession. It seems to be insane for

Germany to persuade global customers to cease from purchasing preferred German products or to price their exports in a separate currency altogether. The often-touted prescription that Germany should raise domestic demand is naïve and ill-conceived as well. Ludger Schuknecht (2014), Director General at the German Ministry of Finance, contends that the GDP gap has been closed and any artificial demand stimuli will be pro-cyclical, representing a waste of public money. Indeed, even if Germany wants to boost domestic demand through Keynesian style fiscal policy instrument and public investment, the constitutional “debt brake”, adopted in 2009, which in principle requires federal government to fund new projects with new revenue stream, is the obstacle that could prove insuperable in the absence of strong political will or knock-down economic argument.

Dominant public opinion circulated in German academia, media and political rhetoric holds that it is entirely up to the euro peripheries, whose fiscal profligacy, structural deficiencies and economic weaknesses in other forms triggered the crisis in the first place, to clear up the mess, tighten their belt and restore economic competitiveness (Weeks 2011; Schofield 2015). The eurozone peripheries’ economic and political troubles have also produced a diminishing appetite for Germany’s long run economic engagement and venture in the monetary union. Accordingly, Germany insists that courageous and swift structural reforms, including public expenditure cut and tax escalation, must be performed – the bolder and the quicker the reforms are undertaking, the shorter time it will take for them to bounce back. In essence, Chancellor Angela Merkel wants to minimise the negative externalities of the rebalancing inflict on German exporters and taxpayers (Privitera 2014) as domestic resentment may spiral out of control should conscientious German workers that have been earning low wages are robbed of the fruits of

¹⁹ According to Hanska (2013), during the first act of the sovereign debt crisis in 2010, the German news magazine *Focus* titled that the Greeks were “Cheats in the Euro Family.” The *Bild Zeitung* reproduced the discourse of Greeks as “dishonest and feckless” people, by coining the neologism ‘Pleite-Griechen’ (bankrupt Greeks).

their labour because of the debt in southern Europe or EU administered bailout schemes (Ntampoudi 2014).

Germany is also afraid that an easier way out for the struggling economies may dis-incentivise them from implementing painstaking yet imperative structural reforms that are tasked to eradicate the underlying inefficiencies and fundamental imbalances in their respective economic systems. Germany's fear is not completely unsubstantiated – in the case of Greece, after unprecedented sum of highly subsidised finance to help it to reduce its excessive spending, still Athens insisted some of its debt must be forgiven to make room for more spending (Hausmann 2015). Germany generally takes the view that GIIPS have to take the bitter pill if they are to recover.

However, the eurozone's southern tier, the US Treasury and a handful of prominent US trained economists approach the same issue from a markedly different angle. The narrative they uphold is that GIIPS are the victims of Germany's political scapegoating strategy (Hanska 2013) – blaming others to distract from Berlin's own failure and incompetence. The illusionary economic strength of Germany manifested in the volume of current account surplus actually calls into question the blind spot and policy errors of Berlin, in the same way as the episodes of the euro crisis bring GIIPS's economic dysfunction into the open. The borrowers maintain that they have done their homework to balance their accounts (see Figure 14) and it is Germany's turn to deliver on its side of the bargain (Krugman 2013b). The deficit economies cite Keynes, arguing that the only way through which a lasting trade imbalance can be corrected is a symmetric adjustment in which debtors' efforts in reducing deficits is matched by creditors' surplus-contracting endeavours. German miscomprehension and misinterpretation of the appeal from southern Europe originates in their

confusion between trade surplus and strong exports (Privitera 2014), which do not necessarily go hand in hand. Germany could simply import and invest more to balance its current account and stimulate European economies without decelerating or jeopardising its flourishing exports given the estimation that every one percentage increase in Germany's spending will reduce German current account surplus by 0.3% to 0.4% and translate into a minimum GDP gain of 0.2% for southern Europe (Veld 2013).

Germany's rigid position has fostered a wave of political backlash as the debate over EU's internal imbalance is increasingly politicised – governments in deficit economies point their fingers to Germany's alleged political cowardliness and economic irrationality in the midst of a prolonged political and economic malaise. The euro peripheries are especially upset by the fact that despite Germany's unique economic capacity and political clout to bring the crisis to an end, Berlin obstinately refuses to accept the obligations that are associated with its leadership role in the eurozone. When times were good, Germany free-rode on the single currency that allowed German exporters to price goods in a less expensive currency and spattered cash on the peripheries, and now it shrugs and acts as if it has never yearned for the much-enjoyed dominant position while continuing to profit from the crisis of others (Economist 2011; Krugman 2013b). Germany routinely lectures southern Europe to export their way out of the crisis and back to prosperity, but eschew products from southern Europe, depriving challenged economies of urgently needed export income and so preventing them from balancing their deficits. On that account the rebalancing adjustment in the distressed southern Europe is achieved through buying less rather than selling more at the expense of the rest of the world as detailed above. Without growth, closing deficits

through austerity is akin to climbing a falling ladder (Economist 2011).

A game of blaming has been staged in the euro area. Under the alleged 'insular', 'short-sighted' and 'egotistical' leadership tainted by national stereotyping and prejudice (Augstein 2013; Ntampoudi 2014), what Berlin has done amounts to little more than political pandering, passing the buck and moralising about GIIPS's past wrongdoings. In response, the southern peripheries counter that while it is incontestable that their failure of conforming to the macroeconomic prudence a common currency demanded precipitated the euro crisis, it is Germany (and France) that violated the economic convergence criteria laid out in the 1992 Maastricht Treaty in 2003, ahead of others, by running a budget deficit to GDP ratio exceeding the legally binding 3% ceiling. The Franco-German leadership core got away with the malpractice and no serious punitive, disciplinary actions were taken at the EU level. Germany's negative demonstration effect sowed the seeds of the eurozone debt crisis and internal imbalances, enervating Germany's righteousness and legitimacy in berating southern Europe's disrespect for and violations of EU regulations.

Admittedly, Germany is confronted with a "paradox of thrift" whereby saving and frugality that are beneficial to Germany turns out to be deleterious to the economic community – a penny "saved" by Germany, however, may not be a penny "earned" for the whole union. A swelling trade surplus during times of economic stagnation contributes to the shortage of aggregate demand and decreases continental wealth to the detriment of all. To southern Europe and the EU, Germany should surmount this moralistic dilemma and its paranoid dedication to "export fetish", being reassured that a controlled increase in domestic consumption, investment and inflation is not a

slippery slope to the dark days of the Weimar Republic. Germany should opt for a growth-oriented imbalance remedy approach instead of an austerity-oriented one, as along the latter route the eurozone will descend to irreversible stagnations. Economic duress may eventually turn out to be a "beggar-thyself", "murder-suicide pact" (Stiglitz 2002; O'Brien 2013).

To some, such as the former Italian Prime Minister Silvio Berlusconi and George Soros, when it is the gatekeeper rather than the troublemakers that drags the European economy down, maybe "it's time to kick Germany out of the eurozone" (Jahncke 2012; Soros 2013; Chovanec 2015).

5. Concluding remarks

This paper identifies five major drivers behind the expanding current account surplus in Germany. The piling-up of surplus over the last decades does not lend itself to a single-factor explanation as intertwining international and domestic factors are jointly at play. Strong global demand for quality German exports, domestic wage restraint, an undervalued single currency, high domestic savings rate and interest rate convergence towards German rate in the eurozone that drains domestic investment are singled out as the main contributing factors. It is concluded that mercantilism with German characteristics is essentially a state of mind that goes beyond a host of trade barriers or protectionist policies (Prestowitz 2012).

Without question, the solid external position of Germany constitutes both a testimony showcasing praiseworthy economic competitiveness and vigour in Germany and, unfortunately at the same time, a creeping threat to other eurozone member states, making their deficit adjustment process and economic recovery a harder mission to accomplish. This makes Germany's current gigantic account

surplus a legitimate concern for the EU as a whole (Privitera 2014).

Although the phenomenon of Germany's macroeconomic imbalance is widely recognised and could even be readily explained by Macroeconomics 101, in the words of Noble Prize laureate Paul Krugman (2013a), there is much less consensus regarding the nature of the surplus and what sort of corrective measures should be taken, adding to the distributional conflicts over who should bear the rebalancing cost. This worsening divide between the core and the periphery Eurozone economies and the accompanying undiplomatic exchange is a game of chicken (Krugman 2015) in which two drivers drive towards each other on a collision course: each expects to survive on the other's willingness to compromise and sacrifice.

For an economy with external surplus of Germany's size, the question is a matter of "use it, or lose it" (Kirkegaard 2014) and for deficit economies in a monetary union in desperate need of restoring order and legitimacy, the question is really a matter of "stay or leave". The eurozone core-periphery animosity is exerting its economic as well as political toll on the European integration project. Abandoning the politics of blaming and rebalancing the disequilibrium obviously convey mutual benefits – stabilising the stagnating eurozone economy is of utmost urgency, not teaching GIIIPS a lesson or accusing Germany for creating a two-speed Europe.

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