

# Why Germany's trade surplus is bad for the eurozone

by John Springford and Simon Tilford



In late October, the US singled out Germany as a threat to the global economy. The Treasury issued a report saying that Germany's current account surplus – now around 7 per cent of GDP – imposes “a deflationary bias for the eurozone as well as for the world economy.” Two weeks later, the European Commission promised to review Germany's surplus under its ‘excessive imbalance procedure’. Many German politicians and business people quickly dismissed these interventions, claiming that the surplus is mostly with the rest of the world, not the eurozone, and so does not affect the periphery; that the surplus reflects the country's competitiveness; and that deflation in the eurozone periphery is positive as it indicates that these economies (and hence the currency union as a whole) are becoming more competitive. They are wrong on all three counts.

There is no doubting the competitiveness of Germany's manufacturing sector, but the main reason the country's external surplus has risen further (despite sluggish demand for German exports from a depressed Europe) is the weakness of domestic demand in Germany: this rose by just 0.8 per cent over the last year, despite very low unemployment. The result is that Germany is doing little to provide any offsetting stimulus to austerity and demand-depressing structural reforms in the eurozone periphery, making the south's adjustment all the more difficult to achieve.

Under a third of Germany's current account surplus was with the eurozone in the first half of 2013, compared with over three-fifths prior to the financial crisis. But this shift is largely

due to falling German exports to the depressed periphery, rather than rising exports from the periphery to Germany. And even if the surplus with the rest of the currency union fell to zero this would be – according to the IMF – largely cyclical (reflecting the collapse in domestic demand in the periphery) rather than structural (reflecting a rebalanced eurozone economy); thus trade imbalances will re-emerge should demand recover across the eurozone.

German policy-makers argue that a rebalancing of the German economy would be of little benefit to the currency union's peripheral economies. After all, Spain's exports to Germany only constitute 4 per cent of its output. A programme to drive up German domestic demand would simply reduce

German competitiveness while doing little to stimulate the periphery's exports. This argument misunderstands how real currency appreciations work. After a decade of wage restraint, the German real exchange rate is strongly undervalued relative to the rest of the eurozone. This makes its goods artificially cheap, crowding out those of other eurozone countries from both eurozone and world markets. If Germany's real exchange rate rose by around 20 per cent (and so returned to its value when the euro was launched), Spanish, Italian and French manufacturers would be able to retake market share. Their exports to eurozone economies and to the rest of the world would rise more rapidly, and the risk of deflation would diminish. The adjustment process for the eurozone – and for that matter, the world – would be less painful.

There are two routes through which Germany's external surplus compounds deflationary pressures in the eurozone, making it harder for the periphery to recover. The first is by pushing up the value of the euro. Before the crisis, Germany's trade surplus was offset by the deficits of the other member-states. But as these deficits have narrowed the eurozone has moved into a large external surplus and the euro has appreciated. An economy with a big trade surplus tends to experience currency appreciation because demand for its currency outstrips the supply of it. A strong euro hits demand for eurozone exports, especially the more price sensitive ones of the southern European member-states, and lowers the prices of imported goods, reinforcing downward pressure on prices. Eurozone policy-makers bemoan the strength of the euro, but it is a product of asymmetric rebalancing within the currency union. The second channel through which Germany's surplus spreads deflationary pressure is through the weakness of German inflation: feeble domestic demand (the flipside of the surplus) means that annual consumer price inflation has fallen to little over 1 per cent.

To pull off what Germany did in the run-up to the financial crisis – cut costs relative to the rest of the currency union and rely on exports to offset the weakness of domestic demand, but without suffering deflation – the peripheral eurozone economies need higher inflation in Germany and much stronger German domestic demand. After all, that is how Germany was able to do it: demand was sturdy (and inflation robust) elsewhere in the eurozone. If Germany is to help stabilise the eurozone economy, demand must rise strongly relative to supply in the German economy (that is to say the external surplus must shrink). If it does not, the periphery will only be able to recoup competitiveness by experiencing deflation. Spain

is now some way down this route, with serious implications for the sustainability of its debt stock.

Deflation in the eurozone periphery should not be welcomed as an adjustment in relative prices and hence in competitiveness; deflation risks leading to falling nominal GDP and worsening debt traps. Deflation pushes up real interest rates (further depressing economic activity), and can render monetary policy ineffective (the ECB cannot reduce nominal interest rates below zero). Moreover, the lower the rate of inflation, the bigger the primary budget surplus a government needs to run in order to prevent the stock of public debt to GDP rising, hastening the point at which debt becomes unsustainable.

“

*Deflation in the eurozone periphery should not be viewed as a welcome improvement in competitiveness; it risks worsening debt traps.*”

The Germans are not powerless to address the imbalances in their economy. If the periphery can take steps to prevent excessively strong growth in domestic demand, then Germany can do the opposite. More expansionary fiscal policy would help, particularly if this took the form of cuts in value-added taxes and lower income taxes for people on low incomes. But fiscal policy alone cannot reflate the German economy, because the obstacles to stronger domestic demand (and inflation) are to an extent structural. One is the country's system of collective wage bargaining which delivers wage restraint even when the labour market is tight and corporate profits are at record levels. The bosses of Daimler-Benz, BMW and VW recently threatened to relocate production if the German government introduced a statutory minimum wage. But wage dumping is not the answer to Europe's economic woes. Another problem is poor productivity (and low wages) across much of Germany's services sector. Liberalisation here would boost investment, and hence productivity, in the longer term.

The US is right to single out Germany for criticism. And the European Commission needs to stick to its guns and demand that Germany address the structural problems behind the imbalances in its economy. These pose as big a threat to the future of the eurozone as those of Italy or France, and need to be approached with the same sense of urgency.

John Springford  
Research fellow, CER  
and Simon Tilford  
Deputy director, CER