Global Counsel

The politics of the German surplus

18 November 2013

Summary

For investors in Europe the question of the Eurozone's internal macroeconomic imbalances is central to the long term sustainability of the currency block. Last week, for the first time, the European Commission, formally triggered a review of Germany's large current account surplus under one of the more obscure parts of the EU's post-2011 economic governance arrangements. Berlin's sensitivity to having its contribution to aggregate Eurozone demand raised as a policy problem being what it is, this is a small but interesting step. It has – in theory - a range of policy tools behind it, although they are more than likely to remain unused. So does the Commission's move simply highlight the limits of Eurozone economic governance? Or could it shift the terms of the policy debate about Eurozone demand?

On November 13 the European Commission released its 2014 Alert Mechanism Report on European macroeconomic imbalances. For the first time, the report singled out the German current account surplus as a potential problem after it has breached the threshold of 6% of GDP for the last three years. As mandated by the EU's 2011 Macroeconomic Imbalances Procedure (MIP) the Commission has announced that it will undertake an in depth review into whether this constitutes evidence that an imbalance exists in the economies of Germany and the Eurozone.

German sensitivity about having its external position labelled a policy problem is exceptionally high. Berlin demonstrated as much on October 30 in its irritated response when the US Treasury pointed out the scale of the German external surplus (bigger than China's) in its annual report to Congress on international economic and exchange rate policies and the 'deflationary bias' that weak German domestic demand imposed on the euro area. The European Commission's judgement is a lot more oblique, but it also comes in principle with a policy tool kit behind it. How significant is it?

The Six Pack in action

The MIP was established as part of the 'Six Pack' of European fiscal and economic reforms adopted in late 2011 to signal to the market the EU's seriousness about closer economic governance. With the 2011 EU Fiscal Treaty's fixation on fiscal deficits, the MIP was an attempt to address the parallel question of economic imbalances within the Eurozone. The MIP focuses on a range of factors, including external debt positions, bank, government and private sector debt, real exchange rates and shares of global exports.

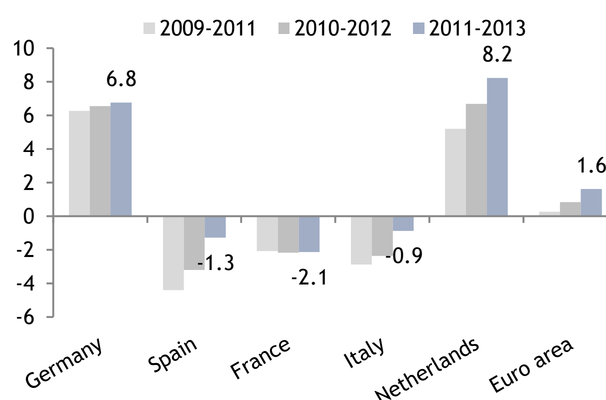

Fig 1: 3yr rolling average current account balance (%GDP)
Source: EC Autumn Forecast 2013, GC calculations

But the Commission's most politically sensitive and closely read judgement by far concerns current account balances. In particular, the deficits which flag vulnerability to external exposures provoked by cross border credit flows and the surpluses which are the single most important indicator of the balance among the Eurozone's economies between domestic and 'imported' demand. The Eurozone's largest economy has of course been a huge importer of demand for the last five years (Fig 1). This despite being by far the strongest performer in a club in which some of the weakest members have seen German-inspired fiscal contraction further weaken already feeble domestic demand.

Eurozone State	Commission assessment November 2013
Germany	Rolling average current account surplus above 6%. In depth review to determine whether imbalances exist.
The Netherlands	Imbalances identified April 2013. High levels of private sector debt; excessive dependence on leveraged housing wealth; large current account surplus driven by structural corporate savings surplus. Further monitoring.
France	Imbalances identified April 2013. Falling trade competitiveness, driven by cost and non-cost factors; rising corporate indebtedness and poor flexibility; rigid labour market. Further monitoring.
Italy	Imbalances identified April 2013. Falling trade competitiveness; high levels of public debt; deteriorating funding conditions for banking sector. Further monitoring.
Spain	Excessive imbalances identified April 2013. High levels of public and private debt; high unemployment and persistent labour market rigidities; high external liabilities. Further monitoring.
Slovenia	Excessive Imbalances identified April 2013. Substantial risk of financial sector instability from corporate indebtedness; adjustment hampered by high levels of state ownership. Weak and falling export performance. Further monitoring.

Table 1: Commission Imbalances assessments, selected Member States
Source: European Commission MIP Alert Report November 2013

Not all current account balances are, however, politically equal under the MIP. The MIP is deliberately asymmetrical and defines a current account deficit as posing a more urgent threat than a current account surplus. The Commission's official reasoning is that those imbalances linked to indebtedness, external exposures and poor export performance are much more likely to predict fiscal crises and short term instability than the more chronic problem of a persistent surplus are. The Commission's thresholds treat a three-year average -4% deficit as problematic, but a 6% surplus.

In late 2012 the Commission initiated in-depth reviews into suspected imbalances in 13 EU Member States, and in all cases the warnings were reserved for states running current account deficits. In April 2013 it confirmed all thirteen diagnoses (Table 1), declaring Spain and Slovenia in particular subject to 'excessive' imbalances chiefly as a result of their high levels of public and private debt. In both cases the Commission did not trigger the 'corrective' arm of the MIP (see below), nominally because of the ongoing adjustment programmes of the governments in question.

Germany was given a pass by in the 2012 Alert Mechanism Report when the Commission projected that its theoretically troublesome 6% current account surplus would fall after 2012. It is now projected to rise to 7% in 2013 (Fig 1) which left the Commission with no real choice but to raise a flag last week. The Netherlands, which also runs a large current account surplus off the back of its high corporate savings rates, will continue to be closely monitored.

The elephant in the room

How does this change anything much? There is a theoretical answer and a practical one. In theory this decision launches a policy response that can go all the way to forcing Germany to take corrective action defined by the Commission to address its surplus or be subject to a fine of 0.1% of GDP. Unlike the sanctions regime of the earlier EU Stability and Growth Pact which policed (or failed to police) Member State fiscal deficits, Commission recommendations under the MIP are deemed adopted after ten days unless rejected by the Council by qualified majority. This in principle increases the automaticity of the process, although it is hard to imagine the other members of the European Council allowing the Commission to impose sanctions on

Berlin, even if the Commission had the nerve to demand them.

Instead and inevitably at this stage, the Commission has chosen the weakest possible form of warning. Effectively, it has initiated an in depth review to determine whether its spreadsheets reflect a policy problem in the real world. But it does mean that in spring 2014 the Commission will have to render a more explicit judgement, albeit one that we can expect to be as carefully worded and hedged as this one. The Commission is constrained by its own legal framework and sense of intellectual independence to raise the issue. Both are, however, still potentially trumped by political pressure. The bias in the MIP towards the 'acute' features of internal and external debt and unemployment over the more chronic problems of structural surplus also lets Berlin off the hook to an extent.

Yet in the small world of Brussels this slightly tortured and incremental step still matters. It has put the German surplus and the question of German domestic demand on the table in a formal way. Since 2010 there have been plenty of voices both in the European Council and the European Commission for seeing economic governance in the Eurozone in wider terms than simply tighter fiscal discipline. But Berlin's ability to dictate the political agenda decisively shaped the Fiscal Treaty in 2011, just as it did any debate on Germany's obligations in terms of fiscal stimulus in 2010. It deflected any policy debate on Germany's fair share of Eurozone demand generation into the far reaches of the MIP.

Experience in the EU suggests that expecting the MIP to be used as an instrument of policy enforcement would be unrealistic to put it mildly. Unlike the basic and rigid budget targets in the Fiscal Treaty, the multiple variables in the MIP (there are eleven benchmark indicators) are less easily captured in explicit policy prescriptions. The Commission is probably reluctant to even try to set concrete policy targets, let alone actually attempt to enforce them with fines – at least not for large, politically powerful Member States. The Commission's two consistent domestic demand policy recommendations for Germany – tax and social contribution cuts for low wage earners and a more open services market – are both areas on which Berlin is not going to take instruction from Brussels.

Yet as the current account deficits of the Eurozone periphery continue to shrink as a result of both falling domestic demand and policy-driven adjustment (Fig 1) the German surplus looks all the more politically incongruous. Germany services a global export market by drawing in value from its European supply chains and benefiting from the Eurozone's check on the appreciation of its currency. The contingent argument that the huge German economy is not making a proportionate contribution to Eurozone recovery through domestic demand will keep being made.

The long North Atlantic campaign of complaint against the Chinese current account surplus after 2007 suggests that imposing this kind of reasoning on a political economy from outside is all but impossible. There are obvious parallels here. But the MIP has also brought the argument inside the European house in a different way. Like Beijing, Berlin will have to develop its own case for growing domestic demand on its own political terms. But it will also have no desire to openly flaunt the kind of Eurozone economic governance rules of which it has been a chief advocate. The Commission has pointed out the elephant in the room, and whatever political fudging follows it is now that little bit harder to pretend it is not there.

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