The German current account surplus and what it means for German-American trade[1]

Summary

Germany is among the most important trade and investment partners for the US. Ten percent of all foreign direct investments in the US come from Germany. Around 672,000 workers in the US are employed by German companies. US companies benefit from high-quality German capital goods and intermediate goods that help to improve their efficiency and allow them to maintain and increase their competitiveness. This creates and preserves a large number of jobs in both countries.

As a member of the European Union, Germany does not pursue independent trade policy: Trade policy falls within the competency of the EU. The German government's policy is in line with all international trade agreements and treaties; in particular German policy complies with WTO requirements.

Germany belongs to the European Monetary Union. On a global scale, the only valid reference for assessing the significance of current account developments is the euro area balance. Monetary tightening in response to the economic recovery in eurozone countries would have an impact on the exchange rate and thus contribute to reducing Germany's current account balance.

Having peaked at 8.6 percent of GDP in 2015, the German current account surplus has since narrowed slightly, falling to 8.3 percent. Current estimates predict that the surplus will shrink further, to roughly 7.5 percent this year, and to approximately 7 percent next year.

The German government's fiscal and economic policy aims at strenghtening domestic and creating favorable conditions for a competitive economcy. Overall, this policy helps limiting the German current account surplus. Given the record level of employment and the considerable increases in real wages on the German labour market, domestic demand has been the main driver of economic growth in Germany for several years now. In addition, the German government takes a range of measures to further strengthen an already healthy domestic demand, for example by improving conditions for private investment, expanding public investment, introducing a statutory minimum wage and offering income tax relief. With regard to domestic demand, the government has created the preconditions for a reduction of the German current account surplus.

However, the German current account surplus is mainly the result of market-based supply and demand patterns created by companies and private consumers on global markets. The German surplus reflects a comprehensive range of economic activities of private households and companies arising from international integration of production, trade and services. The surplus depends not solely on German economic developments and policies, but also particularly on the competitiveness and economic performance of other countries. To a large extent, the German surplus is determined by factors which German fiscal and economic policy have no direct influence on, e.g. short-term such as factors including the euro exchange rate or global commodity and energy prices. In addition, the German current account balance is also shaped by a range of structural long-term factors such as demographic trends, the competitiveness of German suppliers on the global markets, an advantageous goods structure, and its high net foreign asset position.

Trade with Germany benefits the US

- **Germany is one of the most important trading and investment partners for the US.** With US-German trade totalling $164bn in 2016, Germany was the fifth largest trading partner for the US, and the third most important partner outside of NAFTA. Germany exported goods worth $115bn to the US, and imported goods worth $49bn. German-American trade is driven mainly by motor vehicles, machines and other industrial products such as chemicals, pharmaceuticals, and electronics. More than half (55 percent) of German exports to the US consisted of capital goods and intermediate goods. The equivalent figure for US exports to Germany is around 48 percent. US-German trade in the service sector (including tourism) is also burgeoning, totalling nearly $64bn in 2016. The American market is the most important market for German exports, roughly a tenth of which go to the US.

- **The German current account surplus reflects investments made in the US.** The current account balance mirrors international capital movements. Germany's current account surplus is counterbalanced by net capital exports. In 2016, Germany invested more than $63bn in capital into the US. Of those $63bn, German investors put $34bn into US shares and additionally made direct

1 Translated extract from the May 2017 edition of the monthly report "Schlaglichter der Wirtschaftspolitik".

investments worth over $14bn. Portfolio investments in the US by German investors are primarily determined by risk-return considerations and an effort to diversify risk. The US is particularly attractive for foreign portfolio investments because of its economic and political importance for the global economy and because the US dollar is the international reserve currency. German portfolio investments in the US strengthen American capital markets, make it easier for companies to access equity and thus increase investments, which in turn boosts productivity. At the same time, German portfolio investments increase share values and thus boost the wealth of US investors.

- **Germany is the third largest foreign direct investor in the US.** In total, German companies have invested approximately $319bn in the US (2015), and thus account for nearly ten percent of all foreign direct investments in the US. At $133bn, or 42 percent, the greatest share of German direct investments went into the manufacturing sector, which breaks down into investments worth $45bn in the automotive industry, investments worth $36bn in the machinery sector and investments worth $31bn in the chemicals sector. At $46bn, or 15 percent, the second largest share of German direct investments went into the finance and insurance sector. Direct investments promote the international transfer of technology and knowledge and contribute to diversifying the production structure. In addition, various studies show that these investments generate stronger growth in the target country than domestic investments do.

- **German investors are among the biggest employers in the US.** German investors have direct investments in over 3,000 companies that generate a total annual turnover of $466bn and employ approximately 672,000 people, mostly in the automotive industry and machinery sector and in the chemical industry. German subsidiaries in the US pay above-average salaries and make a substantial contribution to training skilled workers in the US.

- **Imports from Germany are important intermediate goods for US consumer goods, investments and exports.** The analysis of value-added shares shows that Germany is the US's most important European supplier of intermediate goods used for consumer goods, exports and gross fixed investments; overall, Germany is the fifth/sixth most important supplier for the US. Germany's contribution to the value chain is above-average for the manufacturing sector, especially the automotive and electronics industry, and for the machinery and plant building sector. The producers of investment goods are highly specialised and provide goods which it is very difficult to find substitutes for. US companies benefit from these intermediate goods, as they help to improve their efficiency and allow them to maintain and improve their competitiveness.

Germany cannot influence the exchange rate and does not use protectionist instruments

- **Within a monetary union, it is not possible to single out any one country.** Rather, each country must be considered as a part of the monetary area as a whole. On a global scale, the only valid reference for assessing the significance of current account developments is the euro area balance. Furthermore, the value of the currency of a monetary union is determined by economic conditions in the union as a whole. Neither the member states of the euro area nor the European Commission can influence the euro area's monetary policy. The euro area's monetary policy is governed independently by the ECB, which aims at maintaining price stability and does not manage the exchange rate.

- **In the short run, the dollar-euro exchange rate is above all determined by capital movements and interest rate expectations.** Since summer 2014, the euro has devalued by approximately one fourth in relation to the dollar, mainly as a result of the divergence between the monetary policies of the two monetary areas. While the ECB is continuing its ultra-expansive monetary policy in order to boost the eurozone's economic recovery, the Federal Reserve has already begun to increase interest rates. Net capital inflows to the US tend to strengthen the dollar, which in turn improves the US terms of trade, i.e. the relation between the price of imports and exports. Economic growth in the eurozone and growing inflation may prompt the ECB to start normalising the monetary policy in the euro area. A stronger euro would automatically reduce the trade surplus.

- **With respect to its long term trend, the US dollar is currently not noticeably overvalued compared with the euro.** Since the introduction of the euro in 1999, the EUR/USD exchange rate averaged 0.85. At 0.94, the current EUR/USD exchange rate is only approximately ten percent above its long-term average. Moreover, the role of a currency's external value in determining its price competitiveness is only one of a number of elements influencing the current account balance.

- **Germany does not use any protectionist measures.** VAT with a deduction of the VAT paid at the preceding stage in the EU, and thus in Germany, is in line with the international standard applied by nearly all OECD countries as well as the overwhelming majority of UN members. According to the country-of-destination principle, exports are generally exempt from VAT, while imports are subject to import VAT. VAT can then be applied to the goods in the country to which they are exported. This practice is clearly in line with WTO requirements. It serves to create fair competition on the respective end user market, i.e. to ensure that goods imported for end use are treated the same as domestically produced goods. The VAT applied is therefore independent of whether the goods sold were produced at home or abroad. Thus VAT does not have any discriminatory effects.

- **In an open economy, surpluses and deficits in the bilateral trade balance are the rule rather than the exception.** Surpluses and deficits reflect the comparative advantages of the various economies and the attendant specialisations within global value chains. As a country with few natural resources of its own, Germany has to finance its commodity imports by exporting other goods in the long term. When conditions are normal, this form of free trade increases welfare for all countries involved.

- **The German government is closely monitoring macroeconomic developments, although the current account balance is not targeted by economic policy.** Nevertheless, the current account surplus may indicate structural weaknesses, also for domestic investments, which may in turn justify economic policy adjustments. In addition, capital in search for potential investment can also contribute to credit booms and/or asset-price bubbles in other countries. Capital flows can thus amplify imbalances that cannot be absorbed and hence require adjustment measures that are all the more drastic in countries with current account deficits. This is where governments have a responsibility to implement fiscal and economic policies facilitating necessary adjustments.

- **Provided the attendant capital inflows are used for investment, current account deficits need not be problematic for a country such as the US.** In the medium to long term, current account deficits boost the US economy's growth potential and thus create the right economic conditions to reduce external liabilities in the future (which are currently at 45 percent of GDP for the US). The deficit can be problematic, however, if foreign capital inflows primarily go into consumption or bad investments, such as property bubbles. The US budget has continuously been in deficit since 2002. This has increased US debt from 64 percent to 108 percent of GDP since 2000. As a consequence, a large share of foreign capital inflows is used for financing the US budget. Reducing new public debt, as announced by the new administration, could have a positive effect on the deficit.

Germany's current account surplus is narrowing

- **Germany's current account surplus shrank in 2016.** It narrowed from 8.6 percent of GDP in 2015 to 8.3 percent of GDP in 2016. In 2016, there was a significant decline over the course of the year: A surplus of 8¾ percent was posted in the first quarter (adjusted for working days and seasonal factors), which decreased to 7½ percent in the fourth quarter of 2016.

- **In particular, exchange rates and energy prices caused the current account surplus to swell in recent years.** Germany's current account surplus stood at 5.6 percent of GDP in 2008, its lowest point in the last ten years. It subsequently climbed to 6.7 percent in 2013 and reached 8.6 percent in 2015. Of those approximately two percentage points, about two thirds can be attributed to the decline in energy and commodity prices as well as the depreciation of the euro. Simulations using the Oxford Global Economic Model show that, if the low oil prices and the weak euro were factored out, the current account surplus would have stood at 5.6 percent in the fourth quarter of 2016, which would have been below the European Commission's six percent limit. More recently, the rise in oil prices and the stabilisation of the euro exchange rate had a dampening effect on the current account surplus. Exchange rates and commodity prices had a similar impact on the balances of other member states within the eurozone.

- **International partners benefit from a strong German economy.** Germany is not only the world's third largest exporter of goods, but also the third largest importer. Our trade partners benefit greatly from the strength of the German export industry, as a high percentage of German exports (about 42 percent) are intermediate goods.

- **In its annual projection, the German government predicts that Germany's current account surplus will continue to shrink.** This is in line with most of the forecasts of other national and international institutions as well as the Bundesbank. In its independent forecast, the German Council of Economic Experts predicts a current account surplus of 7.5 percent this year and 7.1 percent next year.

- **Germany's bilateral current account surplus with the USA most recently also narrowed.** Having reached an all-time high of $76.8bn in 2015, it shrank by approximately $13bn to $63.6bn in 2016. This decline was roughly equivalent to that of the entire eurozone's current account surplus with the USA (which narrowed by $12.9bn to $24.2bn).

- **The current account surplus is a European issue, not just a German one.** The eurozone posted a current account surplus of 3.6 percent of GDP in 2016. According to the European Commission's winter forecast, this is set to decline to approximately 3¼ percent this year. Almost all eurozone member states are contributing to this surplus.

- **From a global point of view, focusing on Germany's current account balance is not particularly conclusive.** Germany is a member of the European Monetary Union. Structural reforms have been implemented in recent years that have sustainably reduced imbalances in the euro area. On a global scale, the only valid reference for assessing the significance of current account developments is the euro area balance. California's current account balance with China is not a subject of debate, and nor should Germany's current account balance with the US be.

The German government has taken a number of steps that are helping to reduce the current account balance

- **The German federal government has launched numerous measures to promote sustainable and inclusive growth and a more dynamic domestic economy.** A general statutory minimum wage was introduced in 2015 and increased in 2017. In addition, the German government enacted income tax relief totalling more than €11bn per year in the current legislative term. These measures serve to boost domestic demand, which has been the main driver of growth for several years now. In the medium term, they can make a contribution, albeit limited, to reducing the current account surplus.

- **The German federal government has taken further important steps to strengthen public investment.** During the current legislative term, federal budget funds appropriated for investment have increased by nearly 45 percent. In addition, substantial relief has been provided to the *Länder* (states) and local authorities that will allow them to channel more money towards investment. In 2016, government gross fixed capital formation went up by 2.2 percent in real terms, following a 3.4 percent rise in 2015. Due to the relatively small value-added share of imported intermediate goods in public investment, however, this is likely to have only a limited impact on the current account.

- **The German federal government is taking steps to boost private investment.** The government's sound fiscal and economic policies are strengthening the confidence of individuals, companies and investors in the German business environment, thus boosting private consumption and investment. In addition, the federal government and the *Länder* have allocated a total of €4bn to expanding the broadband network, to cite just one example. In total, €17bn is being provided for energy efficiency measures. Revised grid regulation has significantly improved investment conditions for the expansion of the distribution network. The first and second Bureaucracy Reduction Acts cut private sector bureaucracy costs by a total of €1bn. Recent changes in tax rules for carrying forward losses will mainly benefit young and innovative companies, as will the top-ups of various project funding programmes. The federal government is also looking into ways of providing tax support for research and development alongside its project funding. The general investment rate is expected to increase slightly again this year, from 20.0 percent of GDP to 20.2 percent of GDP.

- **Real wages in Germany have risen at an above-average rate in the last three years.** This is the first phase of noticeable real wage increases (of 2 – 2 ½ percent) since German reunification. Extraordinarily positive labour market trends, collectively agreed wage and salary rises (which, in Germany, are negotiated without the government's involvement), the introduction of a general minimum wage, and low inflation rates have all contributed to a considerable increase in private consumption. This trend is poised to continue, helping to reduce the current account surplus.

- **Structural reforms in Germany can further boost the economy.** Examples include increasing competitiveness in some parts of the services sector; creating greater incentives to work for secondary earners, low-wage earners, and older workers; and enhancing tax efficiency. At the same time, supply-side structural reforms and public infrastructure investments increase productivity and therefore competitiveness over the longer term, which could cause the current account surplus to swell again.

However, many factors affecting the current account surplus are beyond policy control

- **The current account is not an economic policy control variable.** The extent to which Germany's current account surplus can be influenced by policy measures is limited.

- **The German current account surplus is the result mainly of market-based supply and demand patterns created by companies and private consumers on the global market.** Alongside temporary factors such as commodity prices and exchange rates, it is largely a reflection of long-term structural conditions, which account for about half of Germany's current account surplus. They include the high level of competitiveness of German suppliers on the global markets; the high-quality, complex and industrial structure of German goods; demographic trends; and a high net asset position abroad. The competitiveness and performance of other countries also plays an important role.

- **Germany has built up high net foreign assets through foreign investment in recent years.** Capital exports are a result of German companies' successful globalisation strategies. Businesses are tapping new markets and taking advantage of higher returns in economies that are experiencing dynamic growth. These foreign assets result in corresponding interest and investment income, which in itself accounts for almost a quarter of the German current account surplus.

- **The demographic situation is a central structural factor affecting Germany's current account surplus.** In an ageing society, relatively high savings are reasonable with a view to evening out consumption as more people retire. Different estimates put the demography-related share of the current account surplus somewhere between one and three percentage points. Once a greater percentage of the population has retired, as is to be expected, savings accumulated abroad will gradually be drawn down.

- **Falling unit labour costs improved price competitiveness, but have been rising significantly again since 2010.** From the mid 1990s to the late 2000s, wage restraint in Germany slowed or even lowered (unit) labour costs and improved price competitiveness compared with countries that had higher wage increases. Wage restraint was a response to (a) the high wage adjustments in the wake of Germany's reunification, (b) high levels of unemployment, and (c) the overvaluation of the German currency upon entry into the monetary union. The direct effects of higher price competitiveness were, on the one hand, greater demand for German products, resulting in rising exports and employment levels, and, on the other hand, lower wages and private consumption as a result of wage restraint. In the past, these trends caused the account surplus to swell by about 1½ to 2 percentage points. However, unit labour costs have been rising significantly again since 2010, by an average of more than 1½ percent per year.

Overview of factors explaining Germany's current account surplus

Factors (largely) beyond economic policy control		**Factors that can be influenced by economic policy**
Temporary factors	*Fundamental factors*	
Exchange rates	Demographic trends	Public investment
Commodity prices	Returns on foreign investments	Conditions for private investment
Wage trends	Economic structure, specialisation	Structural reforms
Global economic trends	International interdependency	