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Egon Neuthinger*

Germany's Enduring Current Account Surplus

The Federal Republic of Germany's balance of payments has been in the black for years, a record unparalleled by any other major country since the Second World War. Proceeding from status quo assumptions, the surpluses are unlikely to decline in the medium term, either.¹ Can they be endured? Do they really pose no serious problem, as current debate on national economic policy suggests?

From a national vantage point, the question at issue is the allocation of resources between domestic and foreign demand and the associated distribution and welfare considerations. Internationally, the question is whether the high export surpluses lessen growth prospects for deficit countries or whether the export of capital chasing more lucrative investment opportunities abroad will pull the surpluses along with it.² International discussion on economic policy underscores the pertinence of these questions. The USA and other countries have advocated lowering surpluses as a contribution to international economic coordination. Recently, it has been posited that at least in the long run high trade surpluses should be offset by capital exports or that they are even conducive to the economic advancement of other countries. National economic policy debate seems to dismiss the notion of surpluses as a serious problem. The Federal Government's latest Annual Economic Report (1989) devotes no more than a few sentences to them; nor does the German Council of Economic Experts consider that this issue merits major attention in its latest report for 1988/89.³

Table 1 shows the items of the German balance of payments. At 4% of GNP, the surpluses on current account since 1986 have been the highest since the foundation of the Federal Republic. The only appreciable deficits were in 1965 and from 1979 to 1981. The balance of trade has been consistently on the plus side and the balance of service transactions since 1970 always minus, except for 1984/85. The transfer balance

has been consistently adverse, but it has hardly worsened since the beginning of the 80s.

In the 50s, a major counterpart to the surplus on current account were the mounting foreign currency reserves. Long and short-term capital exports increased in importance in the 60s though and by the end of the 60s and the early 70s lower surpluses on current account were being attended by substantial long-term capital inflows, supplemented by foreign exchange receipts. After the collapse of the Bretton Woods system in 1973, long-term capital exports dominated at first, to be ousted by large capital inflows from 1979 to 1981. Overall, the capital account in the 70s was balanced. The current account surplus was counterposed by changes in foreign exchange reserves.

In the 80s, the current account surpluses have been much higher, with capital movements as a counterpart. Only in 1980 and 1988 were heavy outflows of foreign exchange recorded and larger inflows in 1987 alone. The current account surplus of 3% of GNP on average from 1983 to 1988 was counterposed by a mere 1% in

¹ The German surpluses are higher today than they were more than a decade ago, when Kindleberger dealt with the same topic; cf. C. Kindleberger: Germany's Persistent Balance-of-Payments Disequilibrium Revisited, in: Banca Nazionale del Lavoro, Quarterly Review, Vol. XXIX, 1976.

² Cf. G. Fels: Der Standort Bundesrepublik Deutschland im internationalen Wettbewerb, and E. Wohlers: Internationale Wettbewerbsfähigkeit, Wechselkurse und Außenhandel – einige Anmerkungen zur gegenwärtigen Diskussion in der Bundesrepublik, both in: Hamburger Jahrbuch für Wirtschafts- und Gesellschaftspolitik, No. 33, 1988.

³ Cf. 1989 Annual Economic Report of the Federal Government, Federal Ministry of Economics, Nos. A I 5 and A II 11, and the Annual Report of the Council of Economic Experts 1988/89, section nos. 217, 231 and 232.

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long-term capital exports; in 1988 these capital exports were also boosted by the introduction of withholding tax originally planned for 1st January 1989. On the whole, a predominant role was also played in 1986 to 1988 by high short-term capital exports by the banking system, supplemented by suppliers' credits from German firms to foreign importers. The marked changes effected in the foreign exchange balance by the Bundesbank's buying of foreign exchange in 1987 and its selling of almost the same amount in 1988 helped to stabilize exchange rates.

The analysis reveals alternating phases of strong capital inflows and outflows. The trend towards growing long-term capital exports is discernible, but the basic balance is well in the black, excepting 1988. This takes on added importance when we note that capital movements statistically recorded as long-term are heavily swayed by changing portfolio investment decisions. Whether 1988 has ushered in a long-term shift in developments cannot be reliably assessed.

Macroeconomic Analysis

The competitiveness of a country depends on price or cost and structural conditions.⁴ Measured against structural or non-price yardsticks, German industry is generally rated as highly competitive. Prices and costs as well as demand and the division of income between expenditure and savings are, however, important macroeconomic factors for foreign trade balances.

A major indicator of the price competitiveness of a country is unit production cost. The upper section of Figure 1 shows relative unit labour costs in national currency weighted with the average export shares of the respective trading partners.

Relative unit labour costs in the Federal Republic have almost halved from 1970 to 1988, compared with a decline of almost 25% in Japan and 20% in the USA. In the European Community they were a third higher in 1988 than in 1970. From 1980 and 1985 respectively to 1988, relative unit labour costs in the Federal Republic of Germany and in Japan declined at a similar rate. In the European Community, they had been rising up to the mid-80s whereas in the USA they remained more or less unchanged since the mid 70s. Of the major European

countries, France's relative unit labour costs have been on a steep downward path since 1985. These trends mirror the Federal Republic of Germany's high level of internal stability.

More significant for the assessment of international competitiveness, however, are the relative unit labour costs in relation to the effective rates of exchange,⁵ which gives us the real effective exchange rate. Taking 1970 as the base year, the USA's real effective exchange

Table 1
Balance on Current Account of the FRG with its Counterparts
— Shares in GNP —

	Current Account	Capital Account ¹			Basic Balance ³	Balance of Foreign Exchange Payments ⁴
		Total	Short-term ²	Long-term		
1950-1960	+ 2.1	- 0.5	- 0.2	- 0.3	+ 1.8	- 1.5
1961-1970	+ 0.9	- 0.5	+ 0.4	- 0.9	+ 0.0	- 0.4
1971-1980	+ 0.5	- 0.0	- 0.1	+ 0.1	+ 0.7	- 0.5
1981-1982	+ 0.1	- 0.1	+ 0.1	- 0.2	- 0.0	- 0.0
1983-1985	+ 1.7	- 1.8	- 1.0	- 0.8	+ 0.9	+ 0.1
1986-1988	+ 4.1	- 3.9	- 2.7	- 1.2	+ 2.9	- 0.2
1986	+ 4.4	- 4.1	- 5.8	+ 1.7	+ 6.1	- 0.3
1987	+ 4.0	- 2.0	- 0.8	- 1.2	+ 2.8	- 2.0
1988	+ 4.0	- 5.6	- 1.7	- 3.9	+ 0.1	+ 1.6
1983-1988	+ 3.0	- 2.9	- 1.9	- 1.0	+ 2.0	- 0.1

¹ Capital exports: —

² Diverging from the official statement of the balance of payments, the balance of the statistical discrepancies is allotted to short-term capital and the balancing item in respect of the external position of the Bundesbank to the balance of foreign exchange payments. Though there may be justifiable objections to this arrangement, it probably best reflects the actual transaction-related movements.

³ Current account and long-term capital account.

⁴ Foreign exchange inflows: —

Sources: Annual Report of the Council of Economic Experts 1988/89, Annex V, Table 55; Deutsche Bundesbank: Monthly Report; own calculations.

Table 2
Trends in Terms of Trade Gains (+) and Losses (–) as Shares of Gross National Product

	1979 to 1982	1983 to 1985	1986	1987	1988	1986 to 1988
United States	- 0.3	0.3	0.3	- 0.6	- 0.1	- 0.1
Japan	- 1.3	- 0.2	2.2	0.1	1.0	1.1
FR Germany	- 0.8	0.0	2.9	0.8	0.2	1.3
France	- 0.9	0.3	2.3	0.2	0.3	0.9
United Kingdom	0.5	0.0	- 1.2	0.3	1.2	0.1
Italy	- 0.5	0.3	2.7	0.9	0.2	1.3
Canada	0.7	- 0.3	- 0.7	0.5	1.0	0.3

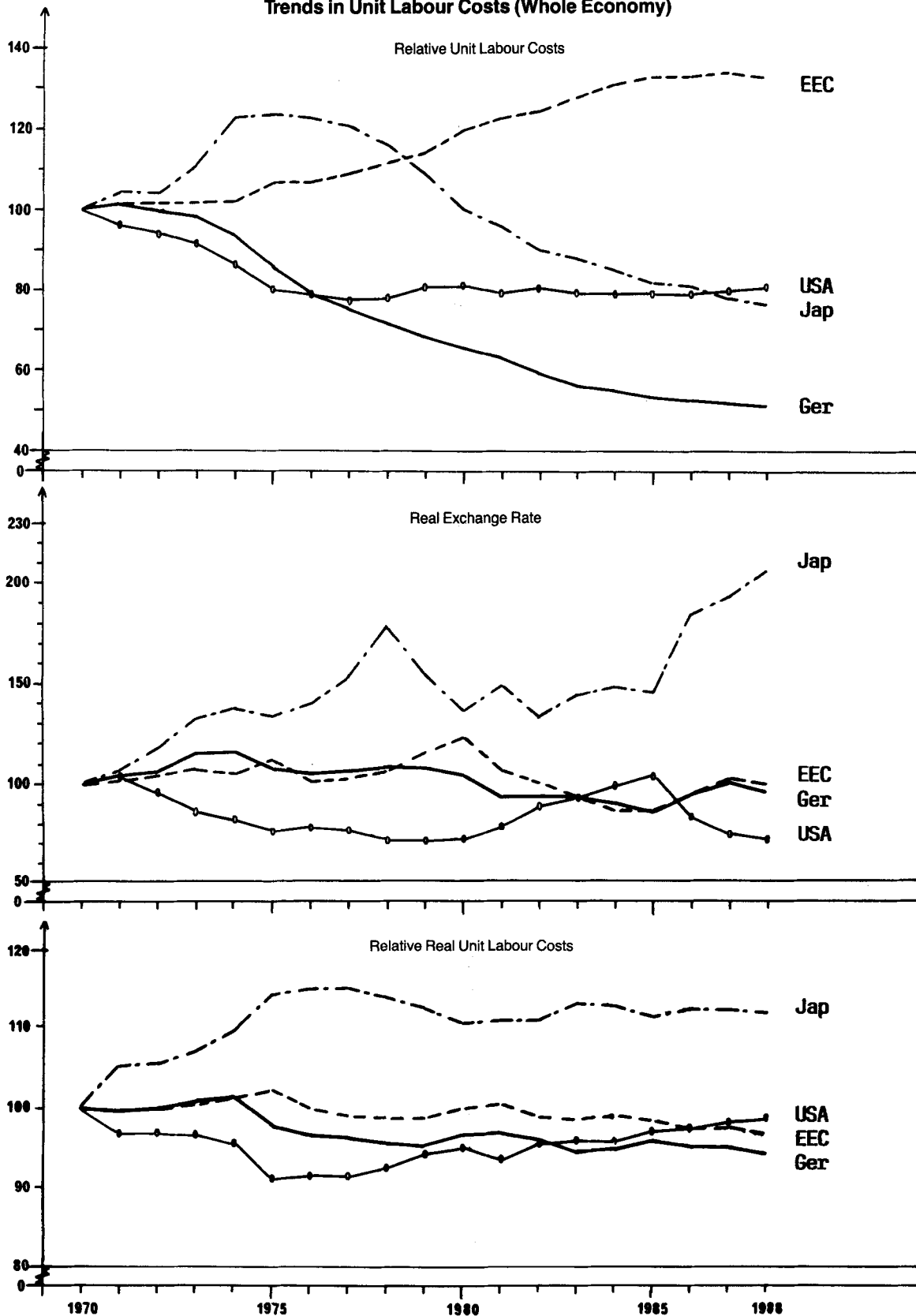
Sources: OECD: National Accounts, Vol. I, 1960-1987; OECD: Economic Outlook, No. 44, December 1988; own calculations and estimates according to national figures. The terms of trade gains and losses are derived from the difference between the rise in the deflators of GNP and of domestic demand.

⁴ Qualitative or non-price factors in the competitive position of a country are for example specialization, application of innovations, quality, delivery conditions, service, etc.

⁵ Real exchange rates can — as with price competitiveness generally — also be calculated on the basis of GNP deflators, consumer and export prices. Since all these indices are associated with labour costs, the latter are given preference.

Figure 1

Trends in Unit Labour Costs (Whole Economy)



Sources: Commission of the European Communities: Annual Economic Report 1988-1989, Preparing for 1992, European Economy, No. 38, November 1988, Tables 32 and 33; own calculations.

rate was at its lowest in 1988, with sharp fluctuations in the 80s, though. The Federal Republic kept within the parameters set by the European Community, with France and the United Kingdom amongst the major states showing a noticeable improvement since the beginning of the 80s. According to these indicators, exchange rates have more or less offset the internal unit labour cost advantages, particularly in Japan, whose real exchange rate appreciated substantially.

Measured according to relative real unit labour costs, i.e. real unit labour costs weighted against those in the partner countries, the Federal Republic of Germany's performance for the periods under review comes off well. The relative real unit labour costs depend upon the rise in nominal wages, but also on the related increase in the GNP deflator. Another relevant factor is the growth in real national product, which is a co-determinant of productivity per head. High real product wages can be offset by enhanced productivity. The relative real unit labour costs are an indicator for the supply conditions in a country. All other things being equal, they are a determinant of the ratio of domestic production to imports in meeting home demand.

The internal cost and productivity advantages have been largely balanced out by the rates of exchange. According to the real rates of exchange in the 80s, though, the overall position has been better than in the previous decade, which has further fostered German industry's strong competitiveness in quality.

Demand, Income and Net Lending

In the absorption approach, demand, income, savings and propensity to borrow are major determinants of current account balances.⁶ Table 2

shows the terms of trade, which reflect an economy's gains and losses in real income terms. After OPEC II, the terms of trade gains of the oil producing countries Canada and the United Kingdom were high, though those of the United Kingdom were heavily influenced by the devaluation of sterling in 1979. During this phase, the oil importing countries suffered terms of trade losses. After only slight shifts between 1983 and 1985, marked changes occurred from 1986 to 1988, owing to the steep drop in oil prices and fluctuations in the rates of exchange. The highest terms of trade gains were recorded by the Federal Republic of Germany and Italy with just about 4% of the GNP, followed by France and Japan with 3%. The accounts for the United Kingdom, the USA and Canada were more or less balanced. The Federal Republic's ability to make high terms of trade gains can be attributed to its strong external position.

Domestic Demand

The terms of trade must be seen in relation to domestic demand, the disposable income of private households and income distribution. Only in France did domestic demand increase more slowly than in the Federal Republic between 1983 and 1985, with more robust growth rates in the USA, Canada, the United Kingdom and Japan. Although the Federal Republic of Germany recorded high terms of trade gains from 1986 to 1988, domestic demand remained within the lower range of growth rates. In the United Kingdom, Japan and Canada, with less favourable terms of trade,

⁶ The absorption approach is now an indispensable part of any balance of payments theory. For a contemporary assessment cf. H. F l a s s b e c k: Preise, Zins und Wechselkurs, Walter Eucken Institut Freiburg i. Br., Wirtschaftswissenschaftliche und Wirtschaftsrechtliche Untersuchungen, 1988.

Table 3
Domestic Demand and Disposable Income of Private Households at Constant Prices
Average Changes in %

	1982 1979	1985 1982	1988 1985	1982 1979	1985 1982	1988 1985	1982 1979	1985 1982	1988 1985
	Domestic Demand			Relative Domestic Demand ¹			Disposable Income of Private Households		
United States	- 0.5	5.8	3.2	- 1.0	3.2	- 1.2	0.7	3.8	3.2
Japan	1.9	3.2	5.6	2.0	- 0.9	2.0	1.6	2.6	3.8
FR Germany	0.4	1.7	3.6	- 1.7	- 1.1	- 0.3	0.9	1.0	3.7
France	1.7	0.6	3.6	1.6	- 2.1	- 0.3	1.1	0.1	2.2
United Kingdom	- 0.7	3.4	4.6	- 0.9	0.6	1.6	0.0	2.4	3.5
Italy	1.8	2.4	4.1	1.8	- 0.3	0.5	0.7	1.3	2.8
Canada	- 0.3	4.9	4.6	.	.	.	2.6	2.7	2.4

¹ Domestic demand of the respective country in relation to that of the trading partners.

Sources: OECD: National Accounts, Vol. I, 1960-1987; Vol. II, 1974-1986; OECD: Economic Outlook, No. 44, December 1988; calculations of the EC Commission, supplemented by own calculations and estimates.

domestic demand rose much more strongly than in the Federal Republic of Germany. Despite the necessary reduction of the current account deficit, domestic demand in the USA rose comparatively strongly. The trends for the demand gap, i.e. the relative changes in domestic demand in relation to the average developments of the respective trading partners, were similar. The largest relative increases since 1982 have been in the USA, the United Kingdom and Japan; in the latter countries, domestic demand has risen most strongly since 1986. Along with that of France, the

relative domestic demand in the Federal Republic of Germany in both phases of the 80s has been sluggish. Between 1983 and 1985, real disposable income of private households, a major determinant of private consumption, grew least in the Federal Republic of Germany, France and Italy. Except for the USA and Canada, real disposable income has risen faster from 1986 on in all countries than in the preceding three years, the highest growth rates being in the Federal Republic of Germany and Japan. Notwithstanding an appreciable increase in real disposable income of private households due to high terms of trade gains and tax cuts, domestic demand in the Federal Republic of Germany remained restrained.

Table 4
Net Exports at Constant Prices
– Shares in GNP –

	1980-1982	1983-1985	1986	1987	1988	1986-1988
United States	1.4	- 2.0	- 3.7	- 3.3	- 2.5	- 3.2
Japan	0.1	3.3	2.8	2.0	0.1	1.6
FR Germany	1.9	4.3	4.2	3.0	2.9	3.4
France	- 0.7	0.9	- 0.9	- 2.0	- 2.2	- 1.7
United Kingdom	2.4	0.7	0.3	- 0.2	- 3.9	- 1.3
Italy	- 2.6	- 1.5	- 2.2	- 3.8	- 4.4	- 3.5
Canada	2.6	4.4	3.4	2.7	1.5	2.5

Sources: OECD: Quarterly National Accounts, No. 4, 1988; OECD: Economic Outlook, No. 44, December 1988; own calculations and estimates according to national figures.

Table 5
Growth and Distribution of Income

	1988/1970	1982/1970	1988/1982
United States			
Gross income from employment	9.0	9.9	7.3
Income from property and entrepreneurship	9.3	8.4	10.9
Japan			
Gross income from employment	10.8	13.7	5.1
Income from property and entrepreneurship	6.6	7.7	4.3
FR Germany			
Gross income from employment	6.7	8.0	3.7
Income from property and entrepreneurship	6.3	5.5	8.2
France			
Gross income from employment	11.8	14.8	6.0
Income from property and entrepreneurship	9.9	9.2	11.1
United Kingdom			
Gross income from employment	12.4	14.7	7.9
Income from property and entrepreneurship	13.2	14.2	11.2
Italy			
Gross income from employment	16.6	19.6	10.7
Income from property and entrepreneurship	15.1	16.2	13.0
Canada			
Gross income from employment	11.0	13.0	7.1
Income from property and entrepreneurship	12.0	12.9	10.0

Sources: OECD: National Accounts, Vol. I, 1960-1987; OECD: Quarterly National Accounts, No. 4, 1988; OECD: Economic Outlook, No. 44, December 1988; own calculations and estimates according to national figures.

Net Exports

The Federal Republic of Germany's outstanding external position is also reflected in its net exports at constant prices. At an average 3½% of GNP between 1986 and 1988, the Federal Republic of Germany's real net exports are the highest followed by Canada's 2½%. In Japan, the figure declined from 4% in 1984/85 to zero in 1988. All the other countries have had net deficits in real exports with large increases in the three European nations.

Income Distribution

As to income distribution, which can be an effect as well as a cause of current account figures, gross income from employment and from entrepreneurship and property rose in the longer term at a more or less equal rate, with the exception of Japan. Table 5 clearly shows the two different phases: up to the beginning of the 80s, an on average overproportional, and thereafter less than proportional, growth in gross income from employment. The years since the 1982 recession have seen in the Federal Republic of Germany the most marked redistribution of income in favour of income from property and entrepreneurship. In Japan, in contrast, business income has continued to rise more slowly in the 80s.

Breakdown of Net Lending

To round off the macroeconomic analysis, we shall look at the structure of net lending. In the Federal Republic of Germany, in France and in Canada, the high financial deficits in the corporate sector diminished substantially, less so in the United Kingdom and Italy. In the Federal Republic of Germany, the financial deficit of the corporate sector has declined to an unprecedented low since 1986, when the current account surplus rose

Table 6
Trends in Financing Balances (Net Lending) of the Economic Sectors
in the Seven Major Countries of the OECD

– Shares in GNP –

	before 1973	1979 1973	1980	1981	1982	1983	1984	1985	1986	1987	1988
United States											
Households and non-corporate	1.8	3.1	3.7	3.8	4.9	3.3	2.7	2.0	1.4	1	1½
Corporate	– 0.6	– 1.5	– 1.9	– 2.5	– 0.9	0.4	– 1.4	– 0.6	– 0.4	– ¾	– 1
Private Sector	1.2	1.6	1.8	1.3	4.0	2.9	1.3	1.4	1.0	¼	½
Government	– 0.6	– 1.4	– 1.5	– 1.1	– 4.0	– 4.9	– 3.8	– 4.1	– 4.4	– 3½	– 3
Foreign	0.5	0.2	0.5	0.4	– 0.0	– 1.0	– 2.4	– 2.9	– 3.4	– 3½	– 2¾
Japan											
Households and non-corporate	8.3	10.2	8.8	9.8	8.7	9.2	8.9	9.5	9.8	8½	7¾
Corporate	– 8.2	– 7.0	– 5.7	– 6.3	– 4.9	– 4.2	– 4.5	– 5.5	– 4.9	– 5¾	– 6½
Private Sector	0.1	3.2	3.1	3.5	3.8	5.0	4.4	4.1	5.1	2¾	1
Government	1.0	– 3.4	– 4.4	– 3.8	– 3.6	– 3.7	– 2.1	– 0.8	– 1.1	½	1¼
Foreign	1.4	0.3	– 1.1	0.4	0.7	1.8	2.8	3.6	4.3	3¾	2¾
FR Germany											
Households and non-corporate	7.0	7.7	7.3	7.9	7.3	6.0	6.2	6.2	6.5	6½	6½
Corporate	– 6.9	– 3.8	– 6.4	– 5.2	– 3.7	– 3.0	– 3.2	– 2.6	– 1.0	– ¾	– ½
Private Sector	0.1	3.9	0.8	2.7	3.7	3.0	3.0	3.6	5.5	5½	6
Government	0.5	– 3.0	– 2.9	– 3.7	– 3.3	– 2.5	– 1.9	– 1.1	– 1.3	– 1¾	– 2
Foreign	0.6	0.9	– 2.1	– 1.0	0.4	0.5	1.1	2.4	4.2	4	4
France											
Households and non-corporate	3.5	4.4	3.3	4.4	4.7	4½	3.8	3.0	3.3	2	2
Corporate	– 4.0	– 4.3	– 5.0	– 4.2	– 5.1	– 2.8	– 1.9	– 1.4	– 1.2	– 0	– 1½
Private Sector	– 0.5	0.1	– 1.7	0.2	– 0.4	1.3	1.9	1.6	2.1	2	½
Government	– 0.5	– 0.9	0.2	– 1.8	– 2.7	– 3.1	– 2.9	– 2.6	– 2.7	– 1½	– 1½
Foreign	0.1	– 0.7	– 1.4	– 1.5	– 3.1	– 1.7	– 0.9	– 0.8	– 0.4	– ½	– ¾
United Kingdom											
Households and non-corporate	1.7	4.2	6.4	5.3	4.7	3.4	3.6	2.9	1.5	– ¼	– 2
Corporate	– 0.4	– 4.1	– 3.5	– 3.9	– 2.8	– 3.4	– 3.9	– 2.9	– 3.1	2½	– ¼
Private Sector	1.0	2.2	5.7	6.9	5.8	5.7	5.2	4.8	4.4	2¼	– 2¼
Government	– 0.4	– 4.1	– 3.5	– 3.9	– 2.8	– 3.4	– 3.9	– 2.9	– 3.1	– 2	– 0
Foreign	0.1	– 1.3	1.5	2.3	1.3	0.8	– 0.3	0.5	– 0.8	– 1½	– 4
Italy											
Households and non-corporate	11.2	14.5	9.6	13.1	13.8	14.8	13.8	13.2	13.2	11	11¼
Corporate	– 4.8	– 5.6	– 4.1	– 3.6	– 2.8	– 2.9	– 1.7	– 0.4	0.2	½	– ¾
Private Sector	6.4	8.9	5.5	9.5	11.0	11.9	12.1	12.8	13.4	11½	10½
Government	– 5.8	– 9.2	– 8.0	– 11.9	– 12.6	– 11.7	– 12.9	– 14.0	– 12.6	– 1½	– 11
Foreign	0.7	– 0.2	– 2.4	– 2.3	– 1.6	0.2	– 0.8	– 1.1	– 0.9	– 0	– ½
Canada											
Households and non-corporate	2.1	4.1	6.1	6.7	11.0	7.8	8.2	7.0	4.6	3¼	2
Corporate	– 3.3	– 4.3	– 3.7	– 7.1	– 4.5	– 1.2	– 1.4	– 0.6	– 1.3	– ½	– ½
Private Sector	– 1.2	– 0.2	2.4	– 0.4	6.5	6.6	6.8	6.4	3.3	2¾	1¾
Government	0.8	– 1.7	– 2.8	– 1.5	– 6.0	– 7.0	– 6.5	– 7.1	– 5.5	– 4½	– 3
Foreign	0.0	– 1.9	– 0.4	– 1.7	0.8	0.8	0.6	– 0.4	– 2.1	– 2	– 1½

Sources: OECD: Economic Outlook, No. 43, June 1988; OECD: Quarterly National Accounts, No. 4, 1988; own calculations and estimates according to national figures.

markedly. In the USA the financial deficits have remained relatively low, and in Japan comparatively high. In both countries, this was associated with high investment and relatively modest business profits or own resources (retained profits and depreciation).

Rate of Saving

Of major importance for the analysis is the trend in the rate of saving or the financial balances of private households. Apart from Japan and the Federal Republic of Germany, where the financial balances of private households as a percentage of GNP have remained reasonably steady, the rate of saving has mostly been on the decline since the beginning of the 80s and especially since 1986. If we combine the savings of private households and the balances of the corporate sector, the Federal Republic of Germany's outstanding position again becomes clear. The surplus in the domestic private sector as a proportion of GNP registered the highest increase since 1986 amongst the major countries and the highest share of GNP since the foundation of the Federal Republic. Since the financial deficit of the public sector has remained comparatively small, the counter-item of the much improved financial

position of the domestic private sector consisted of large current account surpluses.⁷

Level of Investment

Table 7 contains the savings and investment ratios of the domestic sectors in the Federal Republic of Germany as a counterpart to the balance on current account. Between 1986 and 1988, the rate of investment of the private sector was 17½% of GNP, lower than in the period between 1980 and 1982, whereas own resources (retained profits and depreciation) rose from 13% to 17% of GNP. This large net acquisition of financial assets was not offset by the savings and investment decisions of the public sector. Gross government savings have increased since the beginning of the 80s by almost 1% of GNP, with capital formation declining by nearly one percentage point. From 1985, though, the general government deficit rose again slightly but hardly impinged upon the large increase in savings in the private sector.

This breakdown of accounts also permits of some inferences on the so-called fiscal theory of current account, which posits that a change in budget balances will be accompanied by a similarly directed change in the current account.⁸ In purely statistical terms, there are indicators to verify this for the years 1985/86 in certain countries – the USA, Japan, Germany and in part the United Kingdom. The figures for the other countries do not substantiate the theory for this period. Trends in the USA after 1986 also tend to corroborate the theory, but for the other countries the tendency seems to have been more towards diminishing general government deficits together with rising current account

⁷ For further discussion cf. E. Neuthinger: Anatomie eines Wachstumspfad – Zur wirtschaftlichen Entwicklung in der Bundesrepublik Deutschland seit 1983. Rückschauende Analyse, Ausblick und wirtschaftspolitische Bewertung, in: Konjunkturpolitik, Vol. 34, No. 4, 1988.

⁸ On the fiscal theory of the balance of payments cf. E. Milne: The Fiscal Approach to the Balance of Payments, in: Economic Notes, Monte dei Paschi della Siena, Vol. 6, 1977; W. Leibfritz: Staatsdefizit und Zahlungsbilanz, in: Ifo-Schellendienst 35-36/88; and Reinhard Pohl: Staatsdefizite und Zahlungsbilanz, in: W. Filc, L. Hübl, Rüdiger Pohl (eds.): Herausforderungen der Wirtschaftspolitik, Festschrift für Claus Köhler, 1988.

Table 7
Determination of Counterparts of the Current Account (Financial Balance of the Foreign Sector)
– in % of GNP –

	1980–1982	1983–1985	1986	1987	1988	1986–1988
1. Financial surplus of private households	7.5	6.1	6.5	6.4	6.5	6.5
2. Retained profits and depreciation of enterprises (own resources)	13.1	14.8	16.1	16.6	17.6	16.8
3. Savings of the private sector	20.6	20.9	22.6	23.0	24.1	23.2
4. Private gross capital formation	18.2	17.7	17.1	17.4	18.2	17.6
5. Private sector financial balance	2.4	3.2	5.5	5.6	5.9	5.7
6. Government gross savings	– 0.1	0.6	1.1	0.6	0.4	0.7
7. Government gross capital formation	3.2	2.4	2.4	2.4	2.3	2.4
8. Government financial balance	– 3.3	– 1.8	– 1.3	– 1.8	– 2.0	– 1.7
9. Financial balance of the foreign sector (5+8)	– 0.9	1.3	4.2	3.8	4.0	4.0

Sources: Federal Statistical Office: Accounts and Standard Tables 1985 and 1987, National Income Accounting, Fachserie 18, Reihe I, Wirtschaft und Statistik 1989, No. 3.

deficits or lower surpluses. In the Federal Republic of Germany, a slight rise in budget deficits has been attended by larger current account surpluses. So although a statistical correlation between public and trade balances is discernible up to 1985/86, the subsequent changes in the current account balances have been heavily influenced by the expenditure/income decisions of the private sector. These findings are plausible because with generally receding public financial deficits, other determinants gained in importance. When the public balance of only one country changes, the effect on its current account is greater than if public balances in other countries are moving in the same direction. The empirical analysis confirms the prevalent opinion that, *ceteris paribus*, a discretionary fiscal policy in a country induces adjustment processes in the private sector and on the current account.

Causes of the High Surpluses

Real and financial external balances are the result of the actions and preferences of private economic actors and the monetary and budgetary policy at home and abroad. In addition to the quality side, the price or cost competitiveness of the German economy in the 80s has been comparatively good. It worsened for a while from 1985 to 1987 with the drop in the dollar, but has improved again since the spring of 1988. The German surpluses cannot be attributed to competitiveness alone, however; the major cause is the low rate of absorption.⁹

A good export position need not in itself mean high surpluses on the balance of payments. The export earnings and the large terms of trade gains have not been employed to increase overall spending and imports. Nominal and real domestic demand has remained relatively low. The crucial question is therefore, why the savings or the net acquisition of financial assets of private households in the Federal Republic of Germany have not declined as in other countries, and why German enterprise has not reinvested its increased profits.

Owing to economic interdependencies, causal relations are difficult to ascertain. We would draw the following conclusions, however:

□ Private consumption rose rather slowly in the first half of the 80s, because mass income hardly increased. The major sources of disposable income were the withdrawals by the self-employed, the distribution of profits and the income from property of private households. Since the rate of savings for these incomes is generally high, it also had an effect on the overall net acquisition of financial assets of private households, in

spite of the diminution of the rate of savings from mass income. Despite higher real income gains due to cheaper imports and tax cuts, however, consumption has remained relatively restrained since 1986. Since 1986, the rate of savings of the middle income groups and retired couples' households has stopped declining, because when real income goes up, increased consumption contends with a greater propensity to save in the dispositions of private households.

□ Final public consumption also rose rather modestly from 1982 on; public investment started to rise again after 1986. Although real fixed investment by the corporate sector has risen overproportionately since 1983, it has not given a lasting impetus to domestic absorption, particularly as the housebuilding sector has flagged. The heavy dependence on foreign demand and the uncertainty with regard to exchange rates dampened medium term sales and profit expectations, impeding a sustained investment upswing. Even so, the demand effects of export surpluses combined with low wage rises enhanced profits¹⁰ and stimulated investment.

The major cause of the persistent current account surpluses, in addition to German competitiveness, is the high rate of saving, particularly on the part of business and private households, accompanied by low public absorption. The analysis vindicates the hypothesis that surpluses and high business earnings are mutually conducive. Largely due to the low rates of saving the financial situation of the corporate sectors in the other countries improved, but they partly went into higher imports from the Federal Republic of Germany. So, behaviour in the Federal Republic differed markedly from that in other countries. To explain the regional shift of trade surpluses from the USA to the European countries by the high export performance of German firms and the pattern of foreign demand for capital goods and to impute to increased German savings that it has helped raise foreign absorption, is a one-sided view. The surpluses have only shifted regionally; the American imbalance has been aggravated by a European one; the German export industry is finding its

⁹ The absorption or savings/investment approach has recently been applied by Turner to analyze the current accounts of the seven major countries of the OECD; cf. P. Turner: Savings, Investment and the Current Account: An Empirical Study of Seven Major Countries 1965-84, in: Bank of Japan, Monetary and Economic Studies, Vol. 4, No. 2, October 1986.

¹⁰ On the profit enhancing impact of trade surpluses, cf. A. Oberhauser: Änderungen in der Einkommensverteilung und Zinsbildung. Eine notwendige Ergänzung der Zinstheorie, in: W. Filc, L. Hübl, Rüdiger Pohl (eds.), op. cit.; A. Oberhauser: Verstöße gegen die Saldenmechanik. Bemerkungen zum Gutachten „Gewinn, Investitionen und Beschäftigung“ des Wissenschaftlichen Beirats beim Bundesministerium für Wirtschaft, in: Finanzarchiv, New Series, Vol. 46, No. 2, 1988; and E. Neuthinger, op. cit.

outlets under the present conditions and export revenues are still not bringing about greater domestic spending.

Financial Sector

Leaving aside the special situation in 1988, in view of the largely short-term financing of the current account surpluses via the banking system and suppliers' credit, as well as the marked continuous shifts in long-term capital movements, it can hardly be argued that the financial sector is playing a predominant role. Balances on current account and their counterparts are engendered simultaneously by the decisions of private and public economic units. The net acquisition of financial assets by private households, business and the state mirror autonomous decisions on consumption and investment, but the choice of portfolio investment in highly integrated but imperfect financial markets is coming increasingly under the sway of international interest differentials. Considering the sustained high rate of savings of private households, moderate borrowing by private enterprise and the government, and low inflation, the German nominal rate of interest has remained comparatively low. Nor does a traditional investment currency with an interest rate bonus like the Deutschmark mean that foreign bonds are not bought. National investors profit from the higher nominal yield in other countries, which leads to capital outflows, exacerbated in 1988 by the withholding tax. In this sort of constellation, even with trade surpluses, expectations of a rise in the Deutschmark are weak.

It is too hasty to assert that trade surpluses are not an indicator for imbalance, as long as they are offset by capital exports.¹¹ In the theoretical treatments of the definition of external equilibrium, there is hardly any distinction drawn between short-term and long-term capital exports. It is important to note that capital exports statistically defined as long-term can turn out to be short-lived as a result of changes in portfolio decisions. With the deregulation and internationalization of the financial markets and the resultant increased transparency of international portfolio investment opportunities mutual capital flows have expanded a lot. The share of loans issued by German banks including their international subsidiaries to foreign borrowers and of foreign securities in the assets of German investment companies have risen appreciably since 1980. The German banking and financial system has thus done a

lot both directly and indirectly toward recycling current account surpluses. Its lack of flexibility in reallocating resources of ten years ago¹² is no longer the case, but this only applies to the technical management of existing credit relationships and tells us nothing about their equilibrium conditions and the underlying savings and investment decisions.

Current Account

Based on medium-term status quo forecasts – no policy changes, steady real exchange rates – economic growth and domestic demand in the Federal Republic of Germany will hardly increase overproportionately compared to the average growth rates of the other countries and the current account surpluses will not diminish.¹³ The structure of the current account balances of the other countries will also alter little, which means that the current wide discrepancies will persist.

Despite many predictions to the contrary, the current account deficit of the USA has been financed and has not led to the heavy landing of a recession and a renewed plummeting of the dollar, but discussion of this issue is still going on. The optimistic view argues according to the motto "so far so good" that a current account deficit in the USA of 2½% of GNP can be sustained in the long term in view of the savings of other countries without dramatically high US interest rates.¹⁴ Foreign interest payment would only go up by 1% of US GNP. Nor are the European disequilibria any reason for pessimism. With the freedom of movement for capital and the integration of the financial markets the savings of all countries are far more accessible to all other countries than before; the previous close conformity between national savings and investment rates has been loosened substantially.¹⁵ Adjustments in exchange rates or differential growth rates in domestic demand are not absolutely necessary, particularly where current accounts reflect diverging savings, investment and profitability patterns and degrees of maturity of the economy. Wide discrepancies in current accounts could accordingly be reconciled.¹⁶

This policy approach would, however, involve a considerable risk. The divergencies in current accounts and the capital and foreign exchange movements entailed would be enormous. For debt service on capital imports, high earnings from investment and current

¹¹ Cf. B. Kauffmann and J. Scheide: Die amerikanischen Defizite im Kreuzfeuer der Kritik, in: Kiel Discussion Papers, No. 150, March 1989. The Council of Economic Experts also assesses the net capital exports of the Federal Republic of Germany positively, but questions the desirability of the high German current account surpluses or capital exports (Annual Report 1988/89, section nos. 231 and 232).

¹² Cf. C. Kindleberger, op. cit.

¹³ Cf. inter alia International Monetary Fund: World Economic Outlook, October 1988; and OECD: Economic Outlook, No. 44, December 1988.

¹⁴ Cf. J. Sachs: Global Adjustment to a Shrinking U.S. Trade Deficit, in: Brookings Papers on Economic Activity, No. 2, 1988.

¹⁵ Cf. P. Turner, op. cit.

¹⁶ Cf. OECD: Economic Outlook, No. 44, December 1988.

production are needed. This is feasible, provided demand rises and is not lop-sided towards present consumption. As soon as the current high aggregate demand and rates of profit in the deficit countries recede, the adverse impact of greater imports on national production and debt service will make itself immediately felt.

The events of recent years have clearly shown how unstable financial markets and abruptly shifting capital movements are.¹⁷ These risks will not diminish in future, particularly since the foreign assets of the Federal Republic will rise from 16% in 1988 to over 30% by the mid-90s and those of Japan from 15% to 22%, whereas the liabilities of the USA will rise from 10% to above 20% of GNP, according to status quo projections.¹⁸ There is thus a danger of drastic adjustment processes being triggered by market forces, which would have a harmful impact on economic growth and employment. The quicker an adjustment process is deliberately set in motion, the less cause there is to fear national and international growth losses.

Although the allocation of resources in a free market system is steered by preferences, prices and exchange rates, current account surpluses of 4% of GNP are not optimal for German domestic equilibrium. Much militates against the view that the demand for private and public goods and services is satiated, that the distribution of income and savings is in equilibrium according to welfare criteria and that such high current account surpluses are necessary for growth and employment. A higher rate of domestic absorption would also be in the Federal Republic of Germany's own interests.

Economic Policy Aspects

The foregoing analysis has attempted to explain Germany's high export surpluses, by its non-price and price competitiveness, but mainly by means of the absorption or savings/investment pattern; both causes had to coincide. If one accepts the need for greater domestic absorption, i.e. that aggregate savings should be generated and used less by trade surpluses than by augmented domestic capital investment, the question then arises of how this shift can be effected. A possible remedy according to the view propounded here would be to combine an expansive medium-term fiscal programme with supply-side measures – deregulation,

the curbing of subsidies – with a general substantial revaluation of the Deutschmark. An expansive fiscal programme is needed to flank a supply-side policy, which alone does not afford enough scope and lacks the requisite impact, as experience in the 80s has demonstrated. Each approach presupposes or complements the other: a revaluation of the Deutschmark would bolster the comparatively weak service sector, as well as directly containing oversized industry and current account surpluses. Without expansive measures, however, overall demand would shrink. Conversely, an expansive fiscal policy alone would run the danger of inducing more inflation.¹⁹

As regards the domestic components of this strategy, all three facets of domestic demand should bring about greater absorption:

□ A well designed, medium-term scheme of government spending, to include both government consumption and investment, would enhance absorption. The high standard of German infrastructure is an example of the effective application of public funds and in a world increasingly permeated by technology, it is also an important component of the indicator "living standard". There are genuine needs in education, transport, housing, health and local services and in environmental protection, as has become evident recently. Gradually, neglect in these areas would have an adverse impact on the infrastructure and hence on the productivity and growth potential of the private sector.

□ Another strategy goal must be the stimulation of private consumption. In particular the income of the lower and middle classes must be increased. One could therefore also consider higher wage rises, which would also facilitate a more balanced distribution of income. To lower unemployment, however, profitability should probably rise; more rapid wage rises could offset this, so they should be substituted by additional tax cuts, particularly in the lower and middle income brackets.

□ The expenditure programmes and additional tax reductions would be deficit-funded. The borrowing needs

¹⁷ Cf. R. Z. Lawrence: Comments on Sachs, in: *Brooking Papers* . . . , op. cit.; and OECD: *Economies in Transition, Structural Adjustment in OECD Countries*, 1989; on the relationship between financial innovations and monetary policy cf. H.-J. Duder: *Geldmengenpolitik und Finanzinnovationen*, in: *Kredit und Kapital*, Vol. 19, No. 4, 1986.

¹⁸ In 1980, the share of the Federal Republic of Germany was 3½%, Japan's 1%, and the USA had a surplus of 3½% of GNP; cf. International Monetary Fund: *World Economic Outlook*, April 1988. These figures must be treated cautiously, because the stocks are not recorded according to their respective current value, but according to the historical transactions, so that the levels are less significant than the pace of change.

¹⁹ Due to the strong discrepancy in the present level of exports and imports and their income elasticities, at constant exchange rates the rate of growth of German domestic demand would have to be 33 to 50% higher than those of the partner countries if the surplus on the current account were to be reduced.

could be contained by lowering spending subsidies and tax subsidies. Via their demand and profitability effects, greater government and private consumption with moderate wage rises would help stimulate corporate investment. This would enable employment and, gradually, nominal and real wages to rise more rapidly. A sustained momentum for growth would lessen the need for fiscal policies to stimulate demand and elevate aggregate saving and investment to a higher level.

Constraints

The sheer size of the German surpluses and the economic policy situation in the Federal Republic of Germany and in its partner countries pose large obstacles to the solution proposed here. In the Federal Republic, apart from a general disinclination towards demand side policies, the current encouraging state of the economy, largely attributable to foreign demand and vulnerable to the effects of a strong revaluation, militates against it.²⁰ The European partners, too, given the present high demand and growth rates, are not open to a realignment of exchange rates and the attendant possible impact of inflation. After all, the dollar has risen since 1988 and represents an inflation threat for Europe and the Federal Republic of Germany in addition to the rise in raw materials prices.

All these strands are interwoven and are difficult to disentangle:

□ As argued above, at the current exchange rates, the present interest rate differential in favour of the Federal Republic provokes sizable capital outflows. Monetary policy has countered this in order to avoid a devaluation. This precludes an expansive role for German monetary policy, as monetary accommodation to expansionary fiscal policy would require.

□ On the other hand, the dollar is likely to be devalued anew in the foreseeable future, irrespective of whether the USA curtails public deficits or not. If the deficit is lowered, monetary policy in the USA will have to become more expansive; if not, renewed doubts on financial markets as to US policy will exert pressure on the dollar rate.

□ Another devaluation of the dollar and a general revaluation of the Deutschmark against the other European currencies would afford German monetary policy more scope.²¹ A devaluation of the dollar would also act as a buffer against the inflationary impact on the other European countries emanating from a one-sided revaluation of the Deutschmark. A foremost consideration however are the long-term advantages

and drawbacks of retaining the present exchange rate set-up in Europe as against a deliberate realignment, particularly with a view to the imminent European single market. It is doubtful whether the recent disequilibria on current account will provide a tenable foundation. Without disregarding the short-term and mid-term growth prospects, a restrictive fiscal policy in the deficit countries, particularly in the USA, is in our view necessary.

□ A general question that needs posing is whether Germany needs a higher nominal rate of interest in the present climate of interest differentials. If so, there would be a need for higher interest rates on the capital markets not via a tight monetary policy but via the market by means of higher government borrowing. Thus, higher interest rates would not curb overall demand, if the expansive fiscal policy brought about a rise in general productivity and the marginal efficiency of capital. Viewed realistically, this fiscal strategy could only take effect after a certain interval: the expenditure programme at the beginning of 1990, the additional tax cuts for lower and middle income groups not before 1991.²²

Current economic policy thinking in Germany is based on different assessments and geared to other goals than those presented here. Yet despite, or perhaps precisely because of, the high trade surpluses, the current path of economic policy could lead to a dilemma. On the one hand, under present circumstances – practically fixed exchange rates with capital outflows to countries with higher nominal interest rates – the need for flanking measures to safeguard the economy against external influences and secure internal price stability may become acute. On the other, the imbalances due to unstable financial markets may prove unmanageable and force abrupt adjustment detrimental to growth and employment. The therapy outlined here would have to be applied under circumstances of considerable uncertainty and norms would need setting, but the basic internal and external structures argue for it. International coordination with flanking policies in other countries are called for. Perhaps then, it will be possible to gradually lower the German current account surpluses to a tenable 1% to 2% of GNP, without undesirable growth and inflation effects.

²⁰ Cf. E. Neuthinger: Die Ursachen der Nachfragedynamik 1988, in: Wirtschaftsdienst, Vol. 68, No. 12, 1988.

²¹ From this vantage point, the short term aspect of the recent decision to abolish withholding tax could be to strengthen appreciation tendencies of the Deutschmark.

²² This is because the current tax cutting programme is entering its final stage with a net relief of just about 1% of GNP in 1990.