Imbalances: Should the EU intervene?

Economic imbalances keep recurring in the EU. Differences in trade balances dominate the debate. Germany has been generating very high surpluses for years and meets criticism for this reason. Are imbalances a threat to the EU, and what role does the euro play in this? Should politicians adjust differences in the balance of trade? And if so, is that up to national governments or the EU?
Are unequal trade balances a problem?

In the EU, there are imbalances, above all in the current account. At first, deficits were criticised, but now the issue is surpluses: During the crisis in 2008, half of all member states had current-account deficits of up to 20 percent of gross domestic product (GDP). Other countries have been running high surpluses of more than eight percent of GDP for years, including Denmark, Germany and the Netherlands. Germany generated a surplus of 260 billion euro in 2016, for example, which was roughly twice as high as that of China, although the Chinese economy is three times bigger.

Countries with large surpluses are criticised from two directions and called upon to change practice: at both global and European levels. Germany, for example, is accused globally of exporting too much and importing too little. The Trump administration in the United States particularly finds fault with this. Other actors such as the International Monetary Fund and leading economists complain that Germany saves too much and invests too little.

Within the EU, a second topic of debate concerns surpluses: Here it is argued that the German export boom contributes to unemployment in other Eurozone countries. Instead of stimulating domestic demand, increasing investments and importing more, Germany exploits external demand. Critics call on the federal government to take economic countermeasures.

But there are also opponents of such economic policy management. They argue that surpluses such as those in Germany are due to structural factors. The state cannot and should not correct such factors, they say. One of the main reasons for this, they argue, is the demographic structure: If you save money for retirement, then you consume less and increase the savings rate. Furthermore, wages have been rising since the crisis so surpluses will be corrected by market forces, if at all necessary.

Current account
The current-account balance consists of three components: the balance of trade in products and services, asset income, for example from capital gains, and transfers such as monetary transfers overseas. In other words, the current-account balance shows the difference between exports and imports as well as the difference between savings and investments.

Savings rate
The national savings rate is determined by gross national income less expenditures. Empirical studies show that a lower savings rate is connected with a higher current-account deficit. In order to reduce the deficit, the savings rate must rise. Reducing a surplus means a country must save less.

“Germany, with its ageing population, should have, and can legitimately aim to have, a degree of surplus, but not to the extent we see at the moment: four percent would perhaps be justified, but eight percent is not.”
Christine Lagarde, Managing Director of the International Monetary Fund in a press release by the IMF on 12 April 2017

“If wages had risen as much as called for, there would have been fewer jobs in Germany. [...] How can households abroad borrow money in order to buy German products? If financial markets were regulated such that it were more difficult to increase debt levels, the surplus would be lower.”
Clemens Fuest, President of the ifo Institute in the Süddeutsche Zeitung on 19 April 2017
How are imbalances corrected in the EU?

Some Eurozone countries are suffering under such imbalances. In many euro-area countries, the unemployment rate is very high at ten percent or more, for example in France, Italy and Spain. These countries urgently need more external demand so as to stimulate their economy. In Germany, by contrast, the unemployment rate is at four percent, its lowest level since reunification.

The euro influences the balance of trade through two channels. On the one hand, a fairly weak euro makes exports cheaper and imports more expensive relative to the rest of the world, thereby contributing to the development of surpluses. A strong euro has the reverse effect. On the other hand, it is impossible in the Eurozone to correct imbalances between member states by revaluing or devaluing the national currency. Many years of stagnant wages in Germany therefore led to an internal devaluation, giving the country a competitive advantage that showed up in its trade surpluses.

A stronger euro would not automatically correct the imbalances in the EU. If the European Central Bank tapered its bond buying programme, the euro might appreciate as a result and strengthen imports relative to exports. However, this would simply alter the Eurozone’s trade deficit with the rest of the world overall, but not the imbalances among the euro-area countries. One also needs to take into account that Germany, for example, had a surplus for many years prior to the introduction of the euro.

The EU can only take limited action to address imbalances right now. Since 2011, there has been the so-called Macroeconomic Imbalance Procedure: If deficits or surpluses are found to be too high, the European Commission issues reform recommendations, for example, with respect to the labour market or investments. However, only a small portion of these recommendations has been implemented so far.

In recent years, when France produced 100 units of goods and services, it consumed and invested 101 and 102 units on its territory. On the contrary, when Germany produces 100 units it only consumes and invests 92 units. The gap may seem narrow but when it occurs every year it leads to financial and social imbalances of considerable size, which today threaten to undermine Europe.”

Thomas Piketty, French Economist
in Le Monde on 9 January 2017

“[Germany] has practiced its own austerity […] and harassed the ECB as it attempts to boost overall EZ inflation. The result is that the competitive gap that opened up after 1999 has barely closed, producing both huge German surpluses and a deadly drag on the rest of the euro area.”

Paul Krugman, Nobel Prize Winner in Economics
in the New York Times on 27 May 2017
IMBALANCES

A look ahead

SCENARIO 2

Competition between countries

In this scenario, one agrees to view trade imbalances as a natural result of structural differences between countries that should be corrected through the market:

First, labour costs rise in surplus countries only when collective bargaining agreements ensure higher wages. The partners in collective-bargaining agreements are free from government influence in many countries and ensure that the export sectors remain competitive. Second, the savings rate is also determined by the demographic structure. The population saves for retirement and therefore the savings rate increases. If overseas yields are higher, these savings are invested there. Third, a drop in global commodity prices affects current-account balances – a factor that individual countries cannot influence.

In this scenario, there is only limited political need for action. A liberalisation of the service sector in the EU could help, for example, with market mechanisms to reduce surpluses. However, in general the following applies: If you are dissatisfied with your current-account balance, it is up to you to sort this out. The problem in this scenario is that it is considered to be unfair both inside and outside Germany. Here critics complain that deficit countries suffer from weak demand while wages in Germany are too low and have a negative impact on the standard of living.

SCENARIO 3

Internal revaluation

A contrary scenario would be that Germany reduces its trade imbalances and aims for a lower current-account surplus by reversing the internal devaluation. Since the state may not intervene in collective wage-bargaining agreements, it must find other options:

Possible measures include changes to the tax code such as a reduction in value-added tax, which would stimulate consumption. The minimum wage could be raised in order to increase the income of low-wage earners. The number of hours worked per week could be reduced and the retirement age lowered. An increase in state pensions would be an incentive for individuals to save less for their retirement and thereby reduce the savings rate.

All these measures might lead to an internal revaluation after years of internal devaluation. Supporters of such a strategy argue that they would achieve more social justice in Germany and also simultaneously reduce imbalances within the Eurozone. Opponents fear higher unemployment and a loss of international competitiveness.

FACT #1 Current-account balances in the EU: More surpluses than deficits

Current-account balances as a percentage of GDP

When the euro was launched in 1999, Germany and the EU as a whole had surpluses and deficits. During the last decade, the deficit consolidations in surplus countries added up to Germany and the Netherlands, the deficit countries have increased over the last ten years. The surplus countries continue to export and import at a high rate.


FACT #2 Since 2008 the euro has become cheaper for the most important trading partners of the Eurozone Index 1999 Q1=100

The chart shows the nominal effective exchange rate of the euro relative to the 19 most important trading partners of the euro area. Since 2008, the euro has depreciated by around 25 percent.


FACT #3 Germany saves a lot, but invests little

Germany’s net saving rate is below the Eurozone’s

In 2010, Germany was the only country in the euro area with a net saving rate above the average of the Eurozone countries. However, this rate has decreased since then and currently stands below the average for the Eurozone. A possible explanation for this could be a drop in surplus in recent years.


More coordination in the EU

Deficit as well as surplus countries would make adjustments under the third scenario:

Deficit countries in the EU would have to continue to enhance their competitiveness by investing in education and digitisation, for example, in order to increase productivity. Furthermore, they would have to take measures to fight unemployment. These include reforms that increase employment such as life-long learning and active labour market policies for job seekers and an expansion of day care for parents. Here one would have to clarify whether the countries are allowed to finance these measures with new debt in the initial phase without breaching the EU’s Stability and Growth Pact.

Surplus countries would have to take measures to increase domestic demand, for example by reducing taxes on lower and middle incomes. More private and public investment in physical and digital infrastructure would also be an option. As in deficit countries, labour market reforms creating more jobs could also help surplus countries: Since unemployment is already very low, such reforms could raise wages across the board.

In this scenario, a reduction of imbalances in deficit countries would not be achieved through pay cuts, but rather through higher productivity and employment. Surplus countries would not lose their competitiveness, but rather consume and invest more in their home market. For that to work, EU countries would have to improve their coordination and implement clearly defined reforms.

www.strengthentheeuro.eu

“TheauthorisResearchFellowattheJacquesDelorsInstitut–Berlin.”

“Better coordination between surplus and deficit countries in the EU would be more than a political compromise: it would mean that countries do not pursue wage reductions and jointly focus on future-oriented investments and more productivity growth instead.”

Dr. Anna von der Brüse

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In the publication series “Europa briefing”, the Bertelsmann Stiftung and the Jacques Delors Institut – Berlin cover key topics of European politics and present possible scenarios: What is the problem? What might happen next? And what can politics do now?

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