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The surplus dispute has come to Europe

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Disputes over external surpluses are familiar in international economic relations. In the 1980s Japan was frequently criticised by the US for recording large trade and current-account surpluses and in the 2000s it was China that was accused of repressing domestic demand and keeping its exchange rate at undervalued level.

The issue has now come to Europe. Last month the European Commission decided to launch an investigation within the framework of the recently created *Macroeconomic Imbalances Procedure* (MIP) to determine whether the German surplus can be deemed excessive. If it concludes that this surplus is creating severe difficulties within the EU, it will recommend opening an “excessive imbalance procedure”, ultimately opening the way to pecuniary sanctions.

It is not the first time that the German surplus issue arises in European policy discussions, but it is the first time that it gives rise to a formal investigation. The MIP was adopted in 2011 in response to the euro crisis, after it had been observed that countries like Spain and Ireland had had apparently sound budgetary positions in the run-up to their crises, but had recorded very large external deficits (to the tune of 10% of GDP for Spain and 6% for Ireland). It was thought that proper surveillance of external imbalances would help prevent future crises.

In the negotiations about the procedure, a discussion arose over the treatment of surpluses. Several member states argued that surpluses could be as detrimental to stability as deficits. They had John Maynard Keynes on their side: he famously observed that when large surpluses and deficits coexist, adjustment is “compulsory for the debtor and voluntary for the creditor” and that this asymmetry created a global deflationary bias. Germany, however, was adamant that excess borrowing can result in the debtor being unable to repay its debts, thereby creating financial instability, whereas no such danger exists with excess lending. In the end the compromise was to adopt asymmetric indicative alert thresholds: 4% of GDP for deficit countries but 6% for surplus countries.

Germany felt safe. But in 2012 its surplus reached 7 per cent of GDP, thus prompting an investigation. Europe has therefore started a debate as to whether this surplus is a problem and for whom.

German official and most German economists strongly deny the existence of a problem. They argue first that Germany’s export successes are good both for Germany and for Europe, adding that nobody would benefit from and artificial weakening of German competitiveness; second, that the German surplus is the result of a market process and not a planned policy; third, that as the EU is not a closed economy, German surpluses do not imply deficits in other EU countries.

Starting with the first argument, it is undeniable that Germany’s strong performance in world markets benefits the entire European economy. Many smaller European firms do not sell directly on world markets but supply German industry. For example French auto equipment manufacturers have successfully become high-quality providers of specialised parts to the German car industry. German cars are also partially produced in Central and Eastern Europe in countries like the Czech Republic and Slovakia. So it is obviously true that Europe’s interest is that Germany be strong and successful.

The problem with this argument, however, is that it confuses exports and the external balance. The latter being the difference between exports and imports, there is no causal relationship between a strong export performance and an external surplus. While exporting as much as it currently does, Germany could import more. It would actually have imported more, had wage settlements been more favourable to employees. Since 2000 the median real family income in Germany has stagnated. Higher wages would boost domestic demand, it would help the ECB reach its inflation target (in lieu of undershooting it as it does currently) and it would help the rebalancing between Northern Europe and Southern Europe.

The second argument is meant to suggest that Germany's case cannot be assimilated to that of China in the last decade. The exchange rate of the euro is market-determined and transactions in goods and services as well as in financial assets are freely entered into by private agents. Furthermore, it is often argued that Germany is a fast-ageing country whose households must save to prepare for future retirement. Excess saving is therefore the mere result of demographics.

This, again, is true. But some economists in Germany such as Marcel Fratzscher of the Berlin DIW Institute have observed that a problem behind the German surplus is the lack of domestic investment, especially in infrastructure. Germany, he says, has not gained much from exporting its savings. German welfare would have been better served by more investment at home, which would have also led to a lower surplus. The distortion here is that domestic infrastructure investment is kept at low level by public policies and the many obstacles that exist to infrastructure building.

Finally, it is true that German surpluses do not arithmetically imply deficits elsewhere in Europe (as it is the case within the global economy, because we are not trading with the outer planets), but they contribute to making the euro stronger. The former deficit countries like Spain, Ireland and Portugal have moved towards balance while Germany was increasing its own surplus. The result is that the euro area as a whole is now recording a surplus and that, partly as a consequence, the exchange rate has appreciated, hampering the recovery in Southern Europe. So interdependence within the euro area is not arithmetic but economic: German surpluses do not imply deficits elsewhere in Europe but they contribute to making adjustment harder for its partners. This makes the size of Germany's surplus a legitimate cause for concern for the EU as a whole.

Most probably, there won't be any formal procedure opened against Germany. The recent decision by the parties that will form the next government to introduce a minimum wage at 8.5 euros per hour – significantly above current low wages – will give a boost to labour incomes and domestic demand. It is likely to be sufficient for the European Commission to conclude that there is no case for action. But the mere fact that the discussion started and that arguments were swapped is significant: Europe continues to learn how to cope to interdependence within the monetary zone.

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