CEPS POLICY BRIEF

The Macroeconomic Imbalance Procedure and Germany:
When is a current account surplus an 'imbalance'?

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The Macroeconomic Imbalance Procedure (MIP) was designed to prevent the emergence of imbalances like the large and persistent current account deficits that occurred in Spain and Ireland. But within this mechanism, a current account surplus is also viewed as a source of concern. Indeed, last year's Alert Mechanism Report (AMR),[1] issued by the European Commission signalled an excessive current account surplus for the Netherlands and Luxembourg, while Germany just barely scraped by with a 5.9% surplus, marginally evading the 6% threshold (over a 3-year average). With the most recent report,[2] however, Germany's status has changed. Along with the Netherlands and Luxembourg, it too has now been singled out as a euro-area country with a surplus above the upper threshold.

It is clear that one single figure above an arbitrary threshold cannot possibly tell the full story, which is acknowledged by the fact that the Commission's report calls 'only' for an 'in-depth analysis'. It might be useful at this time to look at some of the key elements such an analysis would have to consider.

The analysis presented below argues that the threshold for surpluses is arbitrary and should therefore be looked at not in absolute terms, but in terms of deviations from the euro-area average. Measured in this way, the German surplus appears much less of an outlier. But at any rate, it is difficult to argue that the German surplus constitutes an imbalance that threatens the stability of the euro area.

An entirely different question, not addressed here, would be whether the German surplus constitutes a problem at the global level. This might well be the case, but the MIP was not created to solve global problems.

1. What is an 'imbalance'?

A first key point is the simple question of how to define an excessive current account imbalance.

In the context of the Regulation specifying the MIP, the Commission defines the concept of an

[1] The AMR was introduced with the European Semester, both of which are now standard parts of the EU's new Economic Governance.

[2] See the 2014 report of 13 November 2013 (http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm).

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imbalance (applied to the several indicators of the scoreboard) as follows:

> any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the economic and monetary union, or of the Union as a whole.[3]

The Regulation refers to a trend and the MIP system and its scoreboard are engineered as a preventive tool. Thus, the indicator should be forward, not backwards, looking. For Germany, the forward-looking average (2012-14) still triggers the indicator, but on a forward-looking basis, none of the deficit countries has an imbalance any longer (see the table below), as these countries are moving towards a balance or even a surplus in their current account position. Even the largest crisis-struck countries – Italy and Spain –are moving from a deficit to a surplus position, while Portugal balances its current account. For the Netherlands, the forward-looking indicator suggests that the trend is towards ever-higher current account surpluses, still justifying an early warning.

Table 1. Current account balance as % of GDP, 3-year backward (2010-12) and forward (2012-14) average

	Backward	Forward
Germany	6.6	6.9
Ireland	2.3	4.4
Greece	-9.9	-3.2
Spain	-3.2	0.9
France	-2.1	-1.8
Italy	-2.4	0.5
Cyprus	-6.7	-3.1
Netherlands	6.7	9.1
Portugal	-6.5	0.0

Source: Own calculations based on AMECO data.

The German current account surplus is expected to stabilise at a level just above the MIP threshold for 2010-12. The stark past growth rates are no longer a 'threat' to the balance of the euro area, albeit being still slightly positive. The forecasts of current account balances have been known to be considerably revised, especially in the current fragile state of the global economy. A small forecasted growth rate could turn into a rebalancing throughout the next semester.

Why then use the forecast if its results are ambiguous? The truth is that past current account data have also been continuously revised, as seen in the Fall Economic Forecast which corrected Germany's surplus from formerly 6.1% (on a 3-year average, i.e. 2010-2012) to 6.6%. This reaffirms the view that the trend is the crucial indicator.

Furthermore, the IMF predicts even a slow reduction of the German surplus over the next five years.[4] The longer-term forward-looking average one can construct until 2018 on the basis of IMF figures is 5.3 % of GDP.

For Germany the other indicators for potential external imbalances point in a different direction than the current account: the market share indicator for Germany is worse than the threshold. This would indicate that the surplus is not a result of surging exports, but rather of weakness in domestic demand.

2. When is an imbalance harmful? Negative spill-over effects

Intervention by the EU under the Excessive Imbalance Procedure (EIP) can be justified if there are external effects. This is recognised in the official regulation:

> When assessing macroeconomic imbalances, account should be taken of their severity and their potential negative economic and financial spill-over effects which aggravate the vulnerability of the Union economy and are a threat to the smooth functioning of the economic and monetary union.

[3] See Regulation (EU) No 1176/2011 of 16 November 2011 on the prevention and correction of macroeconomic imbalances.

[4] IMF, "World Economic Outlook 2013".

It states furthermore:

> The surveillance under the MIP covers both current account surpluses and deficits which, from an economic point of view, pose different types of policy challenges. In particular, unlike current account deficits, large and sustained current account surpluses do not raise the same concerns about the sustainability of external debt and financing capacities, concerns that can affect the smooth functioning of the euro area (which is a key criterion for triggering the corrective arm of the MIP).

Unfortunately, nowhere can one find a description of the (negative) spill-over effects resulting from a current account surplus. The two potential criteria for finding external effects are a) vulnerability of the Union economy and b) threat to the smooth functioning of the economic and monetary union. It is difficult to argue on either account, however, that a high surplus in one country per se constitutes a threat which must be dealt with.

The term 'smooth functioning' of the euro area must thus be interpreted widely if one wants to declare a surplus an imbalance. In reality one could well argue that a demand deficiency in Germany has a negative impact on the rest of the euro area, much of which is in a deep recession. This argument of course is valid only in a certain environment (area-wide demand shortfall or liquidity trap). By contrast the negative spill-over from sudden stops to capital inflows arise in almost any economic environment one can imagine. This leads to two issues to be addressed.

Firstly, if (demand) spill-over manifests itself in the current accounts of euro area partners, one should look at the correlation of current account balances within the euro area. There is a strong negative correlation concerning the current account balance between aggregated Germany and the Netherlands vis-à-vis the rest of the euro area until 2009 (close to -90%), thereafter turning strongly positive (2010-14). What can be derived from this observation? Possibly that, up until the crisis, the German surplus meant a deficit for the rest of euro area, but this linkage is no longer valid today, i.e. at least *ex post*. Needless to say, correlation does not mean causation. At any rate the large German surplus did not impede the adjustment in the deficit countries, although it might have made it more difficult.

Secondly, the size of the direct and indirect demand spill-over effects on the deficit countries is likely to be small, as documented in the DG ECFIN study of surplus economies.[5] Even a sizeable reduction in the German surplus would lead only to a small change in the external accounts of the peripheral euro-area countries. However, in considering the external effects of stronger (domestic) demand in Germany and the Netherlands, one should look at the potential increase in employment that could result in the rest of the euro area or at least in that part that suffers from high unemployment. But this is not likely to change the size of the spill-over effect appreciably.

Thus, if demand spill-over effects are the main reason to label the German external surplus an 'imbalance', it does not really matter whether this surplus has arisen because of higher investment incomes or because of a higher trade surplus. From a pure demand-management viewpoint, the key consideration would be that part of any increase in domestic demand in Germany would spill over into increased external demand and that about 40% of any increase in German external demand would go towards goods produced in other euro-area countries. This has considerable impact on the arbitrary threshold chosen for surpluses. It is difficult to justify a threshold for surpluses if the spill-over effect in a demand-constrained environment is the key justification of intervention, since this spill-over effect is independent of the size of surplus (as a % of GDP or otherwise).

> The upper value of the threshold is set at +6%. The upper quartile of the distribution of the three-year backward average of current account balances corresponds to +2%. To this an additional 4% margin has been added in line with the "intelligent symmetry" (??) approach to current

[5] European Commission (DG ECFIN) (2012), "Current account surpluses in the EU", *European Economy*, September (http://ec.europa.eu/economy_finance/publications/european_economy/2012/current-account-surpluses_en.htm).

> account balances. This allows tackling both current account surpluses and deficits but recognises that the urgency for policy intervention is clearly greater in the case of current account deficits. It also reflects the fact that the risk of negative spill-over effects of current account deficits is more prevalent than for current account surpluses due to sustainability considerations.[6]

No economic justification is given here for the number that was adopted. Whether or not a large surplus is in the interest of Germany is irrelevant for the issue at hand. The purpose of the EIP is not to force countries to do what is best for them, but to protect the rest of the euro area from the fall-out of national policy mistakes.

3. Imbalance within euro area? Absolute or relative indicators

As the EIP is envisaged to lessen imbalances within the EA, it is questionable to use absolute indicators to set up thresholds. If all euro-area countries have exactly the same external imbalance, the potential for disruptions that threaten the 'smooth' functioning of the EMU should be much smaller. Moreover, in this case, the recommendation to act on the external imbalance of the Union should go to the EMU authorities. If all countries have a large deficit, a sudden stop to capital inflows would affect all of them at the same time. But given that the euro exchange rate is flexible, the sudden stop would play out quite differently than a sudden stop inside the euro area.

And if most euro-area countries run external surpluses, a particularly large surplus in any one country should not be regarded necessarily as an 'imbalance'. Table 2 shows that it makes a big difference whether one looks at the indicators *per se*, or relative to the euro area.

Table 2. Current account balance as % of GDP, average 2012-14

	Absolute	Difference with EA average*
Germany	6.9	4.4
Ireland	4.4	1.9
Greece	-3.2	-5.7
Spain	0.9	-1.6
France	-1.8	-4.2
Italy	0.5	-2.0
Cyprus	-3.1	-5.6
Netherlands	9.1	6.6
Portugal	0.0	-2.5

*Difference with extra EA17 Current Account Balance as % of EA17 GDP.

Source: Authors' own calculations based on AMECO data.

For the key indicator of the MIP, namely the current account, the difference between Germany and the euro-area average remains comfortably below the threshold. One could thus argue that if one looks at the deviations from the euro-area average it would not be appropriate to consider Germany as having violated a threshold (but this would continue to be the case for the Netherlands).

However, looking at the deviations from the euro-area average would also lead to a different view of the remaining deficit countries. Greece, Cyprus and in particular France would trigger a flashing red light. The French deficit remains modest, but it is now far away from the euro area average.

The Netherlands would still exhibit a current account surplus above the threshold, although it would not be far from the upper bound. The same exercise can be performed for the other external indicators. Notably, the difference is even more striking for the export market share indicators.

It is clear that from the point of view of the outside world, the absolute surpluses/deficits matter and it is thus understandable that from the point of the view of the IMF or the US authorities, the German surplus remains a key issue. However, the purpose of the EIP is not to

[6] http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp92_en.pdf

consider the global savings/investment balance, but to signal emerging intra-euro-area imbalances. From this point of view, it is more appropriate to look at the divergences between the national external deficits/ surpluses relative to the euro-area average.

4. Conclusions

The German current account surplus will exceed the 6% threshold for some time. In this sense, the Commission is justified in launching an 'in-depth analysis'. In itself this step carries no concrete implications because the finding that Germany's surplus constitutes an 'imbalance' can only come at the end of this in-depth analysis. The Netherlands had a higher current account than Germany for some time, forcing the Commission to carry out an in-depth analysis for that country as well. For the Netherlands, the Commission did not find that its current account surplus constitutes an 'imbalance' worthy of corrective policy prescription. Given that the German surplus is lower than that of the Netherlands (and that the other indicators are of a similar order of magnitude), it is unlikely that the Commission will find that Germany's surplus constitutes an imbalance worthy of the sanction that is theoretically possible under the EIP.

The threshold for current account surpluses (6% of GDP) is at any rate entirely arbitrary. Moreover, one should not look at the surplus/deficit of any country in isolation, but relative to the euro-area average. The difference between Germany's and the euro-area's average surplus was over 6 percentage points in 2010, but this is no longer the case.

Even abstracting from these measurement issues, a finding that the German surplus needs to be sanctioned is rendered unlikely by the difficulties that arise if one wants to make the case that Germany has a 'harmful' external imbalance, whose resolution would make the euro area better off. But at the same time, it remains straightforward to make the case that, in a Keynesian perspective, stronger domestic demand in Germany (and the Netherlands) would marginally benefit the rest of the euro area mired in high unemployment.

This leads to the eternal question of what could the German authorities be asked to do to strengthen domestic demand. The Commission will find it difficult to argue that a fiscal expansion would be appropriate as this would require Germany to violate EU rules (e.g. the Fiscal Compact) and its own constitution.

Higher public investment in Germany seems appropriate given its presently low level, but it would have to be financed by taxes, thus strictly limiting the impact on demand.

It has often been argued that service-sector reform could unlock more growth in Germany. This seems very likely. But would it contribute to lowering the German surplus? The answer is very uncertain since reform of the service sector would increase supply, but it is not a certainty that it would also increase demand and boost demand more than supply. Service-sector reforms that increase productivity improve, *ceteris paribus*, competitiveness. One would have to hope that wages would increase by at least the same amount and that consumption would increase more than proportionally (than the increase in productivity). But this is not a foregone conclusion.

Service-sector reforms are recommended by the EU for deficit countries with the opposite intended effect: to improve the external balance. It is difficult to understand why the same reforms should reduce the deficit in one case and reduce the surplus in another.

The only measure that would in all likelihood have an impact on the German surplus is the introduction of a (high) minimum wage. This seems the surest way to increase demand in the short run, but this solution is not advisable in the long run; and the Commission is unlikely to recommend it for Germany.

All in all, the announcement of the Commission in the context of the excessive imbalances procedure appears to be much ado about nothing. All the Commission can and will do is to start an 'in-depth analysis'. This might trigger strong political reactions and lead to an enormous debate in the media. But nothing of substance is likely to follow.

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