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Ten Misconceptions About Current Account Imbalances in the Euro Area

In the pre-crisis period, substantial current account imbalances built up in the euro area. Despite recent progress in economic rebalancing, especially in the countries mostly affected by the euro debt crisis, a controversial debate is still raging about past causes, current interpretations and future outlooks for the current account positions of euro area countries. This article examines ten common claims often heard in the public debate and critically discusses their economic foundation.

The recent in-depth review of the German current account surplus by the European Commission has brought the discussion about current account imbalances within the euro area to the fore again.[1] After these imbalances had built up before the global financial crisis, there has been a considerable reduction in current account imbalances, particularly in the countries mostly affected by the euro debt crisis (Figure 1). However, despite this progress in rebalancing, a controversial debate is still raging about past causes, current interpretations and future outlooks for the current account positions of euro area countries. This article focuses on ten common claims often heard in the public debate and critically discusses their economic foundation.

1. The trade surplus of the euro area is problematic and will definitely lead to an appreciation of the euro

The rebalancing in southern euro area countries and the more moderate (or absent) reduction in current account surpluses (Figure 1) has led to a significant rise in the current account balance of the euro area overall up to 1.8 per cent of GDP on average in the first three quarters of 2013 (and 2.2 per cent of GDP in Q3 2013) according to Eurostat data (Figure 2).

This development is regarded as problematic by some observers, particularly because of the fear that the higher current account balance could lead to a significant appreciation of the euro.[2] In that case, the danger would arise that, in particular, the rebalancing in southern euro area countries (but also of other countries such as France) could be severely hampered as price competitiveness would be eroded.

To evaluate these proposals, two questions need to be answered:

- How problematic is a current account surplus of the euro area in the first place?
- How big is the danger of a euro appreciation?

Concerning the first question, the extent of the current account surplus of the euro area does not appear particularly problematic at and around the current level. In fact, research by the IMF and the European Commission shows that several structural factors can explain a moderate surplus of the euro area's current account – the most important of which are its demographics, the welfare level, and (in the coming years) the pace of fiscal consolidation and of the deleveraging in the private sector.[3] In addition, the euro does not appear to be significantly over- or undervalued.[4]

1 European Commission: Macroeconomic Imbalance – Germany 2014, Occasional Papers No. 174, March 2014, Brussels.

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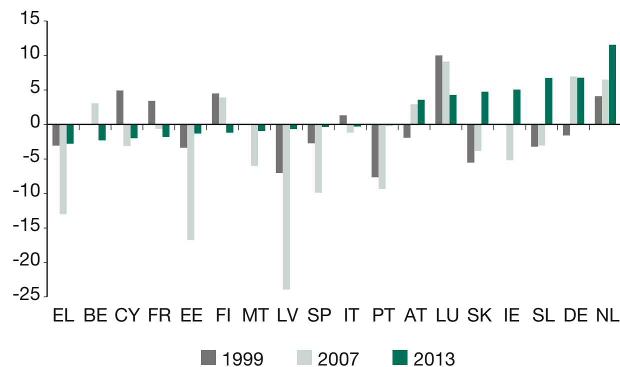
2 See, for example: O. Rehn: Was Handelsüberschüsse mit dem Euro zu tun haben, FAZ-Online, 11 November 2013, available at: http://www.faz.net/aktuell/wirtschaft/gastbeitrag-was-handelsueberschuesse-mit-dem-euro-zu-tun-haben-12657154.html, accessed 4 April 2014.

3 European Commission: Current Account Surpluses in the EU, Brussels 2012; IMF: Pilot External Sector Report, Washington DC 2012.

4 A. Hobza, S. Zeugner: Current-Account Surpluses in the Eurozone: Should they be reduced?, VoxEU, 26 April 2013, available at: http://www.voxeu.org/article/should-eurozone-current-account-surpluses-be-reduced, accessed 3 April 2014.

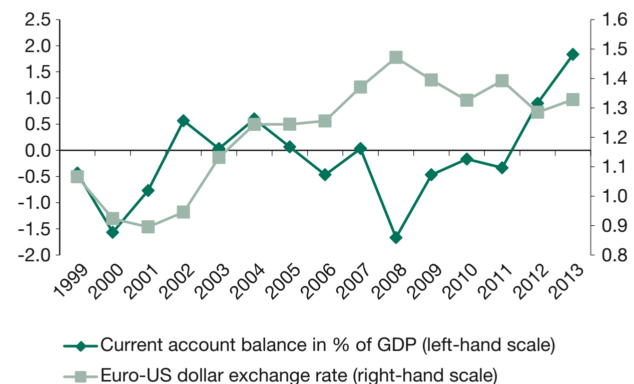
Figure 1
Current account balance of euro area countries
in % of GDP



Note: Sum of Q1 to Q3.

Sources: Eurostat; Cologne Institute for Economic Research.

Figure 2
Euro area current account balance and euro-US dollar exchange rate



Note: Sum of Q1 to Q3 for current account data.

Sources: ECB; Eurostat; Cologne Institute for Economic Research.

Regarding the second question, it is true that if the current account surplus rose substantially further, this could lead to a strengthening of the euro. Whether this will be the case or not depends on, among other issues, the development of the euro exchange rate against the US dollar, as the United States ranks among the euro area's most important trading partners and because many emerging markets particularly in Asia closely align their currencies to the US dollar.

However, the connection between the euro-dollar exchange rate and the current account surplus might not be as strong as often thought. A brief glance at Figure 2 provides a first indication of the relatively loose relationship. Moreover, current accounts are only one of the influencing factors on exchange rates. Capital flows are generally regarded to be more important determinants. They tend to be influenced by differentials between growth and interest rates between the euro area and the United States. Both factors are likely to work against an appreciation of the euro in the near future:

- The economy in the United States is forecast to pick up more strongly than that in the euro area with a GDP growth rate of 2.8 per cent in 2014 compared to 1.1 in the euro area (according to Consensus Forecasts of March 2014).

- Long-term interest rates in the USA have already risen up to around 2.8 per cent for ten-year government bonds – compared to still only about 1.6 per cent in Germany. The Fed has also recently announced that it will start raising interest rates even sooner than previously expected.

This constellation should, *ceteris paribus*, lead to higher net capital flows from the euro area to the USA – and thus more likely to a depreciation (and not an appreciation) of the euro against the US dollar. In fact, the recent above-mentioned Fed announcement seems to have reversed a slow appreciation trend of the euro.

Overall, these arguments provide some consolation for the fears mentioned above. However, exchange rate developments are difficult to predict. Moreover, should the current account surplus of the euro area rise even more or capital flows for other reasons turn more strongly towards euro area countries, a stronger appreciation of the euro cannot be ruled out.[5]

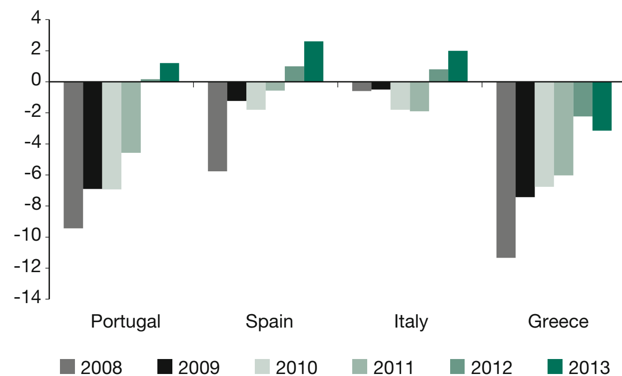
2. Rebalancing has been retarded by TARGET2 credits in a problematic way

In the context of the debate about TARGET2 imbalances, there has also been the claim that the availability of Eurosystem credits effectively worked as a rescue facility,[6] which impeded or at least significantly retarded the required improvement of current account deficits in the southern euro area periphery in a problematic way.

5 In this respect, some consolation is provided by the fact that the German current account surplus is forecast to come down from around seven per cent in 2013 to about 5.5 per cent of GDP in 2015 by the OECD and the IMF.

6 See, for example, H.W. Sinn, T. Wollmershäuser: Target Loans, Current Account Balances and Capital Flows: The ECB's Rescue Facility, in: International Tax and Public Finance, Vol. 19, No. 4, 2012, pp. 468-508.

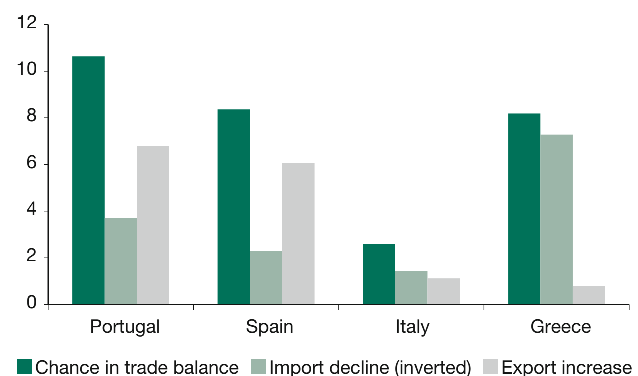
Figure 3
Rebalancing in southern euro area countries
Trade balance of goods and services in % of GDP



Note: Sum of Q1 to Q3.

Sources: Eurostat; Cologne Institute for Economic Research.

Figure 4
Contributions to rebalancing
Change in trade balance between 2008 and 2013 in percentage points of GDP



Note: Sum of Q1 to Q3.

Sources: Eurostat; Cologne Institute for Economic Research.

A closer look at the development of the trade balance in goods and services of the respective countries indicates that this claim is only half true (Figure 3). Trade balances have already turned positive in Spain, Portugal and Italy in 2013, while Greece still displays a relatively small deficit. What is more, the large adjustment required (except in the case of Italy) appears to have been achieved over a relatively short period of time.

It is true that access to the Eurosystem by national central banks (and thus by commercial banks) provided a certain buffer. But in the course of the crisis – and particularly since 2012 – this buffer has more and more been used as a substitute for capital outflows in the face of sudden stops[7] rather than to finance current account deficits. However, to decide whether the speed of adjustment was markedly slowed down in a problematic way requires a comparison to other current account adjustments and is thus an empirical question.

It is true that compared to the extremely rapid current account adjustments in the Baltic states, for example, progress in the southern euro area periphery was slower. However, in a broader comparison to very many cases of large current account adjustments, it has been clearly shown that the rebalancing in southern Europe "took place at a rapid pace" and was "much faster than the typical rate of current account rebalancing following large imbalances".[8]

7 See S. Merler, J. Pisany-Ferry: Sudden Stops in the Euro Area, Bruegel Policy Contribution, Issue 2012/06, Brussels 2012.

8 R. Auer: Rapid Current-Account Rebalancing in the Southern Eurozone, VoxEU, 7 May 2013, available at: http://www.voxeu.org/article/rapid-current-account-rebalancing-southern-eurozone, accessed 4 April 2014.

Thus, access to Eurosystem liquidity (which manifested itself in the TARGET2 deficits) provided to southern euro area countries a certain, but limited, time for the adjustment of economic structures. As a result, exports had the time to pick up and to counterbalance the decline of domestic demand to a certain extent. This approach appears justified *ex post*, because it avoided an even deeper and more severe economic crisis in most southern euro area countries (apart from Greece). This provision of time for adjustment appears to have been particularly important in Spain and Portugal as the next section indicates.

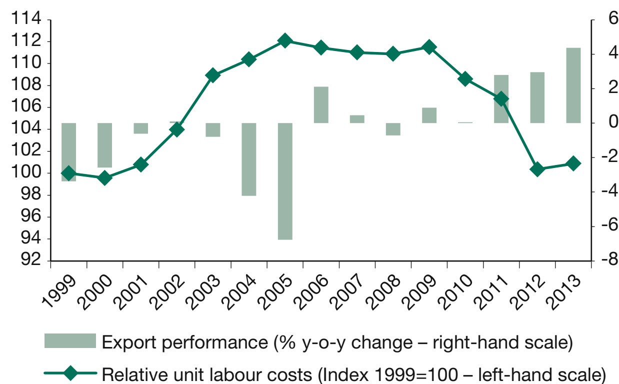
3. Rebalancing in southern Europe takes place only via imports

There are obvious arguments to counter the common belief that the rebalancing in southern Europe has mainly occurred through the contraction of imports of goods and services. Figure 4 indicates that by far the largest part of the rebalancing in Spain and Portugal was driven by export increases rather than import declines between 2008 and 2013. The Spanish and Portuguese export models were often deemed problematic, but in the light of their considerable export success, this no longer appears to be a valid assessment.

For Italy higher exports are only slightly less relevant than shrinking imports for rebalancing. However, as Figure 3 shows, Italy's current account deficit was not excessive before (and after) the crisis.

The headline of this section only applies to Greece, where between 2008 and 2013 most of the current account adjustment took place via import declines. However, since

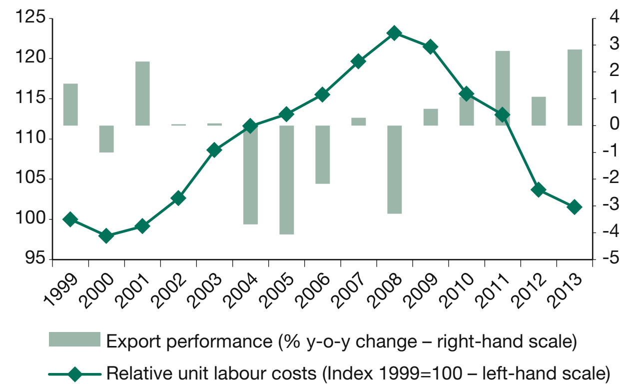
Figure 5a
Competitiveness and export performance in Portugal



Note: A rise in relative unit labour costs indicates a worsening of international cost competitiveness.

Sources: OECD; Cologne Institute for Economic Research.

Figure 5b
Competitiveness and export performance in Spain



Note: A rise in relative unit labour costs indicates a worsening of international cost competitiveness.

Sources: OECD; Cologne Institute for Economic Research.

2009, when exports and imports had declined due to the global financial and economic crisis, Greek exports of goods and services have grown by 5.8 percentage points of GDP (and imports by 1.7 percentage points of GDP). What is striking, however, is that exports did not rise but declined somewhat in 2013 compared to 2012 – a phenomenon that reveals deeper economic and institutional problems in Greece.[9]

4. Southern rebalancing requires wages to fall by 30 per cent

Many prominent experts suggested during the crisis that wages in the European south must be reduced by around 30 per cent in the course of internal devaluation. The belief is that such a large wage reduction is politically close to impossible and that therefore an unsustainable political situation will cause the euro area to break apart.[10]

However, this view can be questioned. Figure 5a shows that there was a substantial decrease in international price competitiveness in Portugal between early 2000 and 2005; afterwards, a very slow recovery is visible which accelerated from 2009 onwards. However, there were already gains in export performance (and thus export market shares) during the time when competitiveness was still very weak. A similar picture emerges for Spain: it also achieved small gains in export performance even when competitiveness was still very low and only slowly improving (Figure 5b).[11]

This finding appears to contradict textbook economic thinking: accordingly, there should not be gains in export market shares for countries with significantly deteriorated competitiveness. Instead, if competitiveness begins to improve again, export growth should slowly start to pick up, but continuous losses in export market shares would prevail, because it is commonly thought that exports would continue to grow slower than exports of competitor countries until competitiveness has sufficiently recovered. Likewise, the proponents of the 30 per cent wage-fall hypothesis seem to believe that a full recovery of competitiveness is required to put exports and current accounts on a sound footing again.

What can be inferred from the fact that this textbook view is not matched by economic reality in Portugal and Spain?

9 D. Gros, C. Alcidi, A. Belke, L. Coutinho, A. Giovannini: State-of-Play in Implementing Macroeconomic Adjustment Programmes in the Euro Area Policy Note, Directorate General for Internal Policies, Economic Governance Support Unit, European Parliament, Brussels 2014, p. 54, draw attention to the Greek export decline in 2013 and attempt to find reasons by consulting indicators of market flexibility and of the quality of public institutions.

10 See, for example: P. Krugman: Et tu, Wolfgang?, blog at NYTimes.com, The Conscience of a Liberal, v. 17.5.210, 2010, available at: http://krugman.blogs.nytimes.com/2010/05/15/ignoring-the-elephant-in-the-euro/; Goldman Sachs Economic Research: European Economics Analyst, No. 3, 17 January 2013; H.W. Sinn: Austerity, Growth and Inflation, Remarks on the Eurozone's Unresolved Competitiveness Problem, CESIFO Working Paper No. 4086, Munich, January 2013.

11 This observation becomes even more relevant when taking into account that cost competitiveness influences exports with a certain time lag.

- The relative unit labour costs – one of the most commonly used measures of competitiveness – are not always a reliable explaining factor for export success, as has been shown by a variety of studies.[12]

- Moreover, aggregate data on unit labour costs might be misleading because larger firms are usually more likely to export and at the same time more productive than other firms so that using average productivity to calculate unit labour costs could be misleading to determine export success.[13]

- Apart from this, other measures instead of unit labour costs could be used to deflate the nominal effective exchange rate (e.g. the GDP deflator, export or consumer prices). However, it is not clear which measure is the most appropriate one.[14]

Another possibility could be that cost and price competitiveness (even if measured correctly) are not as important as often thought. In fact, this seems to be the case in several southern European countries, where current account deficits appear to have been mainly driven by demand factors, particularly by a strong increase in domestic demand and thus in imports.[15] This was mainly due to a strong negative (real) interest rate shock in the course of the introduction of the euro.[16] Interest rates declined substantially around that time in southern European countries and this fostered domestic demand. In some cases such as Spain and Greece, even a dynamic and sustained economic boom and, in part, real estate bubbles materialised. The boom was reinforced by a so-called real interest rate effect which further stimulated domestic demand.

Overall, both the limited relevance of (measured) competitiveness for export success in Portugal and Spain and the strong evidence for demand-driven imbalances imply that wage declines of 30 per cent in southern Europe might not be necessary for a sustainable rebalancing.[17] This is also a strong statement about the political sustainability of the internal devaluations that are taking place in these countries. Even though unemployment is still very high in some of the southern European economies, the perspectives for the euro area appear much better than is often claimed by the above-mentioned critics.

5. Southern rebalancing is not sustainable as imports will exceed exports again in the future

Some commentators see the current rebalancing in southern Europe mainly as a business cycle phenomenon that will not last but that will be reversed soon.[18] They claim that this rebalancing is not structural and that, when economic activity picks up again, imports will once again exceed exports. This view is difficult to square with the empirical facts for most southern European countries (again possibly except Greece). On the contrary, several arguments suggest that rebalancing in southern Europe is sustainable in most countries.

Starting from a trade surplus (Figure 3) where exports exceed imports in most southern European countries already, there is hardly any reason why imports should rise faster than exports in the near and medium term. Before the crisis, this was hardly the case in Italy where the cur-

12 See for a general result ECB: Competitiveness and External Imbalances within the Euro Area, Occasional Paper Series No. 139, Frankfurt a.M. 2012; for Portugal: IMF: Article IV Consultations Portugal – Selected Issues, January 2013, Washington DC; for Italy: IMF: Article IV Consultations Italy – Selected Issues, September 2013, Washington DC; for Spain: M. Cardoso, M. Carrea-López, R. Doménech: Export Shares, Price Competitiveness and the "Spanish Paradox", VoxEU, 24 November 2012, available at: http://www.voxeu.org/article/export-shares-price-competitiveness-and-spanish-paradox, accessed 7 April 2014.

13 This has been shown for Spain by P. Antràs, R. Segura-Cayuela, D.R. Rodríguez: Firms in International Trade (with an Application to Spain), SERIEs Invited Lecture at the XXXV Symposium of the Spanish Economic Society, 2010, and more generally by C. Altomonte, T. Aquilante, G.I.P. Ottaviano: The Trigger of Competitiveness – The EFIGE Cross Country Report, Bruegel Blueprint Series, Vol. XVII, Brussels 2012.

14 See for example T. Bayoumi, R. Harmsen, J. Turunen: Euro Area Export Performance and Competitiveness, IMF Working Paper No. WP/11/140, Washington DC 2011; J. Matthes: Zunehmende Ungleichgewichte im Euroraum: Gefahr für die Europäische Währungsunion, Zehn Jahre Euro, IW-Analysen, Nr. 43, Cologne 2008.

15 J.L. Diaz Sanchez, A. Varoudakis: Growth and Competitiveness as Factors of Eurozone External Imbalances: Evidence and Policy Implications, World Bank Policy Research Working Paper No. 6732, Washington DC, 2013, infer from a thorough panel VAR model (where all macro variables are endogenous) that real exchange rate developments were much less important than the real interest rate and real GDP growth for explaining the current account imbalances of the southern periphery of the euro area.

16 For an overview see R. Kuenzel, E. Ruscher: The Future of EMU, European Commission, ECFIN Economic Brief, No. 22, Brussels, 2013, who summarise a series of Economic Papers that were commissioned by the EU Commission from distinguished scholars; see also for example J. Matthes: Ten Years EMU: Reality Test for the OCA Endogeneity Hypothesis, Economic Divergences and Future Challenges, in: Intereconomics, Vol. 44, No. 2, 2009, pp. 114-128.

17 Similar views are expressed by IMF: Article IV Consultations Portugal – Selected Issues, January 2013, Washington DC, for Portugal, and more generally by G. Corsetti, P. Martin, P. Pesenti: Varieties and the Transfer Problem, in: Journal of International Economics, Vol. 89, No. 1, 2013, pp. 1-12.

18 See, for example H.W. Sinn: Europa verdrängt die Krise, Zeit Online, 20 January 2014, available at: https://www.cesifo-group.de/de/ifoHome/policy/Staff-Comments-in-the-Media/Press-articles-by-staff/Archive/Eigene-Artikel-2014/medienecho_ifostimme-zeit-online-20-01-2014.html, accessed 5 April 2014.

rent account deficit was not excessive as pointed out earlier.

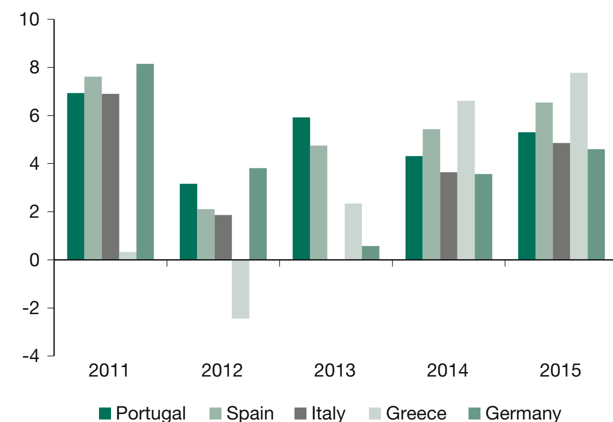
The opposite was true for Portugal and Spain with high current account deficits before the crisis. But here, export growth has been particularly strong recently (Figure 6): between 2011 and 2013, real exports of goods and services grew by 5.3 per cent in Portugal and by 4.8 per cent in Spain on average per year – which is considerably higher than in Germany with 4.1 per cent. The OECD, for example, forecasts that real exports will rise at roughly the same speed in Spain and Portugal this year and next. On the other side, import growth in both countries is likely to remain subdued as domestic demand will be burdened in the near future by private sector deleveraging. Therefore, there is hardly a reason to believe that in the coming years imports should grow faster than exports. On the contrary, the OECD forecasts for 2014 and 2015 that export growth will continue to exceed import growth in real terms so that the current account surpluses will rise further.

This is also true for Greece: Greek real exports are forecast by the OECD to grow by more than seven per cent on average this year and next so that the current account would also turn clearly positive in 2014 and rise further in 2015. As the past has shown, however, forecasts for Greece have to be treated with caution.

On a more general note, empirical evidence suggests that rebalancing in southern Europe is not cyclical but mainly structural and thus sustainable. The ECB compares estimations of different studies and clearly highlights the predominant relevance of structural factors in rebalancing.[19] The studies decompose the adjustments underway in the southern European economies into business cycle and structural components. Accordingly, by far most of the rebalancing between 2008 and 2012 was structural in Portugal and Spain. Even in Greece, about half of the current account improvement is attributed to structural factors in this period.

Two important facts can explain this finding: first, it was mainly the deep recessions in the south that have largely corrected the excessive demand boom which led to these imbalances.[20] Second, particularly in Portugal and Spain, resource reallocation towards the export sector has already been affected to a considerable degree.

Figure 6
Growth of real exports
Change versus previous year in %



Note: OECD estimates for 2013 and forecasts for 2014 and 2015.

Sources: OECD; Cologne Institute for Economic Research.

6. Germany's current account surplus hampered southern rebalancing

In the autumn of 2013, Germany was publicly criticised by the USA for damaging the recovery of southern EMU countries with its current account surplus.[21] With regard to recent years this statement is simply incorrect.

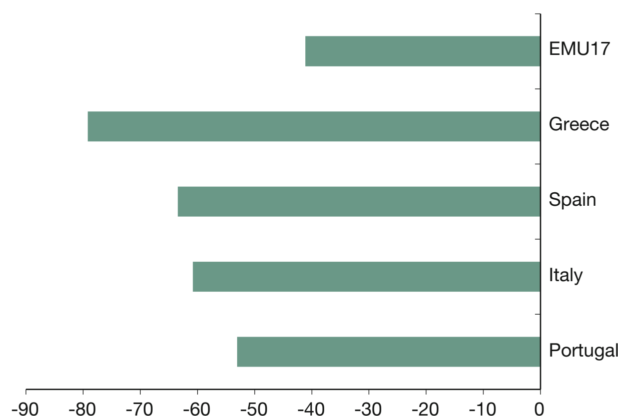
It is true that, before 2008, Germany's current account surplus rose mainly vis-à-vis its euro partner countries. But since the onset of the crisis, this surplus has substantially declined (see Figure 7).[22] There has been a significant reduction of the German bilateral current account surplus: by more than 40 per cent vis-à-vis the euro area countries overall, by nearly 80 per cent vis-à-vis Greece and by more than 60 per cent against Spain and Italy.

As the change in and not the level of trade balances influences economic growth, this means that southern EMU countries have been helped rather than been damaged by the development of the German trade and current account surplus. In fact, German imports of goods and services have risen considerably between 2008 and 2013 – from Spain by around 14 per cent and from Portugal by nearly 19 per cent.[23]

19 ECB: Monthly Report, January 2014, Frankfurt a.M., p. 54.
20 See, for example: IMF, World Economic Outlook, April 2013, Washington DC, p. 39; ECB: Monthly Report, January 2013, Frankfurt a.M., pp. 83-84; also more generally: P.R. Lane, G.M. Milesi-Ferreti: External Adjustment and the Global Crisis, in: Journal of International Economics, Vol. 88, No. 2, 2012, pp. 252-265.

21 US Department of Treasury: Report to Congress on International Economic and Exchange Rate Policies, 30 October 2013, Washington DC.
22 The overall German current account surplus has risen in this timeframe, because the surplus against the rest of the world has increased.
23 However, due to only moderate trade shares of southern European countries with Germany, higher German imports have a relatively limited impact on these economies (see below).

Figure 7
Change in German current account balance vis-à-vis selected EU countries, 2008-2013
in %



Sources: Deutsche Bundesbank; Cologne Institute for Economic Research.

7. Capital flows from Germany and the north were responsible for the woes of the south

Sometimes the argument is made that Germany and the European north were responsible for the former rise in imbalances. Indeed, the notion that strong capital inflows from the north enabled the credit booms in the south is valid at first sight. Particularly, the banking systems in Germany and France intermediated capital flows – also from non-EU countries towards the south.[24] The idea that capital flows are responsible for current account balances (and not vice versa) relates back to Böhm-Bawerk.[25]

On this basis, it has also been suggested that current account deficits (induced by capital inflows) have caused competitiveness declines and not vice versa.[26] Theoretically, a so-called transfer effect is deemed responsible by the authors for this seemingly causal relationship. This effect implies that capital inflows increase demand in an economy and thus tend to lead to a rise in the relative price of non-traded to traded goods which is regarded as a real exchange rate.

However, when looking closer, it is not straightforward to lay the blame for imbalances largely on the north. First, a creditor is generally unable to force a debtor to accept a credit. Second, according to neoclassical economic theory, capital should flow from richer to poorer countries and would thus help – rather than damage – the recipient countries.

Whether this will be the case – and whether resulting current account deficits will be intertemporarily sustainable – depends very much on how capital inflows are used. If they are mainly invested to create new productive (and export) capacities, then the debt incurred today can be repaid tomorrow. Moreover, with inflows largely invested, the competitiveness loss induced by excess demand (which could result from capital inflows) would only be temporary, as in the medium term new supply capacities would arise.

However, in southern Europe, a large portion of the inflows was not channelled to productive uses and went into consumption and real estate investment instead.[27] This booming demand contributed to excessively rising wages in the south, which in turn led to an erosion of competitiveness. Moreover, declines in public interest expenditures were used to increase public consumption and social expenditures.

Governments in the south should have put a halt on the growth of public consumption spending and should have exerted their influence to limit excessive wage increases determined in the private sector. However, policy mistakes were made on both sides as far as financial supervision is concerned. Financial regulators in the north, and particularly in France and Germany, should have had a closer eye on capital flows to the south. And financial supervisors in the southern member states should have tried to limit the resulting credit boom. For example, they could have placed stricter limits on real estate credit expansion.

24 European Commission: Current Account Surpluses ..., op. cit.
25 E. Böhm-Bawerk: Unsere passive Handelsbilanz, in F.X. Weiß (ed.): Gesammelte Schriften von Böhm-Bawerk, Vol. I, Vienna and Leipzig, 1924. A more current analysis showing that financial shocks and resulting capital flows can generate current account imbalances (between the US and Asia) is provided by R. Caballero, E. Farhi, P.-O. Gourinchas: An Equilibrium Model of "Global Imbalances" and Low Interest Rates, in: American Economic Review, Vol. 98, No. 1, 2008, pp. 358-393.
26 H. Gabrisch, K. Staehr: The Euro Plus Pact – Cost Competitiveness and External Capital Flows in the EU Countries, ECB Working Paper No. 1650, March 2014, Frankfurt a.M., conduct Granger causality tests with panel data. However, the authors only employ data on current account changes and the growth of unit labour costs (or the change of real effective exchange rates) and neglect other factors influencing current accounts. It appears questionable whether this approach suffices, as the interaction between current account balances and cost or price competitiveness is rather complex and involves other factors such as, for example, growth and real interest rates.
27 B. Busch, M. Grömling, J. Matthes: Current Account Deficits in Greece, Portugal and Spain – Origins and Consequences, in: Intereconomics, Vol. 46, No. 6, 2011, pp. 354-360.

8. German wage moderation and labour market reforms were a beggar-my-neighbour policy

Concerning the German current account surplus, it has sometimes been maintained that Germany followed a beggar-my-neighbour policy about ten years ago with continued wage moderation during a longer period.[28] However, this view appears to be too simplified.

In fact, the labour market reforms and wage moderation that took place in Germany about a decade ago do not appear to have been targeted directly towards improving international competitiveness. Instead, domestic reasons dominated, particularly when the Agenda 2010 was announced in 2003, at a time when unemployment had climbed ever higher and the German economy had been in stagnation for a prolonged period. At that time of crisis, reforms appeared indispensable. It is true that particularly the resulting wage moderation contributed to weak domestic and import demand, but this was mainly a side effect during the reform phase.[29] Improving price competitiveness by wage moderation was not the main aim of the reforms, but to reduce the relative price of labour compared to capital and to thus foster job creation.

The reforms contributed substantially to reducing unemployment in Germany and improved the function of the labour market. As a result, domestic demand and also private consumption have picked up in recent years. Both demand aggregates have profited from strong employment performance and solid wage growth – particularly in important parts of the service sector. As a result, surveys find the willingness to consume to currently be exceptionally high.[30] Untypically, employment continued to grow moderately in 2013 despite a very weak economy – again indicating the positive reform effect. Overall, the German economy grew by only 0.4 per cent in 2013, being driven solely by domestic demand – with real net exports being a drag on growth. The strength of domestic demand is forecast to continue, and business investment should also pick up over 2014. This development should contribute to a decrease in Germany's current account surplus.

All in all, it does not appear appropriate to reproach Germany for having taken the reforms necessary to revitalise its economy and to call this strategy a "beggar-my-neighbour policy". In fact, there is considerable evidence to the contrary, i.e. that other euro partner countries benefit from the export success of the German economy on the world market. Research conducted by the Cologne Institute for Economic Research has shown that a ten per cent rise in German goods exports goes hand in hand with a nine per cent rise of intermediate goods exports of EU partner countries to Germany.[31]

However, the import potential of the German economy does not appear to be fully exploited. Instead, the German trade surplus is largely due to an import deficit which is closely connected to weak private and public investment.[32] Increased imports (and less net capital exports) would benefit the German economy because it would thus be able to make more of its exports.[33]

9. Germany should support rebalancing in the south by raising wages and domestic demand

In the public debate, Germany is sometimes requested to deliberately raise its wages in excess of productivity growth in order to support the rebalancing in southern Europe. However, this approach is neither recommendable nor does it promise to achieve its aim in a meaningful way.

First, wage policy lies mainly in the hands of trade unions and employers; the government can only influence public wages (which have risen considerably recently and will continue to do so). Second, raising wages beyond productivity growth would deliberately worsen export price competitiveness. However, Germany's current account surplus is not problematic due to its export success, but due to its import deficit.

So the question arises whether large German wage increases would improve domestic demand and thus import demand from southern European for a sustained period. Several recent empirical studies have cast doubt on this

28 See, for example: M. Wolf: Europe's beggar-my-neighbour policy, ft.com blog, 9 May 2013, available at: http://blogs.ft.com/martin-wolf-exchange/2013/05/09/europes-beggar-my-neighbour-policy/, accessed 5 April 2014.

29 This is also pointed out by the recent in-depth analysis of the German current account surplus by the European Commission: Macroeconomic Imbalance – Germany 2014 . . . , op. cit.

30 GFK: German Consumer Climate takes a Breather, Press release, 26 March 2014, available at: http://www.gfk.com/news-and-events/press-room/press-releases/pages/german-consumer-climate-takes-a-breather.aspx, accessed 3 April 2014.

31 G. Kolev, J. Matthes: Die wirtschaftlichen Verflechtungen zwischen Deutschland und der EU, Die Zukunft der Industrie in Deutschland und Europa, IW-Analysen, No. 88, Cologne 2013.

32 S. Bach, G. Baldi, K. Bernoth, B. Bremer, B. Farkas, F. Fichtner, M. Fratzcher, M. Gornig: More Growth through Higher Investment, in: DIW Economic Bulletin, No. 8, Berlin 2013, pp. 5-16; European Commission: Macroeconomic Imbalance – Germany 2014 . . . , op. cit., pp. 40-53, 60-65.

33 See also European Commission: Macroeconomic Imbalance – Germany 2014 . . . , op. cit.

relationship by using the NiGEM model.[34] The model shows that wage increases in Germany that exceed productivity growth would even be counterproductive in the medium term from the southern European countries' points of view. According to the NiGEM model, small short-lived increases in German private consumption would be counterbalanced by declines in investment, employment and GDP in the medium term. Eventually, even negative spillovers to euro partner countries would result and Germany's current account surplus would rise. Whether the NiGEM model reliably describes reality might be open to discussion. But a negative employment effect of excessive wage increases appears rather probable. This should not be neglected in the discussion due to the high relevance of employment for private consumption and domestic demand.[35]

Moreover, even if there were positive demand effects to the benefit of German trading partners, other European countries with high trade surpluses would profit more than southern euro partner countries.[36] In fact, southern peripheral countries account only for about 8.7 per cent of German imports of goods and services. On the other hand, the Netherlands alone (with a current account surplus of ten per cent of GDP currently) supplies more imports to Germany, accounting for 8.9 percent of the total. Other European countries with large current account surpluses – Switzerland, Norway and Sweden – together account for another nine per cent of German imports.

From the perspective of southern European countries, it is true that Germany is one of the most important trading partners. However, trade connections to Germany are not very relevant for their respective total economy – amounting to between around two and four per cent of GDP.[37] Thus, a significant increase of German real imports by, for example, ten per cent (which would be about double the currently forecast growth rate) would contribute only between 0.2 and 0.4 percentage points to GDP growth in southern European countries [38] – a non-negligible, but still not outstanding contribution.

10. The German "model" should be imitated by southern euro area countries

Germany is sometimes said to intend to export its trade surplus "model" to other countries. This would indeed be a problematic approach, as not all countries can have trade surpluses. However, this approach would misinterpret what the German "model" is about.

The German current account surplus is not the model to be emulated. This is all the more true as it is mainly the outcome of market forces and of long established economic and institutional structures, and not of deliberate policy action or of strategic economic planning.[39] What can rather serve as advertisements to a certain degree are, first, some special features of the German economic model and, second, the German structural reforms that fostered broad based economic competitiveness.

Regarding the first aspect, among the commendable special features are the constructive industrial relations, the long-established apprenticeship system, and a strong *Mittelstand* with a considerable number of hidden champions, i.e. SMEs specialised in niche products where they are among the world market leaders. However, due to path dependencies and institutional interdependencies, these features are not easily introduced in other countries. Moreover, simply copying them does not seem appropriate; rather an adaptation to country-specific circumstances is required.

Second, significant structural reforms have enhanced Germany's competitiveness. But improving price competitiveness was not the main objective, as mentioned above. Rather, enhancing competitiveness in a broad sense is what counts, i.e. improving economic framework conditions for growth and employment.

34 Deutsche Bundesbank: Monthly Report, March 2013, pp. 19-21 models a one-off wage increase exceeding productivity growth by 2 percentage points. BMF – German Ministry of Finance: Lohnpolitiik – geeignet zur Korrektur von Leistungsbilanzungleichgewichten im Euroraum?, in: BMF Monatsbericht, December, Berlin 2014, pp. 37-44, assumes rising wages that exceed productivity growth by one percentage point over five years.

35 Moreover, if large increases in wages reduce equipment investment as predicted by the NiGEM model, then negative effects on trading partners seem relatively plausible. This is due to the fact that the (direct and indirect) import share of private consumption by private households is much smaller (19 per cent) than that of equipment investment (44 per cent). This has been shown by R. Döhrn: Außenhandelsüberschüsse in einer Wirtschafts- und Währungsunion sind anders zu bewerten, ökonomenstimme.de, 4 February 2014, available at: http://www.oekonomenstimme.org/artikel/2014/02/aussenhandelsueberschuesse-in-einer-wirtschafts--und-waehrungsunion-sind-anders-zu-bewerten/, accessed 3 April 2014.

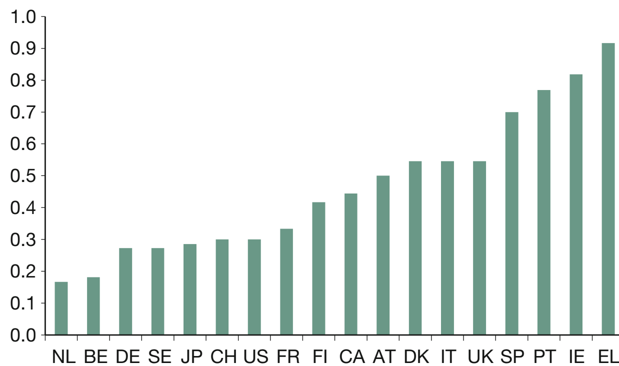
36 See D. Gros: Germany as Scapegoat, CEPS Commentary, 10 December 2013, Brussels; J.M. Irigoyen, J. Monteagudo: Multiregional Trade Spillovers of Economic Activity in EU Countries, mimeo, DG ECFIN, 2013.

37 European Commission: Macroeconomic Imbalance – Germany 2014 . . . , op. cit., p. 65.

38 For a similar calculation see B. Busch, M. Grömling, J. Matthes: Ungleichgewichte in der Eurozone, IW-Analysen, No. 74, Cologne 2011, pp. 19-21.

39 Among long-established economic structures the specialisation in investment good production is particularly relevant as it has been generally shown to be contributing structurally to the current account surpluses, see M. Grömling: A Supply-Side Explanation for Current Account Imbalances, in: Intereconomics, Vol. 49, No. 1, 2014, pp. 30-35.

Figure 8
Reform intensity in euro periphery countries
Responsiveness rate 2011-2012[1]



[1] Responsiveness rate displays the relation between reform efforts and reform recommendations: The indicator takes a value of one if "significant" reforms were taken in all policy areas in which the OECD had previously set reform recommendations, a value of 0.5 if "significant" reforms were taken in half of the recommended policy areas and a value of zero if no reforms were taken in any policy area with recommendations.

Source: OECD.

Thus, the German experience can serve as a promising example particularly to southern European countries signalling that implementing reforms, if they are done thoroughly, will be beneficial. However, it is not only the German case that highlights the promising effects of structural reforms: there are a variety of other examples. In fact, many industrialised countries were forced to implement structural reforms in times of crises and benefited from more growth and employment after a few years: starting with the USA, the UK and the Netherlands in the early 1980s and continuing with several Nordic countries in the 1990s. Moreover, there is ample academic evidence that structural reforms of labour and product markets have a high payoff in terms of productivity, growth and employment.[40]

The reforms that have been taken to date in southern Europe are quite significant, as Figure 8 indicates. Many of these reforms were not thought possible before the crisis. Judging by the experience of the German (and other) model cases, this reform effort will also pay off in the medium term.

40 J. Varga, W. Roeger, J. in 't Veld: Growth Effects of Structural Reforms in Southern Europe: The Case of Greece, Italy, Spain and Portugal, European Commission, Economic Papers No. 511, Brussels 2014; G. Nicoletti, S. Scarpetta: Regulation, Productivity and Growth: OECD Evidence, OECD Economics Department Working Papers No. 347, Paris 2003; S. Djankov, C. McLeish, R.M. Ramalho: Regulation and Growth, in: Economics Letters, Vol. 92, No. 2, 2006, pp. 395-401.