



Germany

Only modest decline in the current account surplus

September 6, 2010

The German economy is currently benefiting from extremely dynamic world trade. In Q2 real goods exports rose by more than 20% and Germany's macroeconomic growth hit a new record of 2.2% compared with the pre-year quarter.

German export momentum is, however, likely to ease significantly in H2 2010 and above all in 2011, as the international inventory cycle as well as the catch-up effects from investments postponed in 2009 will slowly tail off and also the underlying cyclical performance in major client countries will probably recede.

In addition to the impact of this cyclical development the highly export-dependent German economy is also being hit by the adjustments in Europe's crisis-ridden countries. The correction of the excesses in the real estate markets and the partially drastic consolidation programmes will severely dampen the import demand of these countries over the longer term.

The strain on the German current account is, however, likely to remain within bounds, as the importance of the problem countries for the German economy is relatively low, other major markets are stable, and any adverse effects may be offset by demand from emerging markets, especially in Asia.

Nevertheless, in the medium term Germany's large current account surplus needs to be reduced, as the origins of the crisis lay in undesirable structural developments on both sides, that is not only in current account deficits, but also in the reciprocal surpluses. All in all, we expect that the German current account surplus will first widen from 5.0% to 5 ½% of GDP this year, before narrowing slowly, however. In 2012 it could then stand at 4 ½%.

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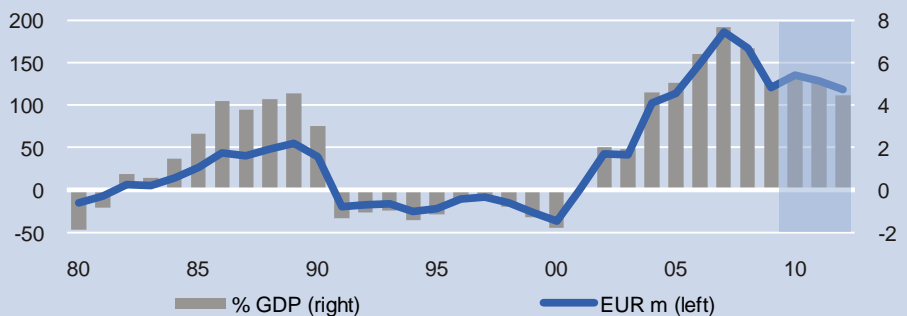
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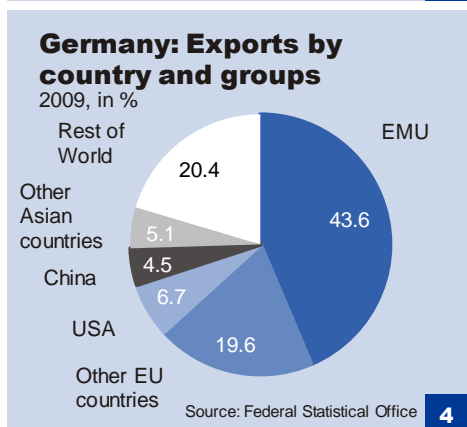
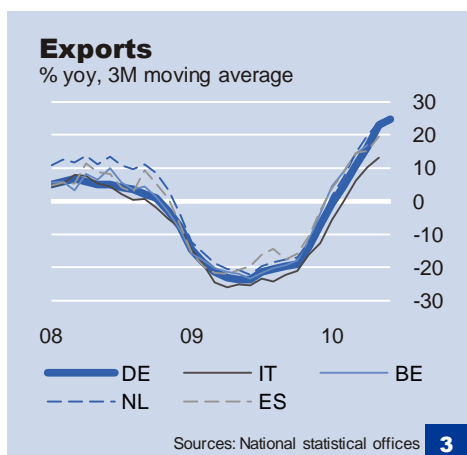
Thomas Mayer

Germany: Balance on current account

EUR m (left), % GDP (right)



Source: Federal Statistical Office



The financial crisis and the subsequent deep global recession have laid bare the vulnerability of German's heavily export-dependent economy and intensified the debate about the necessity of structural adjustments. In Germany real economic output fell by nearly 5% last year, especially on account of the drastic slump in exports as well as highly export-dependent capital investment. The decline in economic activity, the deepest that Germany has suffered during the postwar period, was nearly twice as large as in the US and the only significantly worse performers within the eurozone were the relatively small nations of Finland and Ireland.

It's all about the country and goods mix

The degree of openness of the German economy was undoubtedly a major factor in the sharp decline. In 2009 the share of German goods exports in GDP came to more than 33%, a figure exceeded by only two other major euro-area countries, namely Belgium (79%) and the Netherlands (63%). It comes as a surprise that although nominal exports slumped by virtually the same amounts across the eurozone, the declines in real GDP in these countries were much lower than in Germany – despite their high export shares. This had a great deal to do with the goods structure and its price elasticity.

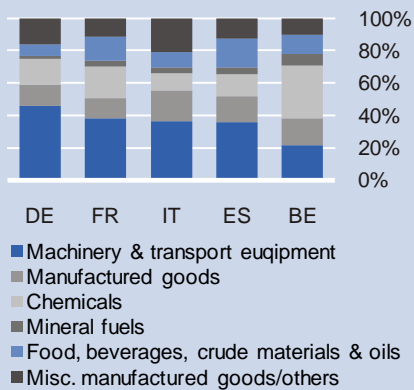
The demand for durable industrial goods, for instance, can be postponed quite easily. Accordingly, sales of such goods slumped particularly dramatically during the crisis. While total German exports contracted by nearly 18 ½% in 2009, exports of machinery and transport equipment fell by 25%. Machinery and transport equipment, however, account for almost half of German exports, whereas the corresponding shares for Belgium and the Netherlands are just roughly 22% and 27% respectively. Compared with Germany, however, these countries boast food shares that are nearly twice as high, at about 10% and 12% respectively. The Netherlands also has the highest export share of mineral fuels in the EU at over 12% (Germany: 2%). Furthermore, the goods mix has a strong influence on the reaction of export prices to changes in demand. The demand elasticity of food and consumer goods prices is much stronger than that of capital goods prices. In addition, the prices of crude oil and gas fell by about one-third in 2009. Accordingly, the slump in demand led to a decline of over 2 ½% in the export prices of consumer goods in Germany, whereas export prices for German capital goods actually rose by 1% during the crisis. Overall, German export prices fell just 2%, whereas Dutch export prices dropped more than 8%. This means that despite roughly similar declines in nominal exports, the drop in real exports, which are relevant for GDP growth, was much sharper in Germany's case.

But just as Germany was among the major industrial nations hit hardest by the global recession the German economy is now benefiting disproportionately more from the pick-up in the global economy and global trade. Germany has precisely the range of products for which demand is particularly strong in the once again fast-growing emerging markets and purchases of which were postponed in many cases in 2009. New orders, especially those from abroad, have risen nearly 40% from their low in spring 2009 and exports are some 30% higher year on year. In addition, the smaller rise in export prices in Germany compared to other European countries ensures that, while the two countries' nominal increases in exports are roughly the same, Germany's export-driven growth impulses are stronger than in the Netherlands. Nominal



Exports by main categories

SITC sections, 2009, in %



Source: OECD

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Goods exports

National accounts, 2009, % yoy

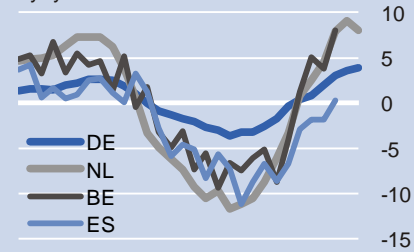
	Germany	Netherlands
Nominal	-18.6	-16.4
Prices	-2.4	-8.3
Real	-16.5	-8.9

Sources: CBS, Federal Statistical Office

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Export prices

% yoy

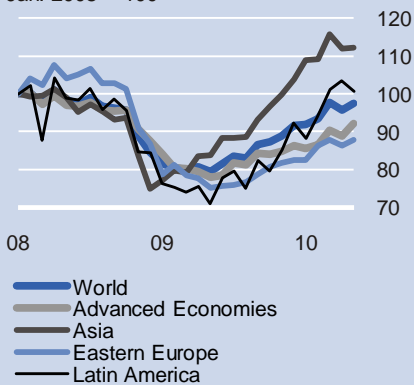


Sources: CBS, Federal Statistical Office

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World imports

Jan. 2008 = 100



Source: CPB

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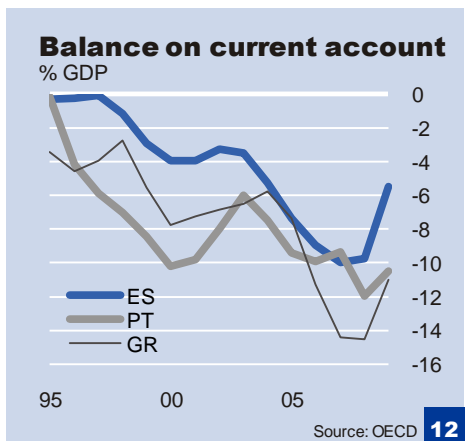
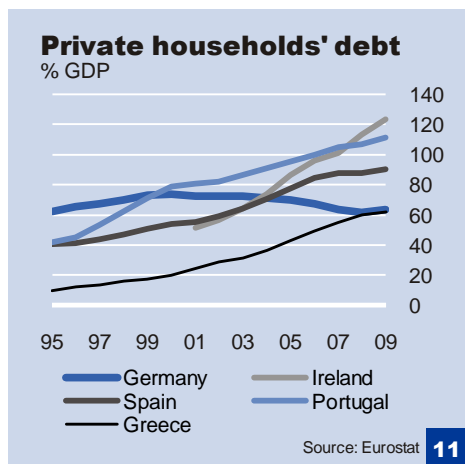
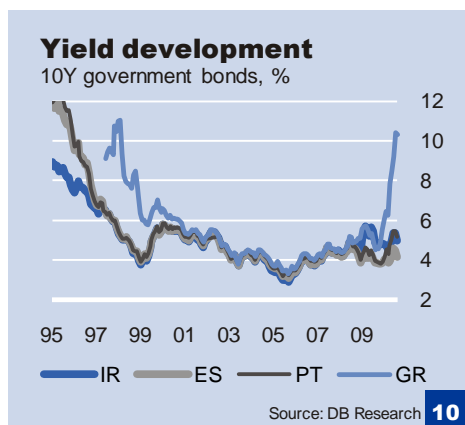
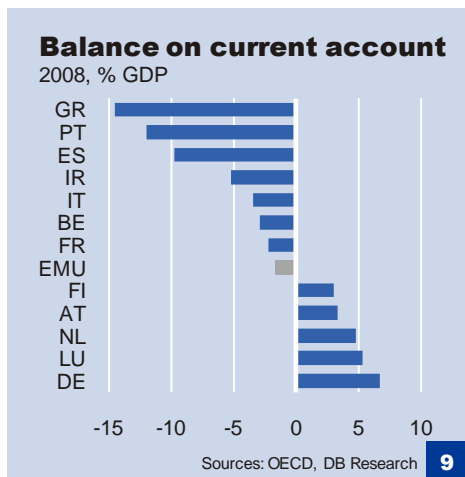
goods exports increased by around 24 ½% in both countries in Q2. While Dutch export prices climbed 8 ½%, however, in Germany they rose only 3 ½%. Accordingly, Dutch exports rose by only around 15% in real terms, while the corresponding statistic for Germany was an impressive 20 ½%. All in all, the full year 2010 is likely to see real exports of goods and services increase by 12% and real GDP grow by about 3 ½%. This would make Germany the fastest-growing nation in the eurozone as well as among the G7.

Improvements mainly cyclical in nature at present

Does this mean the crisis is over and we are back to “business as usual”? Probably not, for the currently positive development is primarily cyclical in nature and predominantly due to the buoyant import demand of Asian emerging markets, which is already a good 10% higher than its pre-crisis level. By contrast, the structural adjustments that the crises have made necessary in many European countries pose major challenges for the Germany economy in the medium term. After all, the origins of the crisis lay in misguided structural developments and the resulting imbalances. These include not only the high current account deficits but also the corresponding current account surpluses. The current account position of the eurozone since the launch of the euro has been roughly in balance on average and only showed a meaningful deficit in 2008 at 1.7% of GDP. There were nevertheless considerable differences within the eurozone. In 2008 the spectrum of current account positions ranged from deficits of over 14 ½% of GDP in Greece, 12% in Portugal and nearly 10% in Spain to a surplus of 6 ¾% of GDP in Germany. Differing current account developments do also have cyclical components, but they primarily reflect the structural differences and/or special characteristics of the countries concerned, such as the real estate boom in the case of Spain.

Causes of the crisis: Undesirable structural developments and inattentive financial markets

In many euro-area countries low interest rates as a consequence of convergence prior to the launch of the euro and the rate cuts by the ECB between 2001 and 2003 as well as an often loose fiscal policy led to a sharply rising demand for credit from the private and public sectors with corresponding effects on real estate demand and house prices. Private consumption was further stimulated by wealth effects, which promoted economic growth and import demand and led to large current account deficits. Prominent examples of this are the US and the eurozone members Ireland and Spain. In Spain private-sector debt rose from about 50% of GDP in 2000 to around 90% by the end of 2008. Over the same period house prices climbed by 145%, private consumption expanded by an average of 3 ½% p.a. – just like real GDP – and the current account deficit, which had been just under 3% of GDP in 1999, widened to roughly 10% of GDP. One contributory factor was the worsening of price competitiveness. In Spain unit wage costs in the manufacturing sector rose by 25% between 2000 and 2008, whereas in Germany they fell by more than 10%. Accordingly, Spanish exports posted below-average growth relative to global trade and German exports during this period. There were also similar developments in Portugal, Greece and Ireland. Financial markets ignored these imbalances so that credit spreads of the countries’ government bonds remained very low.



In Germany, by contrast, monetary union did not generate any monetary stimulus or accordingly any excessive demand for credit. Unlike in many other European countries household debt in Germany actually fell from 73% to 63% of GDP. Accordingly, the real estate market posted extremely subdued performance and wage restraint boosted price competitiveness, which sent Germany's current account surplus surging to a record high of nearly EUR 190 bn or 7.7% of GDP in 2007.

Adjustments in full swing in the deficit countries ...

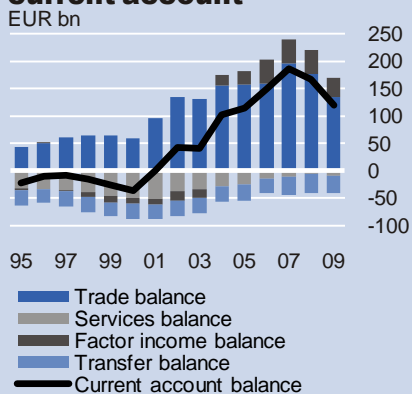
With the bursting of the real estate bubble, the shakeout in the residential market and the planned – or in many eurozone countries already implemented – consolidation measures, especially in the problem countries of Greece, Portugal, Spain and Ireland, the adjustments to European current account balances are in full swing. Last year the Spanish current account deficit, for example, already fell by 4.2% of GDP and the Greek deficit narrowed by 3.6%. Virtually unnoticed by the markets, the US current account, which used to be seen as the sword of Damocles hanging over the global economy, narrowed by a further 2 percentage points last year to just 2.7% of GDP, having still amounted to 6% in 2006. Given the consolidation efforts it is to be expected that the current account deficits in the European problem countries will continue to shrink. Does this mean that the German surplus will decline sharply, tempering growth as a result? Probably only to a certain degree.

... but still limited strain on German exporters

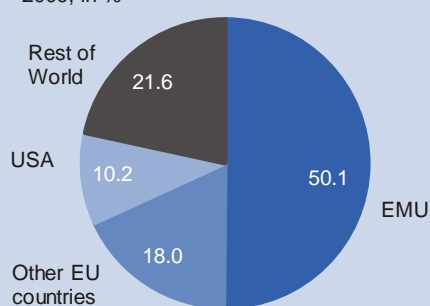
Regardless of this external pressure, a more robust domestic economy would lead to more balanced overall growth and thus reduce the degree of vulnerability to external shocks. From 2000 to 2008, net exports generated nearly two-thirds of the average annual GDP growth of 1.5%. In some years, such as 1994 and 1995, economic growth was in fact solely attributable to net exports. During the years after Germany's reunification up to 1999, by contrast, growth was driven virtually exclusively by the domestic economy. In view of the shrinking current account deficits of the eurozone's problem countries the adjustment pressure on the German economy has, however, remained within narrow limits so far. The problem countries, i.e. the countries with very exacting consolidation requirements and sizeable current account deficits, play a relatively minor role for the German export sector. Moreover, it looks as if other non-European countries (Asia/China in particular) may (partly) compensate for any shortfalls, and the adjustments in Germany's major European export markets (such as France, Austria, Switzerland and the UK) will probably turn out to be very moderate.

Germany's current account surplus is shrinking only slowly

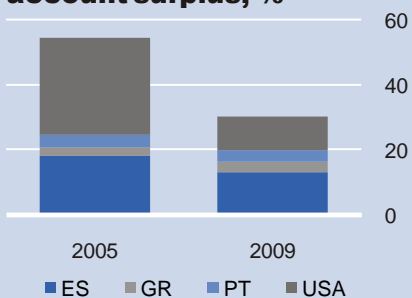
Considering its performance so far in 2010, Germany's current account surplus is likely to continue climbing towards EUR 130 bn, or 5 ¼% of GDP, before possibly narrowing in 2012 to 4 ½% of GDP. All in all, the resultant adjustment pressure on the German economy as a whole will probably remain within narrow limits for the time being.

Germany: Contributions to current account

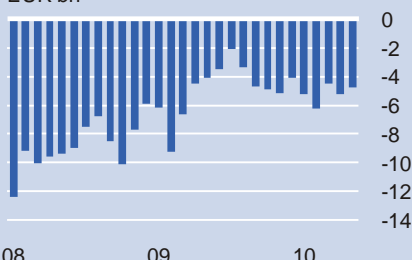
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Germany: Contribution to current account surplus 2009, in %

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PGS & USA: Contribution to Germany's current account surplus, %

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Spain: Current account

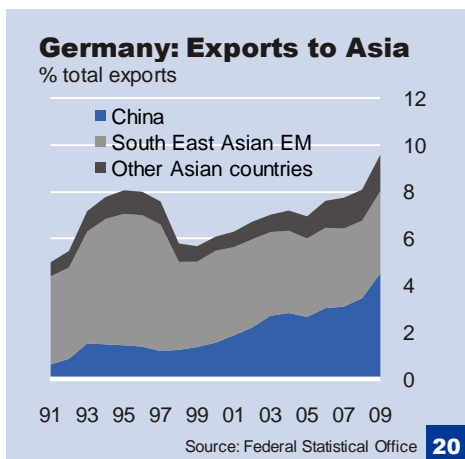
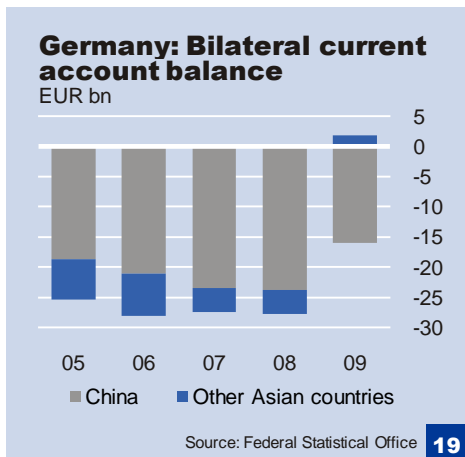
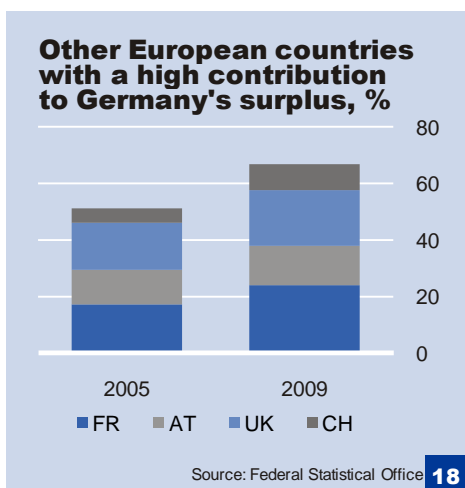
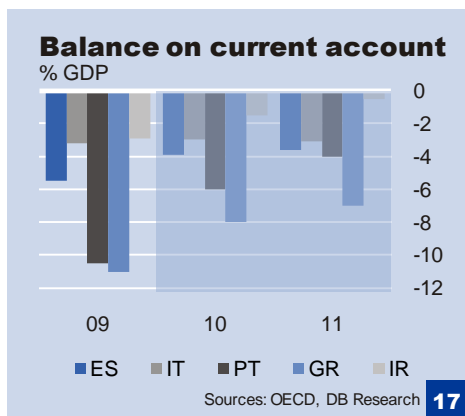
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Facts and estimates**1. Germany has posted a current account surplus since 2000**

Following a series of negative balances triggered mainly by reunification effects, Germany's current account has been in surplus again since 2000, reaching record territory in 2007 at almost EUR 190 bn or 7.7% of GDP. By 2009, the surplus had receded to EUR 120 bn, or 5% of GDP. In the first 6 months of this year, though, it ballooned again by nearly EUR 12 bn. The component driving the current account has been trade, with the trade surplus having increased from around EUR 10 bn in the early 1990s to nearly EUR 200 bn in 2007, reflecting the success of Germany's export sector. This enabled Germany to lay claim to the title of "World export champion" every year from 2003 to 2008 and not be "outboxed" until 2009, by China. Since 2004, the balance on the income account (earned and investment income) has also been positive, while the services balance continues to post a deficit – albeit only a small one.

2. Importance of "problem countries" has declined

A look at bilateral current account balances shows that in 2009 Germany generated about 50% of its surplus with the member states of the eurozone, 18% with the other EU countries, around 10% with the US and close to 22% with the rest of the world. The chief export markets in Europe for German products are France (a good 10% of total exports), the Netherlands and the UK (both 6¾%), Italy (6½%), Austria and Belgium (around 6%) and Switzerland (4 ½%). The problem countries, i.e. the countries of Europe with a pressing need to consolidate their finances and thus posting correspondingly large current account deficits (Spain, Portugal, Ireland and Greece), absorb only slightly more than 5% of total German exports. Their share of the total current account surplus remains limited, accordingly. Germany generated 13% of its surplus in 2009 in trade with Spain, and roughly 3 ½% each with Portugal and Greece. By contrast, over the past few years Germany has posted a growing deficit vis-à-vis Ireland. Even when the bilateral surplus with the US (roughly 10%) is factored in, merely 30% of the total surplus comes from these countries. In addition, the importance of the problem countries has already decreased noticeably. In 2005, 30% of Germany's current account surplus was attributable to the US; including Spain, Portugal and Greece, the share even approached 55%. We expect virtually no changes in the Italian current account, where a deficit of roughly 3% of GDP was posted in 2009. Given a public-sector deficit of "only" 5.3% of GDP in 2009 and only moderate consolidation efforts towards meeting the Maastricht budget criterion, though, this hardly comes as a surprise. Besides, it has to be noted that the rapid improvements in current account balances, which have mainly been driven by a swift recovery from recession, have either slowed noticeably of late or have come to a standstill, not only in the problem countries in particular, but in many of the other countries of Europe as well. In Spain, for instance, the current account deficit has narrowed by only EUR 4.6 bn in the first 5 months of this year, compared with a decline of nearly EUR 20 bn in the year-earlier period. In Greece, Portugal and Italy, the balance on current account has remained virtually unchanged, while in Ireland the deficit has in fact started to widen again of late. All in all, we expect Spain's deficit to narrow by nearly 2 percentage points to 3.6% of GDP by 2011, while Portugal's deficit shrinks by 6 ½ pp to 4% of GDP and Greece's deficit contracts by 4 pp to 7% of GDP. These developments ought to bring



only moderate pressure to bear on Germany's current account balance.

3. Other trading partners are more important

In comparison with the problem countries, other European countries whose current account balances are relatively small and hardly likely to change appreciably over the coming years play a bigger role for Germany in terms of its surplus. These countries include France, Austria, Switzerland and the UK. There is a huge need for the UK to consolidate its finances, as the public-sector deficit ran to over 11% of GDP in 2009. However, the UK reported a current account deficit of only slightly more than 1% in 2009. This means there is only very limited long-term pressure on the UK to adjust its external balance involving repercussions on Germany's current account balance. In 2009, Germany generated a current account surplus vis-à-vis the given countries equal to nearly 70% of its total. In 2005, by contrast, the reading only slightly exceeded 50%. Correspondingly, this component of Germany's current account balance will probably remain a stabilising factor in future.

4. Potential compensatory effects

The bilateral current account balances with the emerging markets of Asia are chronically in deficit, although they do show an improving trend. After hitting a record of nearly EUR 30 bn in 2006 the deficit vis-à-vis the Asian countries started to shrink, declining by roughly 50% to just over EUR 14 bn by 2009. This is attributable to the fact that the trade deficit with China narrowed and that the bilateral current account balances with the other emerging Asian markets turned positive. These, however, are the very countries posting above-average growth, and Germany offers the exact range of products required by these countries to foster their development. Machinery and transport equipment, for instance, account for an above-average share of total German exports to these countries at about 60% (world: 44 ½%); for China, in fact, the reading is close to 70%. The significance of the Asian markets for German exporters has increased substantially. Since the early 1990s, the proportion of exports shipped to Asia has doubled to nearly 10%, with China's share expanding from roughly ½% to 4 ½%. This means that the export markets of emerging Asia now outstrip the US in importance. There are good chances of trade relations with this region intensifying further thereby helping to reduce Germany's bilateral current account deficits, which is likely to be instrumental in bringing about a stabilisation of Germany's current account surplus.

Outlook: Current account surplus needs to shrink

The external adjustments in many countries will also increase the strain on Germany's current account surplus. However, this pressure will probably remain very limited for the time being and the surplus is likely to shrink only slowly. A narrowing of the surplus is necessary for more balanced overall growth anyway and – considering the misguided structural developments of the past few years that triggered the recent crisis – its importance must not be underestimated. This includes not only a correction of the current account deficits but also – by definition – a reduction of the current account surpluses. The German economy thus faces major challenges going forward. In the shorter run, too, the euphoria currently surrounding Germany's export and growth achievements appears to us to have gone through the roof, since the current cyclical recovery of net exports is likely to lose considerable momentum before long. At



present, German exporters are still benefiting from inventory adjustments, catch-up effects and the underlying cyclical recovery of demand – in Asia and China in particular. But the inventory-cycle and catch-up effects are likely to peter out shortly, and recent indicators, such as the latest results of purchasing manager surveys, flag a slowing of growth in the US and China. The slowdown will no doubt also feed through to German exports. This is why we forecast only moderate GDP growth in H2 in the wake of an extremely strong second quarter, and nothing more than average expansion of 1 ¾% for 2011 as a whole.

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