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The Macroeconomic Imbalance Procedure and Germany: When is a surplus an "imbalance"?

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The Macroeconomic Imbalance Procedure (MIP) was largely designed to prevent another boom/bust cycle as occurred in Spain and Ireland. But now, with the release by the European Commission on November 13th of its latest Alert Mechanism Report (AMR),[1] which was introduced with the European Semester, this procedure is being used to address a surplus (that of Germany), which is widely perceived as constituting a problem for the euro area's recovery.

The 'red light' signalling an excessive current account surplus had been triggered in the past for the Netherlands and Luxembourg, while Germany scraped by (in 2012) with a 5.9% surplus, marginally evading the 6% threshold (over a 3-year average). With this most recent report, however, this has changed. Germany alongside the Netherlands and Luxembourg are the three euro area countries that now have a surplus above the upper threshold.

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

The analysis present below finds that it is difficult to argue that the threshold for surpluses is arbitrary and should anyway looked at not in absolute terms, but in terms of deviations from the euro area average. Measured this way, the German surplus appears much less of an outlier. But at any rate it is difficult 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 what an imbalance really is.

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

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According to the Commission's definition and for the purpose of the Regulation, an imbalance means:

> 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.[2]

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. The largest crisis-struck countries – Italy and Spain – even move from a deficit to a surplus, 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 moving average, 2012

	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 EA, albeit being still slightly positive. The forecasts of current account balances have been known to be considerably revised especially in the current fragile world economic state. A small forecasted growth rate could turn into a rebalancing throughout the next semester. Why use the forecast if it is ambiguous? The truth is that also past current account data is continuously revised as seen for Germany 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.[3] 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 into 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 weakness of domestic demand.

2) When is an imbalance harmful? Spill-over effects

Intervention by the EU under the 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.

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,

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

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

> 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. However, on both accounts it is difficult to argue 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 is of course an argument which 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 euro area until 2009 (close to -90%), thereafter turning strongly positive (2010-2014). What can be derived from this observation? Possibly that, up until crisis, German the surplus meant a deficit for 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, though 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 ECFIN study of surplus economies[4]. 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 which could result in the rest of the Euro Area or at least that part which 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 judge 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. In a pure demand management view 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 motivate a threshold for surpluses if the spill-over effect in demand constrained environment is 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 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

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

spill-over effects of current account deficits is more prevalent than for current account surpluses due to sustainability considerations.[5]

There is no economic justification given here for the number which 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 which 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 below 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, 3-year moving average, forward-looking

	Absolute	Difference to 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

Note: *Difference to extra EA17 Current Account Balance as % of EA17 GDP, i.e. the CAB spread to the EA17

Source: Own calculations on AMECO data.

For the key indicator of the MIP, namely the current account the difference between Germany and the EA average remains comfortably below the threshold. One could thus argue that if one looks at the deviations from the EA 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 EA average would also lead to a different view of the remaining deficit countries. Greece, Cyprus and in particular France would trigger a red flashing warning. The French deficit remains modest, but it is now far away from the EA average.

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

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 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.

5 http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp92_en.pdf

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 that Germany for some time, forcing the Commission to do 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 the other indicators are of a similar order of magnitude) it is highly unlikely that the Commission will find that Germany's surplus constitutes an imbalance worthy of the sanction which is theoretically possible under the EIP.

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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 German surplus was once over 6 % of GDP higher than the euro area average, 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 do much to make the euro area better off. But it remains also straightforward to make the case that, in a Keynesian perspective, stronger domestic demand in Germany (and Netherlands) would marginally benefit the rest of 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 been often 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 must be very uncertain since service sector reforms would certainly increase supply, but it is not at all certain that it would also increase demand and increase demand more than supply. Service sector reforms which increase productivity improve, ceteris paribus, competitiveness. One would have to hope that wages increase by at least the same amount and that consumption increases 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 way the same reforms should reduce the deficit in one case and reduce the surplus in another.

The only measure which 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 recommendable 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 little. All the Commission can, and will, do is to start an 'in depth analysis'. This might lead to strong political reactions and an enormous echo in the media. But nothing of concrete substance is likely to follow.