

# **What drives the German current account? And how does it affect other EU member states?**

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This paper studies the German current account using an estimated Dynamic Stochastic General Equilibrium (DSGE) model with three countries: Germany, the Rest of the Euro Area (REA) and the Rest of the World (ROW). The model is estimated using quarterly data for the period 1995q1-2013q2. The model assumes a rich set of demand and supply shocks in goods, labour and asset markets, and it allows for nominal and real rigidities, and financial frictions.

Several hypotheses about the causes of Germany's external surplus have been debated in the policy and academic literature. Our estimated model allows us to recover the shocks that drive the German external balance—and, hence, we can determine what shocks mattered most, and when.

We devote particular attention to the following potential causes of the German external surplus: (i) In the run-up to the Euro (1995-1998), REA interest rates converged to German rates, an indication that the Euro led to greater financial integration in Europe; it has frequently been argued (e.g., Sinn (2010) and Hale and Obstfeld (2013)) that greater financial integration triggered capital flows from Germany to the REA. (ii) A second widely discussed factor was the strong growth in emerging economies during the past two decades—German exports may have benefited particularly from the rising demand for investment goods by emerging economies, given German's specialization in the production of those goods; strong growth in emerging economies may have also have added to intra-EA imbalances by increasing competition for exports from the EMU periphery (e.g., Chen et al. (2012)). (iii) The growth of outsourcing by German firms to low wage countries (notably in Eastern Europe), and the German labour market liberalization during the period 2002-2005, have often been viewed as factors that raised German labour supply, and restrained German wage growth, thereby boosting German competitiveness (e.g., Dustmann et al. (2014)). (iv) Finally, it has been argued that depressed German domestic demand, and thus a high saving rate, are key drivers of the German surplus; high saving may partly reflect German households' concerns about rapid population ageing, following pension reforms (2001-2004) that markedly lowered state-funded pensions, and created tax incentives for private retirement saving (Deutsche Bundesbank (2011), Huefner and Koske (2010)). Fiscal consolidation in Germany after the financial crisis may also have contributed to weak domestic demand (Lagarde (2012), IMF (2013b), in 't Veld (2013)).

Our empirical results suggest that all of these factors played a role in driving the German external surplus, but that their quantitative importance and timing differed markedly. Mono-causal explanations of the German surplus are, thus, insufficient: the surplus reflects a succession of distinct shocks.

According to the estimated model, greater financial integration (narrowing of the REA-German interest rate spread) had a positive effect on aggregate demand in the REA, which boosted REA and German GDP and raised the German current account. However, quantitatively, these effects are rather modest, and they operated mainly during the late 1990s and early 2000s; thus, REA-German interest rate convergence cannot explain the persistence of the rise of the German external surplus. We find that strong ROW growth contributed positively to German and REA GDP and net export—the effect of ROW growth was stronger than that of interest rate convergence, and it mainly affected the German external balance between the early 2000s and the global recession. German labour market reforms had a marked effect on German GDP and the German current account, after 2007; these reforms also had a positive, but much weaker, effect on REA GDP (due to stronger German demand for REA exports), and a weak negative effect on REA net exports. According to our estimates, positive shocks to German private saving strongly depressed aggregate demand in Germany after the mid-2000s and lowered German GDP, while raising the German current account; these shocks also stimulated aggregate demand in the REA (due to a fall in interest rates).

All in all, the key shocks that drove German real activity and the German current account only had a minor effect on real activity and inflation in the REA. In other terms, real activity in the REA was largely driven by domestic factors rather than by German economic conditions. The key supply and demand shocks that kept the German surplus at a high level likewise only had a weak effect on inflation in the REA. The model also allows us to make predictions about the future path of the German external balance. The rise in the interest rate spread between the REA and Germany since the sovereign debt crisis, and pressure toward labour market reform in the REA suggest a gradual reduction of the German current account surplus. Also the effects of labour market reforms enacted in Germany during the early 2000s are likely to be gradually eroded by higher German real wage growth. As far as savings are concerned, illustrative model simulations suggest increased awareness about future demographic developments and pension generosity could explain a sizable and persistent positive effect on the German current account. To the extent that this holds, it would not call for corrective policy actions. Regarding public demand, Germany's sound fiscal position provides space for a less restrictive fiscal policy; the rise in German demand would reduce the external surplus and help to achieve a rebalancing in the EA, albeit by a modest amount.