III. Anatomy of current account surpluses in the euro area

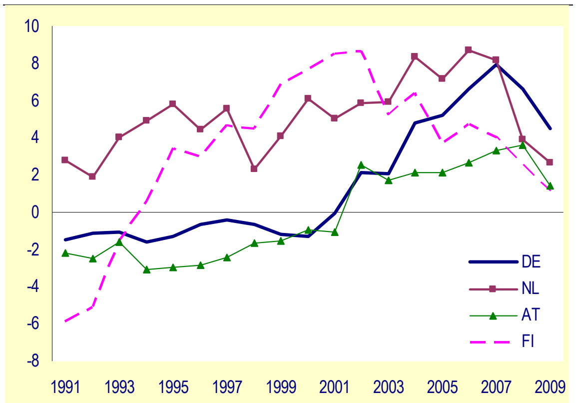
This section analyses developments of current accounts in four surplus euro-area Member States: Germany, the Netherlands, Austria and Finland. A significant and lasting upward shift in the current account occurred in all these countries but Finland in the early 2000s. This shift was associated with persistent weakening of domestic demand with increased net lending of the corporate sector playing a key role. Moreover, in Germany, the household sector increased its net lending by reducing investment and increasing gross savings. As an additional factor, over 2004-07, the surplus countries' strong export performance allowed them to take advantage of the boom in world trade. This provided room for fiscal consolidation and raised domestic savings and current account surpluses further. During the crisis, surpluses contracted substantially on the back of significant fiscal expansions and comparatively resilient private-sector demand. However, looking forward, signs of structural strengthening of private-sector demand remain elusive.

Policy action appears particularly pressing in Member States that have accumulated large current account deficits and experienced significant competitiveness losses. However, there is also a need to better understand the main drivers of large surpluses in some Member States. This section analyses the anatomy of current account surpluses in four major surplus countries of the euro area.

Current account surpluses increased substantially in the early years of the euro

Germany, the Netherlands, Austria and Finland have been running substantial current account surpluses (Graph III.1). Both, Germany and Austria had a slightly negative current account from 1991 up to 2002, when the external balance moved forcefully into surplus. The surplus increased particularly strongly in Germany, where it reached a peak of almost 8 % of GDP in 2007.

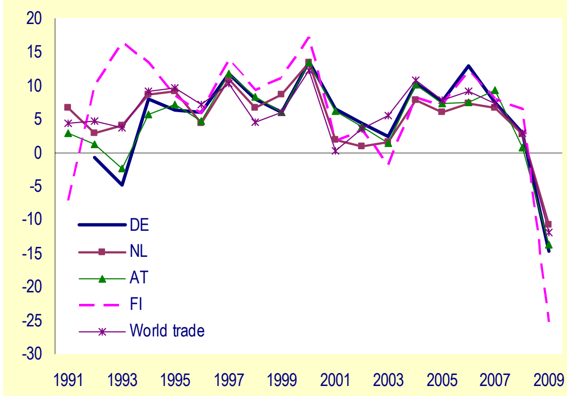
Graph III.1: **Current account** (in % of GDP) (1)



(1) Net lending of the total economy.
Source: Commission services.

The Netherlands has traditionally run a current account surplus which increased substantially after the introduction of the euro. In contrast, during the 1990s, Finland's current account moved quickly from a deficit to a substantial surplus of above 8 % of GDP in 2001, but has been falling since then. Luxembourg has also been running a significant current account surplus but is not considered in the following due to the particular nature of its external position. ([14])

Graph III.2: **Real export growth** (in %, y-o-y)



Source: IMF World Economic Outlook, Commission services.

Developments in external competitiveness have been only partly in line with trends in the current account. For Germany and Austria, sizeable reductions in unit labour costs relative to trading partners were recorded during the period 1998-2009, in line with rising current accounts surpluses. However, the reductions were much more significant relative to euro-area trade partners than relative to a larger group of partners. In Finland, a deterioration in competitiveness in the early 2000s was followed by a shrinking of the

([14]) Luxembourg's balance on goods and services is huge compared to GDP (31.7 %) reflecting among other things exports of financial services. At the same time, the net primary income balance received from the rest of the world is strongly negative (-20.6 %).

current account. ([15]) In contrast, in the Netherlands, substantial losses of competitiveness went hand-in-hand with rising current account surpluses.

The global trade cycle is a major driver of exports

Exports of the four current account surplus countries considered are strongly driven by the global trade cycle. The correlation between real export growth and real world trade growth was above 0.85 in all four countries during 1992-2009. Graph III.2 shows that the export growth of the four countries correlates very strongly. This correlation reflects the global trade cycle.

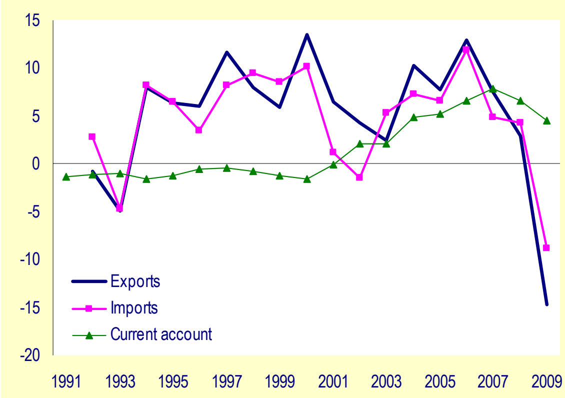
Over the past decade, export growth in all four countries, and in particular Germany, has significantly outpaced that of the euro area. However, such buoyant export growth performance cannot explain the surge in current account surpluses per se. In principle, higher exports tend to generate higher income and thereby higher imports, potentially leaving the current account unaffected. For instance, some large current account deficit countries have experienced an acceleration in export growth under the euro similar to that of surplus countries without observing a significant improvement of the current account (EL). Ultimately, the current account depends on domestic saving and investment balances. Export growth can only affect it to the extent that it affects saving and investment behaviours.

Import growth fell significantly behind export growth on the back of weak domestic demand

In the early 2000s, import growth fell significantly behind export growth in Germany (Graph III.3), Austria and the Netherlands. Accordingly, the current account surplus shifted significantly upward in the three countries. In Finland, export growth lagged behind import growth in the early to mid-2000s.

Weakness in domestic demand has been the central driver of the downshift in imports and increasing current account surpluses. This can be assessed on the basis of a simple demand-side growth accounting exercise. As results documented in Table III.1 show, the contribution of domestic demand to growth during 1999-2007 was weak in Germany and Austria but also in the Netherlands. In the eight years prior to EMU, domestic demand was the central component of growth in all the countries. Domestic demand growth then fell much more strongly than GDP growth compared to the period 1991-1999. In contrast, in Finland, the domestic demand contribution was much more important for growth. The contribution of net exports to growth was important in Austria and the Netherlands and, in particular, in Germany during 1999-2007. Accordingly, imports were weaker than exports leading to a widening current account. In particular during the first four years of EMU, domestic demand was especially weak and consistent with that, import growth fell significantly short of export growth as documented above.

Graph III.3: **Export and import growth and the current account in Germany** (in %) (1)



(1) Real export and import growth and net lending of the total economy.
Source: Commission services.

Table III.1: **Demand-side growth accounting**

		Real GDP growth	Domestic demand contribution	Export contribution	Net export contribution
DE	1999	1.7	1.8	1.5	-0.1
	2007	1.5	0.4	3.0	1.1
	2009	-1.9	0.0	-2.8	-1.8
NL	1999	3.5	3.4	5.0	0.1
	2007	2.3	1.6	3.9	0.7
	2009	-1.3	-0.5	-3.1	-0.7
AT	1999	2.5	2.1	2.3	0.5
	2007	2.4	1.4	3.8	0.9
	2009	-0.8	0.1	-3.8	-1.0
FI	1999	3.0	1.9	3.5	1.6
	2007	3.7	3.1	3.0	0.5
	2009	-2.8	-1.9	-4.5	-1.0

(1) 1999 refers to the period 1991-99, 2007 refers to 1999-2007 and 2009 refers to 2008-09.
Source: Commission services.

([15]) At least based on unit labour cost data. Measures of the real exchange rate based on other deflators show more benign developments in competitiveness.

Demand has been comparatively resilient during the crisis

The forces that were at play in surplus countries during the early years of the euro have, to some extent, reverted in the global economic crisis. The surplus countries have been deeply affected by the world trade slump. In all four Member States, net exports provided a negative contribution to GDP growth over the period 2008-09 and the negative export shock is anticipated to be particularly large in Austria, Finland and the Netherlands. In contrast, domestic demand has remained relatively resilient, at least in Germany and Austria.

Persistent rises in corporate net lending are a central driver of the rise in current account surpluses in the early 2000s …

A breakdown of saving/investment decisions by the household, corporate and government sector sheds further light on the determinants of the significant current account surpluses. Table III.2 documents the changes in the net lending/borrowing (NLB) of the institutional sectors from the second half of the 1990s to the period 2003-07. ([16]) The largest part of the increase in the current account in Germany, the Netherlands and Austria can be traced back to the corporate sector. The household sector has also been contributing substantially to the increase in the current account in Germany and to some extent also in Austria. In this medium-term picture, the government contributed modestly to an increase of the surplus except for Finland, where reduced net lending by the private sector was partially compensated by increased lending of the government.

Table III.2: **Net lending across sectors (in % of GDP) (1)**

	DE	NL	AT	FI
Total economy	6.3	3.1	4.5	-0.6
Non-financial corporations	2.3	4.1	2.7	-0.8
Financial corporations	0.8	0.5	-0.1	-1.2
Households	2.6	-2.5	0.8	-2.1
Government	0.6	1.0	1.1	3.5

(1) Net lending of the institutional sectors. Changes of average 2003-07 relative to average 1995-2000.
Source: Commission services.

In Germany, Finland and in particular the Netherlands, the non-financial corporate sector is a very significant net lender to the economy. In Germany, Austria and the Netherlands, net lending increased significantly around the turn of the century and in the early 2000s. The shift appears to be structural as the corporate sector in these economies continues to provide net finance to the economy except for Austria, where corporate net lending has moved back to slightly negative territory.

… pointing to balance-sheet adjustment

Around the turn of the century, the corporate sector increased gross savings and reduced investment in Germany, the Netherlands and Austria. Such a strategy leads to an improvement in the net financial assets of the sector; it can thus be called a balance-sheet adjustment process. The persistency of the balance-sheet adjustment as indicated by increased net lending suggests that corporations in Germany and the Netherlands appear to have suffered from a significant deterioration of their balance sheets in the early 2000s.

To achieve the balance-sheet adjustment, NLB can be directly increased by cutting investment. But the greatest lever to increase savings in the corporate sector is via moderate wage compensation.

The development of wage compensation can be assessed by studying the wage share. As in other parts of the global economy, the share of wages in GDP has been falling significantly in the euro area as a whole. However, the fall has been significantly more marked in Germany and Austria than in the euro area as a whole. Although in the Netherlands, the wage share has been falling at the rate of the euro area, it has still been falling more significantly than in the current account deficit countries. Only in Finland, has the wage share been falling less than in the euro area. Wage share developments are broadly in line with disposable income developments which, in turn, have led to weak consumption and domestic demand thereby resulting into current account surpluses. ([17])

([16]) NLB is the difference between saving and investment of the institutional sector considered. NLB is positive (resp. negative) when the sector lends to (resp. borrows from) the rest of the economy.

([17]) See for example Eppendorfer and Stierle (2008), German consumption: is there hope for a revival, ECFIN country focus, 5(6).

Households' net savings also played a role

On top of weak disposable income developments weighing on consumption, the household sector has significantly increased its NLB in Germany. ([18]) This means that more of its income has been saved and less has been consumed and invested. As in the corporate sector, the increase was sharpest in the years right after the turn of the century. Also in Austria, an increase in households' NLB can be observed, even though at a significantly smaller rate. With gross savings rates rising at a similar rate in Austria and Germany, the weakness in German household investment led to the stronger increase in German net lending. In contrast, in the Netherlands and Finland, the household sector has reduced its NLB, also reflecting falling gross savings rates.

The empirical evidence indicates that corporate as well as household decisions explain much of the strong increase in current account surpluses. The desired level of net savings seems to have shifted in the early 2000s and a rather protracted process of balance-sheet adjustment started at that time. This led to weak domestic demand and an increase in the current account surplus.

Fiscal consolidation is the counterpart to the further rise in current accounts during 2004-07

Governments reacted to the balance-sheet adjustment process in the early 2000s, which involved a significant reduction of private sector demand, by expanding fiscal deficits. This dampened the initial impact of the increased net lending in the private sector on demand and the current account.

When global trade boomed during 2004-07, Germany, the Netherlands and Austria were able to benefit strongly from world demand and significantly expanded their exports. The current account surplus continued to increase in that period. In terms of saving/investment balances, this trade-driven current account cycle finds its counterpart in the net lending of the government. In fact, fiscal consolidation was important for the dynamics of the 2004-07 period.

In this period, the current account surplus increased while private sector net lending stayed fairly constant and fiscal deficits decreased substantially. ([19])

Is the reduction in current account surpluses permanent?

During the crisis, domestic demand remained relatively resilient in surplus countries due to significant fiscal expansion and comparatively stable private sector net lending. As a result, imports have been falling much less than exports and current account surpluses have contracted. This constituted a sizeable positive growth contribution to the rest of the world. At this juncture, it is difficult however to discern any substantial structural strengthening of private-sector demand. The changes in risk attitudes and in bank lending triggered by the crisis could prolong the period of corporate balance sheet correction which has contributed to the accumulation of surpluses in some of them in the pre-crisis years.

Clearly, more research is needed to confirm this diagnosis and uncover the causes of structural weakness in domestic demand in surplus countries. This concerns in particular the determinants of the significant shift in NLB in the corporate as well as the household sector in the early 2000s and the factors rendering the shift rather persistent, particularly in Germany. The impact of the bursting of the dot-com bubble on balance sheets could be a useful research avenue in that respect. Furthermore, the impact of tax reforms on corporate net lending decisions should be assessed. Finally, a better understanding of the impact of the comparatively underdeveloped services sector on the current account of surplus countries is needed.

Overall, current account surplus countries in the euro area should revisit the factors underlying the structural weakness in private sector demand. Removing structural obstacles to growth in domestic demand would be beneficial for the surplus countries themselves. First, increased consumption is typically associated with an increase in welfare. Second, stepped-up investment is conducive to increasing the long-term growth potential.

([18]) Huefner and Koske (2010) analyse the increase in the gross savings rate in Germany and find that it can be partly attributed to wealth effects ('Explaining household saving rates in G7 countries: implications for Germany', OECD Woking Paper No. 754).

([19]) The increasing fiscal consolidation can be linked to the world trade boom as rising exports meant higher sales and greater corporate profitability, leading to buoyant (corporate) tax revenues.

In addition, a structural strengthening of domestic demand in surplus countries would also be beneficial to the current account deficit countries. Via the trade channel, increased demand in surplus countries could help reducing current account deficits. Quantitatively, however, this channel is relatively weak and deficit countries cannot rely exclusively on stepped-up demand in surplus countries to reduce their imbalances. But greater demand in surplus countries would ease the adjustment burden.