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A QUESTION OF BALANCE

AN ANALYSIS OF EXTERNAL SURPLUSES IN THE MAIN EURO AREA COUNTRIES

Main points

- There has been a significant rebalancing of external current accounts in the euro area since 2008.
- Italy's net foreign position is now almost in balance, while Spain's remains substantially in debt.
- Germany's current account surplus is considerable...
- ...partly the result of non-financial corporations having shifted from borrowers to lenders.
- A boost in domestic demand in Germany could reduce its surplus....
- ...but, based on our results, it is unlikely to have a significant effect on Italian GDP growth.

I. Introduction

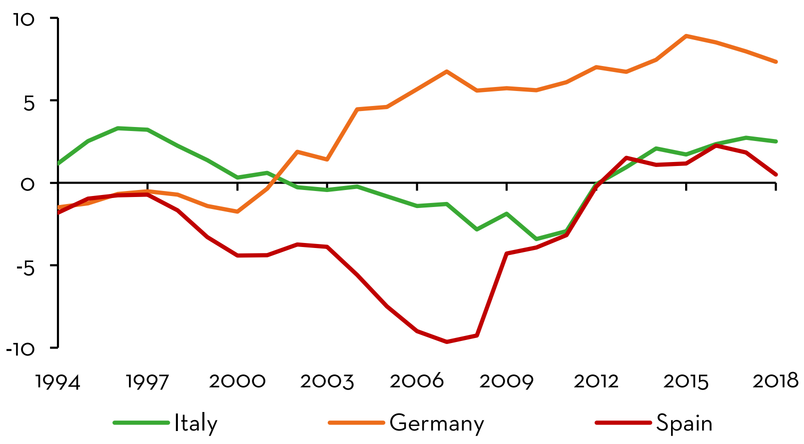
External rebalancing by the countries with high current account deficits... The global financial crisis and the European sovereign debt crisis triggered an adjustment to external deficits in the financially weaker euro area countries, through severe and abrupt compression of domestic demand and, in some cases, increased exports. Among the main countries, Spain and Italy have achieved surpluses (Figure 1), but, in Spain, which is having to manage a very large external debt position, the balance restoration process is not yet complete.

... but not by those in surplus, such as Germany. Germany's current account surplus has increased further since 2008. At the end of 2017, Germany was the world's second-largest net

Figure 1

Current account balances

% of GDP



Source: Prometeia's calculations on national statistics and Eurostat data.

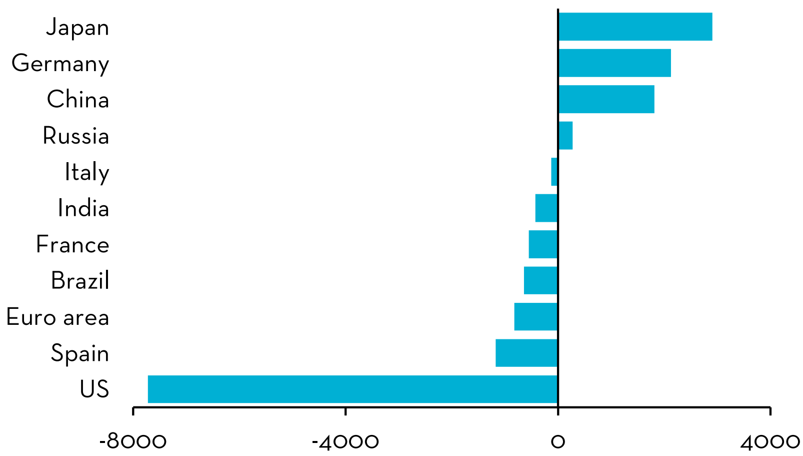


Figure 2

Net international investment position in 2017

billions of US Dollars

Source: IMF.

creditor in absolute terms, behind Japan (Figure 2). Net external assets amounted to 54 per cent of GDP, three times the ratio recorded in 2007. Although its surplus hugely exceeds the benchmark value based on the economic fundamentals (such as productivity and population ageing)[1], Germany has failed to make significant progress to reduce it, which only began to decline slightly from 2016.

The role of the corporate sector. The sectoral breakdown of investment/saving balances shows that non-financial corporations have contributed to improving the external balance, driven by increased saving and weak investment. Although non-financial corporations should be borrowing to finance investment, since 2008 in Italy and Spain they have become net lenders of funds and in Germany their balance, in surplus since 2002, increased.

The focus of this note. This note reviews the evidence and offers an interpretation of the most recent data and policy options related to correcting imbalances. As well as focusing on Germany, it includes Italy and Spain, the other main euro area countries running an external surplus, and examines the evolution of current account balances (Section II) and investment/saving balances in different sectors (Section III), mainly non-financial corporations. We run the Prometeia econometric model to evaluate the effects that an increase in German domestic demand would have on Italian growth (Section IV). Section V concludes.

II. The evolution of current account balances

Overview. Starting in the late 1990s, the dispersion of current account balances within the euro area, as within the OECD overall, increased steeply, owing chiefly to increased deficits in Greece, Spain, Portugal and, to a lesser extent, Italy, and growing surpluses in Germany and the Netherlands. The deficits were financed by the rapid advances in financial integration with countries in surplus, facilitated by the absence of an exchange rate risk premium and expectations of high growth in the catching-up countries and also by the perception that financial market innovations would enhance

1 On the basis of the fundamental variables, the European Commission set the 2017 current account "norm" for Germany at 3 per cent of GDP, against an actual value of 7.8 per cent.

market participants' capacity to manage risk. However, these capital flows went mainly to finance investment in non-productive real estate rather than investment in machinery and equipment and, so, failed to create the conditions for sustaining future debt increases. Against this backdrop, the external imbalances among the members of the monetary union failed to attract much attention, most likely because of the fear that policy intervention might hamper the upward phase of the cycle.[2] Between 2007 and 2011, heightened uncertainty and loss of confidence among lenders and borrowers in the interbank and government bond markets halted further progress towards financial integration. The current account deficits would no longer be financed by the countries in surplus. At the same time, Target2 balances grew considerably, reflecting the redistribution of central bank money among members. Moreover, the financing difficulties of the peripheral countries were addressed using financial aid provided by the European Commission and the International Monetary Fund, supported by the European Central Bank.

Italy's net foreign position is almost in balance. The sharp reduction in domestic demand during the crises and the good performance of exports in recent years have driven the improvements in Italy's external balance, which went from a deficit of 3.4 per cent of GDP in 2010 to a surplus of 2.5 per cent in 2018. The persistent surpluses and the valuation adjustments to securities[3] produced substantial improvements in Italy's international net debt position, which according to our forecasts will come into balance at the end of the current year (at the end of 2010, net debt was 20.2 per cent of GDP). However, a balanced external position does not preclude financial market strains when there are imbalances elsewhere, as was shown by the new crisis of confidence in the Italy's public debt following the 2018 elections.

Spain remains in a substantial net debtor position. Spain's external account balance shifted from a deficit of 9.6 per cent of GDP in 2007 to a surplus of 2.3 per cent in 2016, which narrowed in the following years. Despite a brilliant export performance, the trade balance has continued to post a deficit partly due to a rapidly growing propensity to import. The adjustment process helped to reduce the net debtor position, but this remains very large, at 84 per cent of GDP at the end of 2017. Thus, to reduce this debt and the risks for sustainability, will require Spain to run an external surplus for an extended period of time.

The euro area is losing its weight in Germany's trade. In the years preceding the introduction of the EMU, the German current account balance experienced a deficit, followed by rising surplus mainly due to reduced unit labour costs (the result of low wages and rising productivity). Surplus achieved the maximum value of 8.9 per cent of GDP in 2015 and since then, it has declined only slightly. German trade (exports plus imports) with the euro area has diminished, and since 2010 has been below 40 per cent of the total. In addition to the trade balance, the investment income balance has played a significant role in the improved current account due to an improved net creditor position and favourable returns on foreign assets.

2 Giavazzi F. and Spaventa L., 2011, "Why the current account may matter in a monetary union. Lessons from the financial crisis in the euro area". In Beblavý M., Cobham D., and Ódor L. (Eds.), The Euro Area and the Financial Crisis, (pp. 199-221). Cambridge University Press.

3 Price and exchange rate changes accounted for 8 per cent and 4.5 per cent respectively of the reduction in the net external debt between 2014 and 2017 (Relazione Annuale May 2018, Banca d'Italia). In 2018, between March and June, the increase in government bond yields was reflected in a reduction in the value of the bonds held by non-residents, contributing significantly to the reduction in liabilities.

III. The current account balance from the perspective of saving and investment

The link between the external position and saving/investment. According to national account definitions, the current account balance is the difference between national saving and investment of all sectors of the economy. If an economy records national saving lower than investment, then it is a net borrower and accumulates net foreign liabilities. If saving is higher than investment, the reverse applies.

Non-financial corporations shifted from being borrowers to lenders. Figure 3 shows that non-financial corporations (NFCs) and the public sectors of both Spain and Germany have played an important role in current account balance improvements. In Germany, the public sector balance shifted into positive territory in 2014 and strengthened gradually in the years that followed, helping to achieve a value of 60 per cent of GDP for public debt in 2018.[4] Note that the positive balance of German households is larger than in Spain and Italy. In all three countries, NFCs changed from being net borrowers of funds from the rest of the economy into net lenders of funds, a role usually played by households while companies should ordinarily be borrowing to finance investment. In general, there are various reasons for this peculiarity: for example, elevated uncertainty, credit constraints, low demand with an ageing population.[5]

What has driven this change? The shift of NFCs to net lenders was led, mostly, by increased savings (Figures 4-5), which grew steadily as a share of GDP. The investment ratio was more stable in Germany than in Italy and Spain, where it collapsed during the crisis, but by 2017 it had almost regained its pre-crisis levels. In Germany the investment ratio has been gradually decreasing since the early 2000s, but turned marginally back upwards in 2014.

Sources and... Figure 6 shows the gross[6] saving rate for NFCs decomposed into gross operating surplus, interest and income received, corporate income taxes, interest paid and income distributed. In Italy and Germany, the reductions in both interest paid and income distributed led

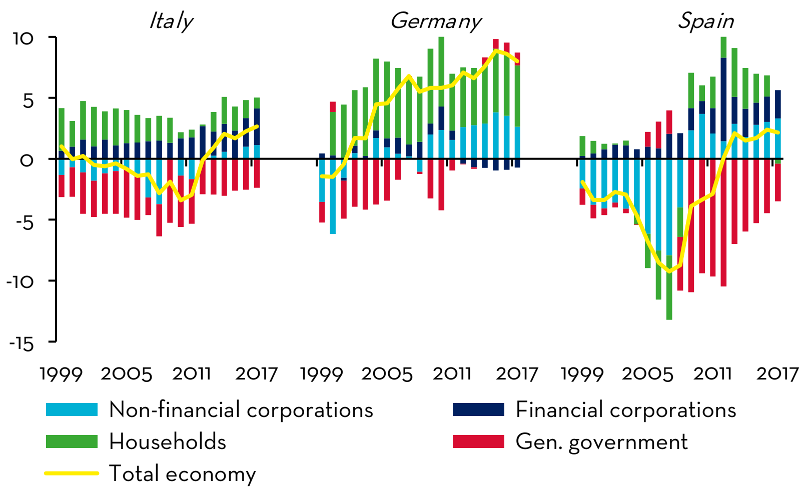


Figure 3

Sectoral breakdown of net lending/borrowing

% of GDP

Source: Prometeia's calculations on Eurostat data.

4 *Rapporto di previsione, March 2019. Prometeia.*

5 *Palenzuela D. R. and Dees S. (eds), 2016, "Saving and investment behaviour in the euro area", Occasional Paper Series, n. 167, European Central Bank. Mai Chi Dao and Maggi C., 2018, The rise in corporate saving and cash holdings in advanced economies: aggregate and firms level trends, IMF WP/18/262.*

6 *Gross of depreciation of physical capital.*

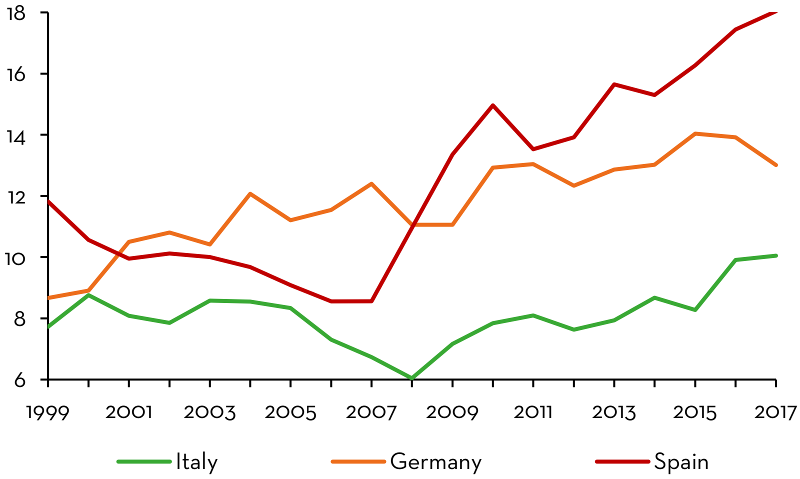


Figure 4

Saving of non-financial corporations

% of GDP

Source: Prometeia's calculations on Eurostat data.

to an increase in the corporate saving ratio between 2008 and 2017, while in Spain the increase in saving was driven by growing operating surplus and declining interest expenditure. The gross operating surplus of German corporations, after the growth recorded in the first half of the 2000s, has remained at high levels, and its moderate reduction between 2008 and 2017 was due to the rise in the share of labour.

... allocation of NFCs' net saving. NFCs allocate their net saving mostly holding liquid assets (currency and deposits) for turnover financing, trade credits and equities, the main difference being the major role in Italy of trade credit[7] with respect to equities. While the relative shares of other assets have not changed much over recent years, a feature common to all three countries is the increasing allocation of savings to liquid assets and equities (Figure 7). The liquid asset increase can be explained by the reduced opportunity costs due to the very low interest rates, but some effect of uncertainty cannot be ruled out.

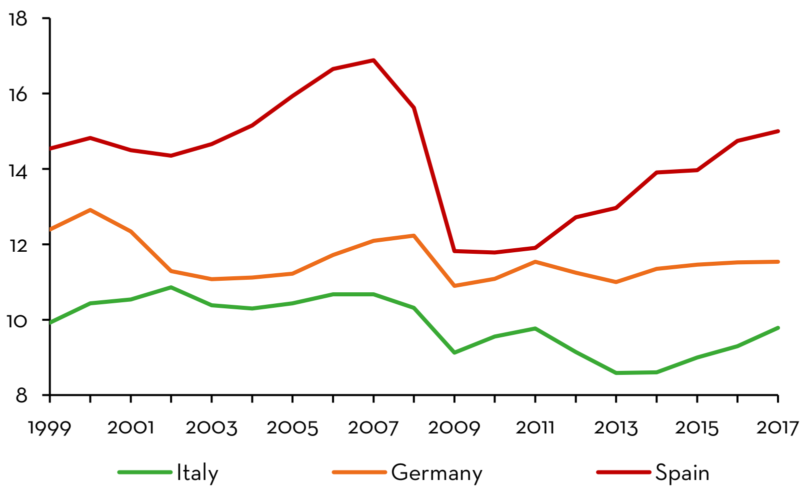


Figure 5

Gross fixed capital formation of non-financial corporations

% of GDP

Source: Prometeia's calculations on Eurostat data.

7 Trade credit is credit granted by one trader to another when goods and services are exchanged.

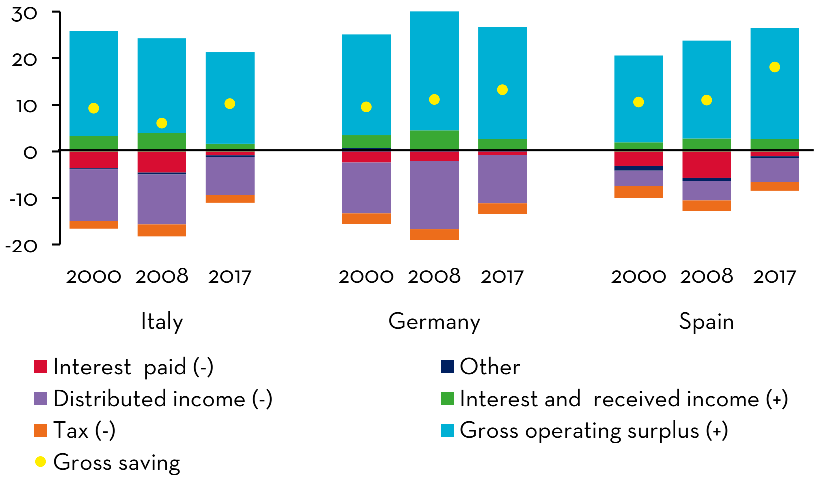


Figure 6

Decomposing gross saving rate of non-financial corporations

% of GDP

Source: Prometeia's calculations on Eurostat data.

Is NFC investment too weak? In all three countries, NFC investment rates have almost regained their pre-crisis levels: 0.7 percentage points short in Germany, 0.9 points in Italy and 1.9 in Spain. Italy and Spain, where investment plummeted during the two crises, have recorded quite rapid recovery during the cyclical upturn. In Germany, although investment was less severely affected by the crisis, the return to pre-crisis levels in terms of GDP is slow, especially considering the favorable credit conditions. This weakness in investment does not seem to depend on increased outward foreign investment, which moved from 3.8 per cent of GDP in 2005-2007 to 1.9 per cent in 2013-2017. A longer-term view would suggest that investment weakness reflects the fall in labour's share under the assumption that labour and capital are complementary and not substitute factors.[8] The progressive ageing of the German population and the future fall in labour supply may be another explanation, because these factors may already be inducing firms to be more cautious about longer-term investments.[9]

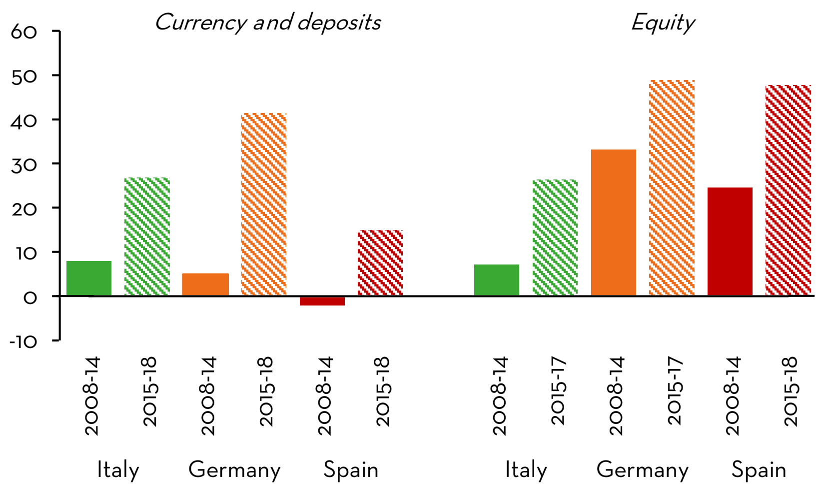


Figure 7

Currency-deposits and equity of non-financial corporations

flows, average values, billions of Euros

Source: Prometeia's calculations on Eurostat data.

8 *See Micossi S., D'Onofrio A. and Peirce F. 2018, On German External Imbalances, Policy Insight, n. 2018/13. Wolf. G, 2018, Germany's current account surplus and corporate investment, May 9 2018, Bruegel Institute.*

9 *Bundesbank Monthly Report, April 2017.*

IV. Assessing the impact of an increase in Germany's domestic demand

Germany is often asked to increase its domestic demand in order to reduce its surplus of the external current account and to give a growth impulse to the euro area.[10] However, according to simulation exercises run with Prometeia macroeconometric models, which take into account all direct and indirect effects of trade among countries, we should not expect a strong impulse on growth in Italy or other euro area countries. This result reflects the decrease in Germany's trade with the euro area. Since 2010 German trade (exports plus imports) with the euro area has amounted to less than 40 per cent of total German trade. Italian exports to Germany now account for only 3 per cent of Italy's GDP.

Because of their favourable financial conditions, room for increasing domestic demand is not only in the non-financial corporate sector, but also in the household and public sectors. More dynamic German domestic demand could stem from various interventions that in turn would produce effects of differing intensity in the domestic economy and have different spillover effects, as our simulation exercises show (Figure 8). In order to make the different option comparable, all the exercises simulate an increase of 1 per cent of GDP applied to different German expenditure items. The greatest expansionary effects on the German economy is produced by an increase in general government investment (a gain of 1.39 per cent for German GDP on average in the first two years, 0.13 per cent for Italy), while the largest gain for Italy would come from an increase in German business investment (0.16 per cent and 0.70 for Germany). The main differences between the two exercises is the flow of imports activated by the two German expenditure items, significantly higher for business than for general government investment (50 per cent of which consists of constructions). As to an increase in total wages, two forces exert positive effects on Italy and the rest of the euro area: higher German domestic demand increases imports, while higher wages in Germany improve the relative competitiveness of its trade partners. In this case, the effect on Italian GDP is 0.09 per cent (0.98 per cent on German GDP).

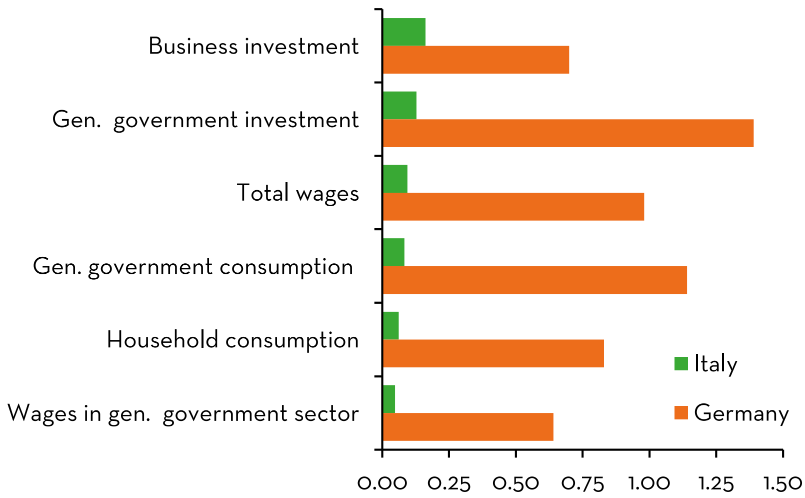


Figure 8

Effects on GDP of Italy and Germany of an increase in German domestic demand components by 1% of GDP

percentage deviations from the baseline scenario in the average of first two years

Source: Prometeia's calculations on Eurostat data.

10 If the objective was support to euro area growth, a more effective instrument would be an expansion of demand in other countries other than Germany. According to our simulations, a shock to public investment worth 1 per cent of GDP in each EMU member state would result in a smaller increase in total GDP than an impulse concentrated in the countries that suffered worst in output and employment during the crisis, because these have higher multipliers. "Le virtù trascurate di una politica espansiva", Rapporto di previsione, October 2014, Prometeia.

V. Summing up

The external surplus in Italy and especially Spain results from corrections to previous imbalances; however, this does not apply to Germany, where the surplus is around twice as high as the fundamental variables (such as productivity, population ageing) would suggest. Contributing to the improvement of external current account, in Germany (as in Italy and Spain) NFCs have become net creditors to the rest of the economy. They have invested their profits mainly in financial assets rather than in productive investments. Over time, Germany has not made significant progress in reducing its surplus. On the one hand, it has been argued that this surplus reduces the prospects for overall euro area growth because it weakens euro area domestic demand; on the other hand, that countries with foreign debt should reduce their imbalances by improving their global competitiveness, not by relying on additional demand from euro area partners. According to our simulations we should not expect a sharp increase in Italy's GDP and in those of other euro countries from an impulse on German domestic demand: an increase in German business investment of 1 per cent of GDP (corresponding to a substantial increase in investment of about 15 per cent) would produce a positive effect of only 0.16 per cent on Italian GDP.

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