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Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

4 December 1989

Prime Minister

CDP 5/xii

Charles Powell Esq
PS/Prime Minister
10 Downing Street
LONDON
SW1

Dear Charles

GERMAN CURRENT ACCOUNT SURPLUS

... As background to the European Council, the Prime Minister might be interested to see the attached paper on the German current account surplus. The Chancellor found it surprising but compelling. In particular it concludes that the surplus has arisen largely for structural reasons, including the strong growth in investment in other European countries and the relatively high savings rate in Germany. It is noticeable, for example, that France has, been gaining cost competitiveness against Germany at a time when its bilateral deficit with Germany has widened sharply.

The recent appreciation of the Deutschemark against most non-ERM currencies will reduce the German surplus slightly, but the effect is likely to be small and to take some time to come through. Similarly, a deutschemark revaluation within the ERM would probably have only a modest effect on Germany's surplus with other ERM countries. As you know, those countries are in any case likely to resist a realignment strongly, because of the effect it would have on inflationary pressures in their countries.

The Chancellor agrees with the point in your letter of 2 November that we should be discreet on this issue. If we were seen to take sides there might be suspicions that we were trying to destabilise the ERM and our intervention could result in delaying any realignment. It would also be awkward if there was any read across, however misconceived, to sterling exchange rate relationships.

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But the Chancellor feels we should keep up the pressure on Germany to reduce its industrial and other subsidies. The direct impact on the current account may not be great, but there can be no justification for Germany protecting its industry, and the benefits to other countries of a larger and more vigorous German domestic market would be welcome.

I am copying this letter to Stephen Wall (FCO) and to Paul Tucker (Bank of England).

JOHN GIEVE

THE GERMAN CURRENT ACCOUNT SURPLUS

Introduction

1. The German current account surplus continues to grow. In the first half of 1989 it averaged $60bn at an annual rate (5 per cent of GNP) compared with $50 bn (4 per cent of GNP) in 1988. Since the beginning of 1988 its trade surplus with the UK has been larger than with any other single country. This note considers whether or not the surplus represents a problem, either for the UK or the world economy generally, and the possible effects on the surplus that Deutschemark appreciation and other policies, including more vigorous structural reform and removal of subsidies in Germany, might have.

The German Current Account Surplus

2. The current account surplus grew rapidly between 1983 and 1986, helped by the high value of the dollar and the fall in oil prices in 1986. Since then it has stabilized at around 4 per cent of GNP, but this year it is likely to increase to around 5 per cent of GNP. Most forecasters expect it to remain at around this figure in 1990.

Table 1: Current Account Surpluses and Deficits $bn

	1984	1985	1986	1987	1988	1989*	1990+
US	-104 (-2.8)	-113 -(2.4)	-133 (-3.1)	-144 (-3.2)	-127 (-2.6)	-124 (-2.4)	-109 (-1.9)
Japan	35 (2.8)	49 (3.7)	86 (4.4)	87 (3.6)	80 (2.8)	67 (2.3)	63 (2.2)
Germany	10 (1.6)	17 (2.6)	34 (4.4)	45 (4.0)	48 (4.0)	60 (5.0)	58 (4.8)

* H1 at annual rate.
\+ OECD forecast.

3. Germany has a substantial deficit on invisibles, about $20bn in 1988, and a trade surplus of over $70bn. Chart 1 shows that the trade surplus with the US has declined absolutely since 1985, whilst the surplus with the EC has tripled over this period. Germany also has a substantial trade surplus with Austria and Switzerland. This is the factual basis for the German claims that their trade surplus is now primarily an intra EC one. Chart 2 shows the bilateral balances with other major EC countries: German trade surpluses have grown with all major EC countries, not just the UK. The UK's particularly strong investment growth compared with other EC countries is one reason why its deficit with Germany has grown quickly.

4. The German current account surplus, by definition, reflects domestic saving in excess of domestic investment. Total investment as a proportion of GDP is similar in Germany to other main European economies, higher than in the US and well below that in Japan, as table 2 shows.

Table 2: Gross investment as % of GDP for G7 countries

	UK	US	Germany	France	Italy	Japan	Canada	G7 average
1981-87	16.7	17.7	20.2	20.1	21.4	28.7	21.0	20.3
1987	17.3	17.3	19.4	19.4	19.9	28.9	21.0	20.0

But national saving is well above the G7 average. This is primarily a result of high corporate and general government saving. Household saving in Germany is about the average for major countries, although in considering this it needs to be remembered that corporate and household savings are close substitutes. The table below summarizes the savings and investment position for 1987, the latest year for which detailed comparable data exist.

CHART 1

GERMAN BILATERAL TRADE BALANCES

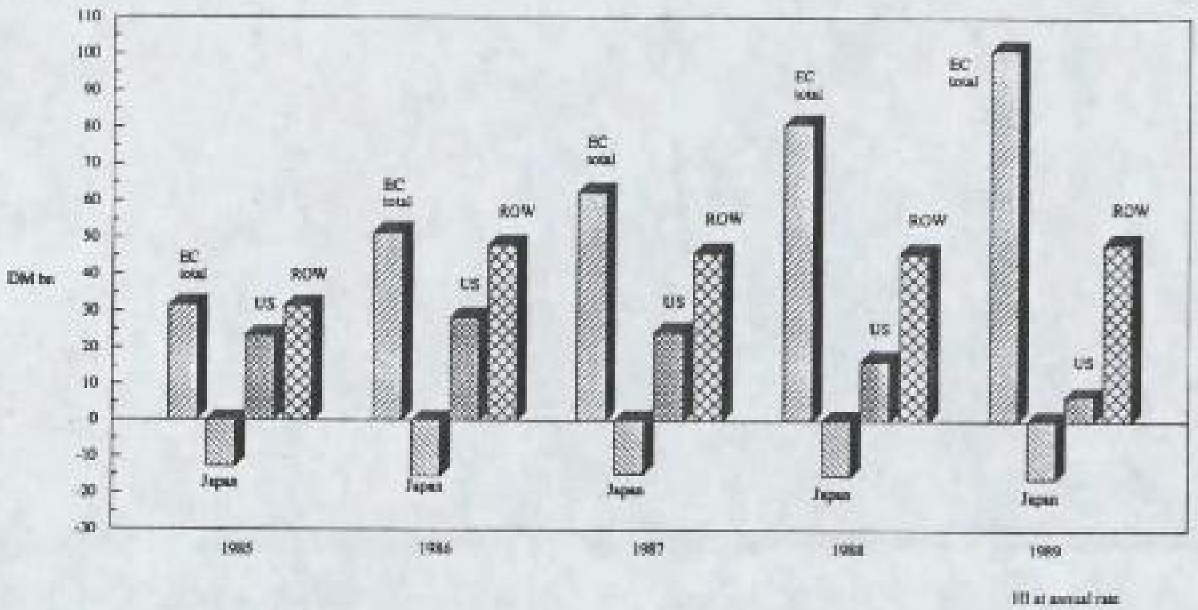

CHART 2

GERMAN BILATERAL TRADE BALANCES

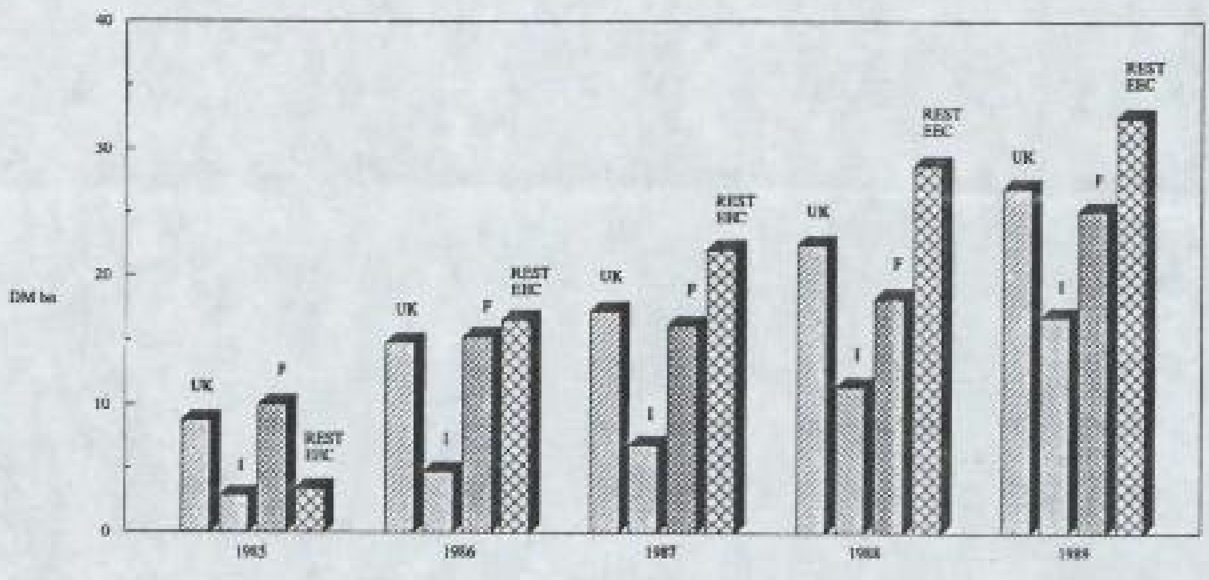

Table 3: Gross Saving and Investment as a proportion of GNP in 1987

	UK	Germany	G7 Average
Household	3.9	9.6	9.5
Corporate	13.2	12.4	10.4
Total Private	17.1	22.0	20.0
General Government	0.0	1.9	0.1
Total Saving	17.1	23.9	20.1
Total Investment	17.3	19.4	20.0

5. Of course, aggregate savings and investment reflect the influence of more fundamental factors such as the policy stance, the real exchange rate and structural and demographic factors.

Demographic Factors

6. It is often argued that economies in which the number of dependent over 65s is expected to rise will have a higher savings ratio than those where this proportion is expected to remain stable. Two reasons are given. Firstly, the government will need to save more to build up reserves to meet future pension liabilities. Without this there is the prospect of higher future tax rates, with adverse consequences for incentives. Secondly, where there are large numbers of people who have completed their families and are now saving for retirement the savings ratio will tend to be high. The age dependency ratio in Germany is expected to rise from about 22 per cent now to 30 per cent by 2010, a significantly higher proportion than in any other major industrial country. Therefore, high saving, both by the government and the private sector, is both to be expected and desirable in these circumstances. As the proportion of retired people increases the savings ratio will tend to decline, although the speed and extent is obviously rather uncertain.

take account of recent immigration from E Europe?

Structural Factors

7. The extent of structural rigidities and protectionist practices, including subsidies, in Germany is well known. The UK,

together with international organisations, have argued that there is considerable scope for reform, which would benefit German consumers, and by improving German economic performance create a larger and more dynamic market for its trading partners. To the extent that the present rigidities act as barriers to investment, consumption and imports, further structural reform may reduce the current account surplus. However, structural reform will also, over the medium term, increase the efficiency of the German economy, especially services, and this, by itself, would tend to increase the current account surplus. The net effect of these two forces, increasing both supply and demand, is uncertain.

8. Additionally, there are reasons for thinking that some of the German structural rigidities impede the adjustment of the economy to a current account surplus. This comes about because the rigidities may reduce both the responsiveness of the exchange rate to any given surplus, and the current account to any given change in the exchange rate. So the Deutschemark tends to appreciate less and the surplus remain higher than they would if there were greater flexibility. The fact that both financial markets and the production of non-traded services are areas where rigidities are prevalent lends weight to this view.

The Deutschemark

9. In effective terms the Deutschemark was quite stable between the Louvre accord and the autumn of 1988, when it weakened a little, and then remained low until early September, since when it has strengthened noticeably. The weakness earlier this year, together with the recent strengthening, seem partly to reflect interest rate differentials against the dollar, which reached a peak at the end of 1988, and have fallen gradually during 1989: it is now close to zero. The effective exchange rate and interest differential are shown in chart 3.

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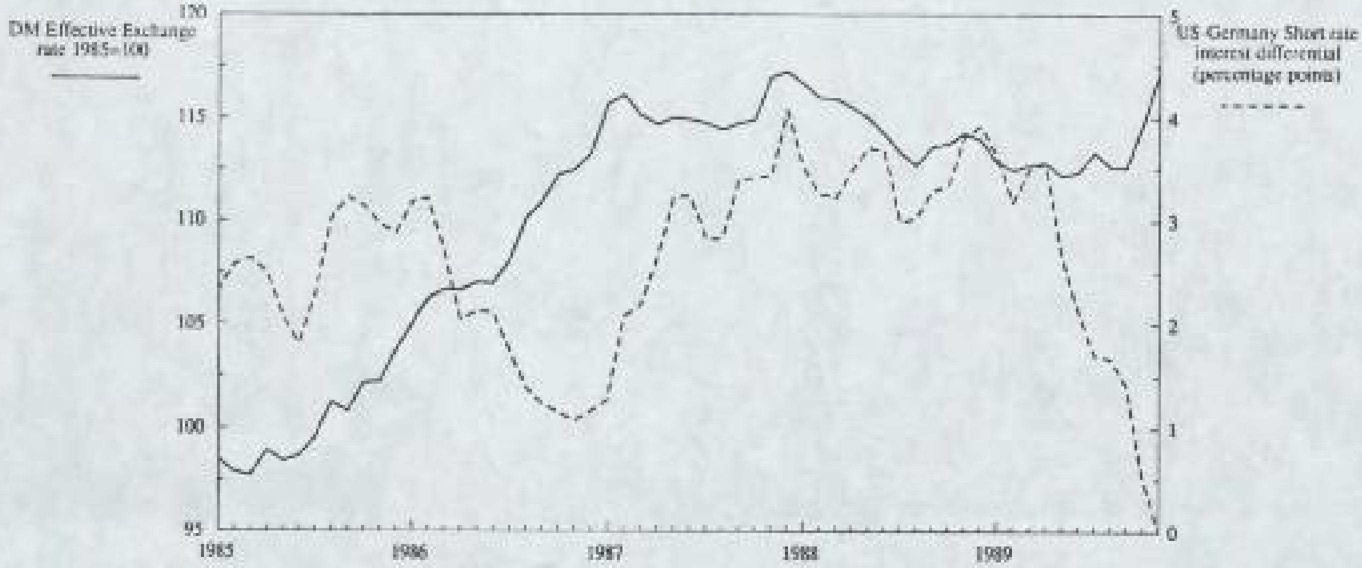
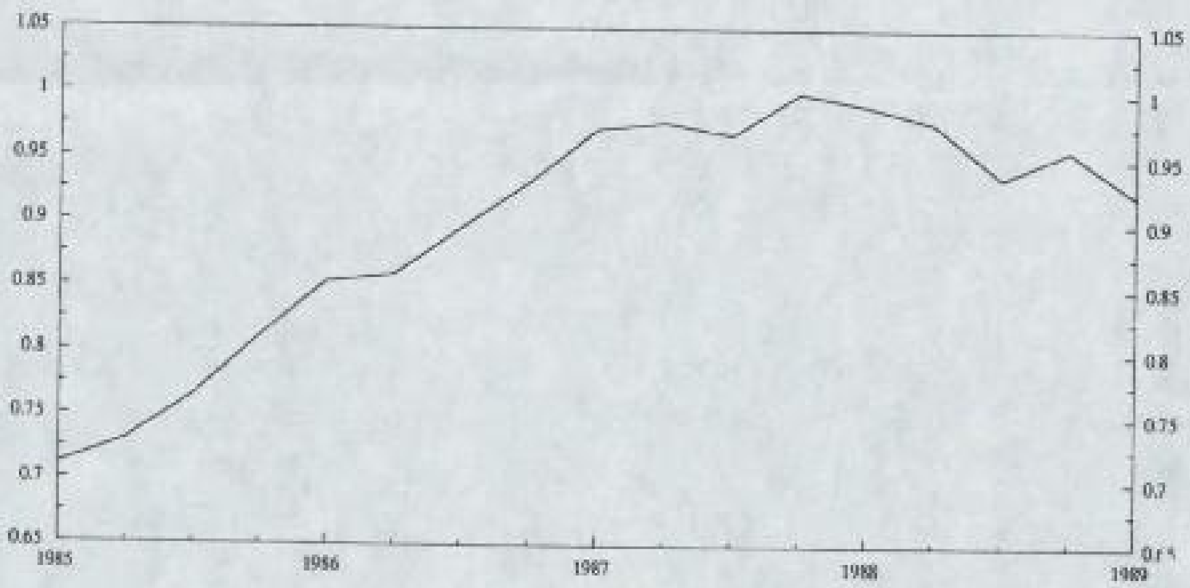
CHART 3



10. The stability of the nominal exchange rate since early 1987, together with good inflation performance and stable unit labour costs in manufacturing mean that German competitiveness, as measured by relative unit labour costs, has gradually improved since late 1987, although only to the extent of reversing about one third of the competitiveness lost between 1985 and 1987, see chart 4.

CHART 4

GERMAN RELATIVE UNIT LABOUR COSTS



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11. Most other European economies have, at least until this year, maintained a good level of competitiveness against Germany since the beginning of 1987, the time of the last ERM realignment, as table 4 below shows. France, Belgium and the Netherlands have actually improved their competitiveness.

Table 4: Unit labour costs relative to those in Germany*

1986=100	UK	France	Italy	Belgium	Denmark	Netherlands
1987	90.1	93.1	96.4	94.8	105.2	99.7
1988	98.2	89.4	97.4	89.6	106.9	98.9
1989 Q1	103.6	87.2	102.6	88.4	105.6	97.3
Q2	101.8	87.0	104.3	87.9	105.9	95.2

Unit labour costs in domestic currencies converted to DM using bilateral exchange rates and expressed relative to German unit labour costs. Values less than 100 represent an improvement relative to Germany.

12. Against a background of pervasive structural rigidities, the changes in competitiveness brought about by exchange rate movements have probably had only a minor effect on the current account surplus. This is confirmed by model simulation exercises which show, for Germany, a prolonged J curve effect and weak competitiveness effects. This implies that an exchange rate appreciation would take some time to reduce the current account surplus, and then only by a small amount.

13. Since the beginning of September the Deutschemark has appreciated by between 4 and 5 per cent. The reduction in the interest differential with the dollar in October, the relative buoyancy of activity in Germany and the possible need for further monetary tightening, and the increasing current account surplus have all contributed. Developments in Eastern Europe probably reinforce this trend, as does the weakening of the US economy and the likelihood of lower dollar interest rates.