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Trump is correct: German surplus is bad news for everybody else

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Donald Trump with German chancellor Angela Merkel

Over the past week it has been easy to believe that the most important economic issues have their roots in politics. I will discuss the impact of this week's general election on things economic next week, once the result is known. But amid all this hullabaloo, some other developments have taken a worrying turn, especially the evident strain that has developed in US/German relations, most recently over climate change, but before that over trade. Put climate change to one side. Does Donald Trump have a point on trade?

The United States runs deficits on its external accounts, that is to say, it buys more from abroad than it sells abroad. In the process, it exports employment and profit possibilities to other countries. Germany does exactly the opposite. It is running a surplus on its current account (broadly speaking, exports minus imports) of over 8pc of GDP. This is what lay behind President Trump's recent outburst at the G7 summit in Taormina, Sicily, describing German trade practices as "very, very bad".

Yet most Germans are proud of their surplus and suggest that other countries would be better if they copied Germany, seemingly oblivious of the fact that in order for Germany to be able to have a surplus, someone else has to have a deficit.

The problem now extends beyond Germany. The workings of the single currency have turned the whole eurozone Teutonic. The eurozone's external surplus now exceeds the combined surpluses of China and Japan. Germany and the euro are the source of the world economy's greatest imbalance.

Interestingly, there has been support for the German position on trade from some economists. They say that the US's external deficit is not connected with trade practices in Germany or any other country but is rather the inevitable outcome of the imbalance between American savings and investment. In short, Americans collectively do not save enough.

This argument completely misses the point. Of course, it is true that the US is under-saving or, if you like, over-spending. Indeed, if a country is running an external deficit, this is true by definition. But things that are true by definition are completely empty with regard to what they say about behaviour.

Suppose that the US imposed a tariff on imports and that this had the effect of diverting demand to American-made products. Given available spare resources, this increased demand would increase American incomes and employment. Increased incomes produce increased savings. So there is a mechanism through which a change in behaviour set off by changes in competitiveness and/or policy reduces the deficiency of savings that is definitionally implied by the external deficit.

A variant of the argument about the centrality of savings behaviour ascribes the US external deficit particularly to the US fiscal deficit, that is, the excess of government spending over tax receipts. Those who take this view argue that if the American government reduced its spending and/or increased taxation (that is, reduced its negative saving) in order to reduce its budget deficit then, hey presto, the external deficit would also fall back.

They are right, up to a point. But the consequent contraction of demand would also depress the American economy. Moreover, there is no absolute or necessary aggregate connection between the size of, or even the direction of movement in, the public sector deficit and the external deficit.

For example, in the late 1980s, the UK underwent a boom that led to higher tax receipts, with the result that the government budget deficit turned to surplus. (At the time, some experts misguidedly forecast the elimination of the whole of the UK's national debt.) Simultaneously, this increased spending caused a big rise in imports, with the result that the external deficit increased substantially. So the budget balance and the external balance went in opposite directions.

Germany's economic policy is under pressure not only from President Trump. The new president of France, Emmanuel Macron, and umpteen other European leaders want Germany to relax the stance of its fiscal policy. They are right. Yes, Germany tends to save quite a lot and yes it produces some wonderful goods for export. But the German surplus is far from being inevitable. Over and above these factors, it arises from the interaction between tight German fiscal policy and the gains to competitiveness that have occurred to Germany as a result of being part of the single currency. The latter cannot easily be undone, unless Germany leaves the euro.

But fiscal policy could be relaxed. Germany is currently running a budget surplus that is due to grow over coming years. Its debt ratio which, at 68pc, is about 20pc below our own, is due to fall quite substantially. Looser German fiscal policy would mean a lower German national saving rate and, as a result, a lower external surplus.

All this has relevance to the present British situation. The UK is nursing a large external deficit of about 4½pc of GDP and a largeish budget deficit of 3pc. If the Conservatives win this week and continue with their policy of gradually reducing the budget deficit through fiscal tightening, then you might expect the external deficit to contract also. But things are not so simple. The value of the pound will exert a critical influence. If it stays down, then the external deficit will probably come down alongside the budget deficit, but this will not happen if the pound shoots back up to pre-referendum levels.

Should Jeremy Corbyn prevail, by contrast, he would apparently pursue a much looser fiscal stance that would, other things equal, imply a larger external deficit. But the pound would be critical here also. I venture to suggest that in the event of a Corbyn victory the pound would be much, much weaker, even if the Bank of England raised interest rates. Readers may recall that I have approved of the weakness of the pound since the referendum. But let me make this absolutely clear: you can have too much of a good thing.

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