The World Economy According to an Excess Savings Country

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The position of any country in the process of global economic policy discussion and coordination is determined to a large extent by a combination of its economic fundamentals and the perception of how the economy works.

For the German economy, the key fundamental characteristic is that of continuing excess savings. Indeed for most of the time since the early 1950s, national savings in Germany have tended to exceed national investment, resulting in a continuing series of current account surpluses. The decade following unification constitutes the only deviation from this constant characteristic as the cost of unification was so large that Germany ran a current account deficit for over 10 years. But once the country had adjusted to its new situation, the old pattern of excess savings re-asserted itself.

Most German savings are intermediated by the domestic banking system, which has difficulties investing these surpluses abroad given that it cannot really take any large exchange rate risk. Before the launch of the Economic and Monetary Union (EMU), this constraint kept the surplus within limits most of the time (less than 1-2 percent of GDP). With the advent of the euro, however, German surpluses could become much larger and seem now to have become structurally engrained at 6 percent of GDP, or over one-quarter of total national savings.

When the excess savings reappeared in the early years of the euro, the large German surpluses did not constitute a problem for the global economy, as the excess German savings went into the eurozone periphery with the assumption that the high growth rates of these economies and the 'umbrella' of the euro made these a secure investment. The external current account of the eurozone thus remained in rough balance until 2011, as excess German savings were initially offset by dis-savings in the eurozone periphery.

The euro crisis, however, has changed this picture radically. As capital has fled from the euro periphery, these countries have had to adjust by reducing their domestic expenditure, thereby eliminating their current account deficits. The result has been that the eurozone is now on course to run a large current account surplus. In 2014, it is likely that the current account surplus of the eurozone will be much larger than that of Japan and about the same size as that of China (around $300 billion); and the surplus of the eurozone plus that of Switzerland (whose currency is pegged to the euro) will be the largest in world. Excluding Germany, the rest of the eurozone is now also in surplus in the aggregate. Moreover, the current account surplus of the eurozone is projected by the IMF to increase to about 2.5% of GDP. This implies that the eurozone (together with its satellites) is now exerting a substantial deflationary impact on the global economy.

Given that the current account surplus has by now persisted in Germany for a decade, it has become ingrained in the economic structure of the country. Powerful interest groups, which are often inclined to defend the status quo, thus have a tendency to portray this situation as 'natural' and in the interest of the country. This has affected the perception of the government which tends to argue that the German surplus is an expression of a superior economic system, one that is more 'competitive' than others.

A strict economic view of the situation would be different: the large current account surplus reflects an excess of domestic savings over domestic investment. Whether a continuation of this situation is in the interest of the German economy depends on the relative rates of return one can expect on domestic investment relative to foreign investment.

This question of what Germany actually earns on its foreign assets constitutes the Achilles heel of Germany's economic strategy. Since the start of the euro crisis, German private savers have repatriated a large part of their investments from the eurozone periphery, effectively unloading their exposure onto the public sector as German banks have deposited hundreds of billions of euro at the Bundesbank. The interest rate paid by the ECB on these hundreds of billions of euro deposits is zero. This implies that German savers receive a negative real return on a significant part of their foreign investments. At the end of 2012, the claims of the Bundesbank towards the euro system totalled some €800 billion, which is about equal to 80 percent of the entire net foreign asset position of the country.[1] The return on a very large part of German investment abroad is thus zero in nominal terms and thus necessarily negative in real terms. But at the same time, there must be plenty of domestic investment opportunities that would yield a positive real return for the country. Public investment in infrastructure has been falling in Germany and is now below the average for the eurozone, and much below the average for developed countries in general. Moreover, an incipient housing shortage is developing in a number of German cities. More investment in housing should thus also yield a good real return. This suggests that it cannot be in the long-term interest of the German economy to continue to accumulate very large current account surpluses when the rate of return on foreign investments is so low.[2]

During a financial crisis, excess savings provide of course a quite different advantage for the country as they protect the country's financial system from the disruption that the debtors face. In this case, the onset of the crisis actually led to the realisation of large losses that German banks had made in their investment in U.S. subprime assets, which had during the boom years been regarded as riskless and classified as AAA. However, these losses could be hidden from public view by putting them into special vehicles whose accounts are so opaque that the true losses, which will have to be borne by the government, will not be known for years. The financial crisis thus created the impression to the German public (and political elite) that a current account surplus protects against any negative effect from a financial crisis. This is partially true in the sense that Germany was protected from the financial distress that brought havoc to the debtor countries. But one must keep in mind that Germany could have such a large surplus only because the debtors had run up such large deficits and debts.

This brings one back to the obvious point that it would be impossible for all countries in the world to have a savings surplus. The key issue for the global economy is thus where additional investment would have the highest return. This question should be placed at the centre of G-20 discussions on the global economy. In reality, however, the 'mutual assessment process' is driven by the perceptions of the participating governments of their national interests, each taken individually.

The position of the German government in the G-20 process is thus determined mostly by its perception that ideally, the global economy should be managed in such a way that the German surpluses can continue, while that at the same time, other countries adopt policies that enable them to service their debt towards German investors. A priori this would imply that an expansionary monetary policy in the rest of the world is not in Germany's interest as this would tend to depress other currencies relative to the euro, which in turn would make it more difficult for German exports, but also, and this might be more relevant, it would devalue the foreign assets held by German investors.

It is thus not surprising that from a German point of view, the various rounds of quantitative easing (QE) by the Fed were not welcome when they were instituted. However, it now appears that unconventional monetary policy actually is about to achieve its aim, namely to kick-start the U.S. economy such that both consumption and investment start growing again without needing further stimulus. Indeed, the U.S. economy seems now close to this situation. This implies that German criticism of 'excessively lax' macroeconomic policies must now be more muted as these policies seem to have yielded a result which should be in Germany's interest: a resumption of growth without a major depreciation of the U.S. dollar.

Germany is of course not the only player whose past criticism of U.S. macroeconomic policy must be re-evaluated. The talk about 'currency wars' from some emerging market economies thus seems, in retrospect, misplaced.

The key question now is whether the eurozone as such will become effectively a greater Germany. One might compare the eurozone today with the situation of Germany before EMU. Before the introduction of the euro, German excess savings exerted generally upward pressure on the nominal exchange rate of the deutsche mark. But the exchange rate appreciated very unevenly, with periods of relative stability interspersed with periods of rapid appreciation, during which the real economy suffered numerous exchange rate shocks. In periods of a quickly appreciating exchange rate, slowing export growth tended to reduce the current account surplus, but it also lowered GDP growth and raised unemployment. Conversely, in periods of exchange rate stability, accelerating export growth tended to lead to growing current account surpluses but also to stronger GDP growth and lower unemployment.

The exchange rate barrier thus kept the German current account surpluses from rising much above 2-3 percent of GDP. An economy of the size of the eurozone is also likely to experience similar difficulties in running a surplus above this size. It would thus appear to be in Germany's best interest that the rest of the eurozone does not become too Germanic in its savings habits. As for the rest of the world, Germany can only hope that stimulus abroad works so that foreigners can continue to buy German goods and services and hopefully service the debt accumulated in the meantime.

Endnotes

[1] The German government might receive a small positive nominal return since these funds are being lent by the ECB to banks in the eurozone periphery (at 25 bps), and the ECB might thus make a minuscule return on these funds, of which the Bundesbank will receive a large share. Still, this return will certainly be negative in real terms.

[2] Over the period 2008-2012 Germany accumulated current account surpluses worth €644 billion, but the net foreign asset position of the country improved by €200 billion less than this figure. These €200 billion represent the losses on the value of German foreign investment abroad. In this way the country wasted resources worth about 10 percent of GDP.