Mr Remsperger addresses the imbalances in global savings and analyses the savings process and investment structure in Germany*

Lecture given by Prof Dr Hermann Remsperger, Member of the Board of the Deutsche Bundesbank, at the "Seminar for Central Banks and Governmental Institutions", held in Kempfenhausen on 21 October 1999.

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Ladies and gentlemen,

I would like to present my ideas in two parts. In the first part I shall address the imbalances in global savings. The second part will then focus on analysing the savings process in Germany. In doing so, I shall mainly deal with the decline in the savings ratio, although I shall also go into the globalisation of German savings.

Global savings imbalances in the 1990s – the "absorption effect" of the United States

Let me start by reminding you that after the fall of the "Iron Curtain" the question was raised as to whether the world financial markets were at all able to provide the considerable additional funds needed both for investing in the developing and emerging market economies and for reconstructing the Central and East European countries in transition along market economy lines, if major western industrial countries such as the United States[1] were simultaneously requiring a significant amount of international resources as a result of their public sector budget deficits. There was talk of a risk of a global "savings gap". At the IMF, which at the time was undertaking an in-depth examination of the problem of savings in a growing world economy, this was put in the following words:

"With today's large potential investment demands, especially in emerging market economies in the developing world and among the countries in transition from central planning, the question naturally arises whether the supply of saving will be adequate to finance worthwhile projects around the world. The question is made sharper because of growing pressures on savings. Since the early 1980s, government absorption of private sector saving has increased sharply, and the retirement-age populations of some industrial countries are starting to increase rapidly."[2]

But today, we may say that global savings have obviously grown more sharply than the total demand for funds. A major contributing factor to this has been the reduction in excessive government deficits which was prompted in Europe, not least by compliance with the fiscal criteria for entry into the planned monetary union. In terms of gross domestic product, the budget deficits in the European Union fell from 6% to slightly below 2%[3] in the period between 1993 and 1998. In the United States, the considerable budget deficits have even turned into surpluses. On the demand side, the fact that the development of capital spending in many countries was subdued following the 1993 recession also contributed to an easing of the situation, insofar as external financing requirements of the private sector remained limited.

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1 The financing deficit of the federal budget was 3½% of GDP on average in the years 1990-93.

2 International Monetary Fund, *World Economic Outlook*, May 1995, p. 67.

3 The IMF's estimates for 1999 are 1½% altogether.

In the meantime, the turbulence emanating from South-East Asia which rapidly shook the financial and foreign exchange markets one after another, as well as the severe structural crisis in Japan, have led to the emergence of new macroeconomic imbalances. This is characterised by the high aggregate surpluses of the economies in the emerging markets of South-East Asia which, with their own absorption being weak, set off a massive export offensive. An additional factor is the large surplus in the Japanese external balance. By contrast, the United States has a large external deficit, whereas the European economies have been less affected – at least directly – by the shocks from the Far East.[4]

Above all, the "sucking-in" of imports which went with the robust domestic economy led, within a short period, to a rapid expansion of the current account deficit in the United States. In 1998, it accounted for around 2½% of gross domestic product and was one and a half times as high as on an average of the years 1995-97 and is likely to rise even further in 1999. The United States' increasing recourse to foreign resources, which is reflected by those figures, is closely linked to the decline in private savings of US citizens. This decline has not even been offset by the notable progress made in consolidation by the public sector.[5] The savings ratio of the US population was almost halved in the 1980s.[6] Thereafter, it weakened further. In 1998, the savings volume was only one-seventh of the amount at the beginning of the 1990s. The private savings ratio has now reached negative territory.

The continuous and steep decline in savings primarily reflects a sharp expansion of private consumption. Along with the similarly strong growth in fixed capital expenditure, private consumption has played a key part in stabilising economic growth in the United States for more than seven years now and in creating almost 14 million new jobs. Consumption has been given an additional stimulus by the sharp increases in asset values.[7] The general assumption is that only 5% of each one-dollar gain in value results directly in an expansion of consumer spending.[8] If the volume of capital gains from the exceptional boom in the stock market is added to the equation, however, the wealth effect is indeed of some quite considerable relevance.

The US population's net financial assets at the end of 1998 were slightly less than USD19,000 billion and have hence more than doubled since 1990. Only around one-third of the growth in assets was due to current savings, two-thirds was mainly attributable to capital gains from direct and indirect private equity holdings. On an annual average, this meant a valuation gain of just under USD1,000 billion or almost one-fifth of disposable income. As a result, the distribution of wealth is likely to have widened further. Moreover, it is likely that capital gains in assets have also been regarded as a substitute for savings.

At this point, please allow me to make the cautious observation that it is only the existence of a favourable growth-interest rate situation accompanying a given external primary balance which makes it possible for the total use of funds for consumption and investment to exceed the scope for income of the economy as a whole for any extended period of time. If that is not the case, the country in question has a sustainability problem. At any rate, it should not be forgotten that the funding of current consumption by capital imports represents a burden on future incomes, since, in this case, the servicing of debt cannot be generated from a higher capital stock. At the same time, there is a cyclical

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4 See also Deutsche Bundesbank, External economic adjustments in the industrial countries after the crises in major emerging markets, *Monthly Report*, September 1999, p. 27 ff.

5 In 1998 the Federal budget alone closed with a surplus of 1.6% of GDP; an even better result is expected for 1999.

6 According to the NIPA concept, from slightly below one-tenth to no more than 5%.

7 See H C Sherman, Die amerikanische Sparquote sinkt auf Null, IFO Schnelldienst 8/99 p. 10 ff.; BHF-Bank, USA: Entwicklung des Aktienmarktes beeinflußt Sparquote und Konsum, *Wirtschaftsdienst Nr. 1926* vom 24.3.1999; L Boone, C Giorno and P Richardson, Stock market fluctuations and consumption behaviour: some recent evidence, *OECD Economics Department Working Papers*, No. 208, Dec. 1998.

8 See S Ludvigson and Ch Steindel, How important is the stock market effect on consumption? in *FRBNY Economic Policy Review*, July 1999, p. 32.

downside risk associated with the savings gap in the national economy caused in part by wealth effects.

Scale and underlying causes of the decline in private savings in Germany

Unlike in the United States, savings trends in Western Europe as a whole, and in Germany in particular, have been less dramatic and rather quiet. Even so, there have been some major structural changes in Germany, too. For example, the private savings ratio has been declining in Germany since the early-1990s as well. If, as an initial stage of adjustment to the new methodology of the ESA 95, the calculation of savings is extended to include the purchase and use of private residential property and the related financing process, then the private savings ratio is estimated to have fallen by around 3 percentage points between 1991 and 1998. At around 10½% latterly it roughly corresponded to the 1967 level. The decline in savings in Germany has thus been somewhat weaker than in the United States, although it stands in marked contrast to the development in other countries (such as France and the United Kingdom).[9]

Since German unification the declining trend in savings also contrasts quite clearly with the cyclical savings pattern which – although quite often eclipsed by special factors – had prevailed in Western Germany since 1970 in line with the development of households' real incomes. The pro-cyclical savings behaviour suggests that German households basically preferred as steady a supply of consumer goods as possible. In doing so, they were guided by the experience that changes in income growth are often not of a permanent nature. Furthermore, there exists the tendency of adjusting only gradually to a new income situation. Both factors resulted in the savings ratio cushioning discontinuities in the income trend at least for some period of time and thus helped in a certain sense to smooth consumption over time.

The fact that the previous savings pattern gave way to a continuous downward trend from the early 1990s initially reflected a return to normal from the high level reached in 1990. At that time, the 1986-90 tax reform had considerably expanded households' scope of action in the old Länder. Thereafter, both cyclical and structural factors led to a lower propensity to save. In the period from 1992–1998 real disposable income per capita grew at an average of ¾% and hence less strongly than real consumption (+1%).

The deceleration of income growth was accompanied by a marked divergence of the income situation within the households sector which already becomes evident in the differing developments in the individual categories of income. There was a sharp reduction in employment in the 1990s. The resultant losses in income led to labour income becoming continuously less important as a source of savings within private income budgets. Transfer payments were not able to provide an adequate counterweight to this.

An equally negative effect came from the sharp fall in interest rates since autumn 1990 which – in terms of the yield on bonds outstanding – reached almost 5½ percentage points by the end of 1998. As a result, income from financial assets lost a considerable amount of momentum and was no longer able to act as a mainstay of savings in its own right to the same degree as it had done before. The stronger preference for investments with potential capital appreciation had the same statistical effect. According to the usual methodological definitions of the national accounts, revaluation gains are reflected neither in income nor in savings.

As a rule, a certain part of the received interest payments and dividends is reinvested, although the level cannot be quantified exactly. Over the longer term, this self-alimentation of savings has undoubtedly increased. This is revealed, for example, by the preference for insurance savings and

[9] See also Deutsche Bundesbank, Overall financial flows in 1998, *Monthly Report*, June 1999, p. 26 ff.; Deutsche Bundesbank, Changes in households' asset situation since the beginning of the nineties, *Monthly Report*, January 1999, p. 33 ff.

portfolio investments. If, for the sake of simplicity, total income from financial assets is used as a yardstick, in the years 1997/1998 this accounted for around three-quarters of the concurrent financial asset formation, but this was well down on the comparable figure at the time of the last peak in interest rates (82%).

The cumulative negative influences emanating from labour and property income could no longer be offset by the relatively higher savings resulting from the stronger expansion of entrepreneurial income. Households in the new Länder were affected by this much more than those in Western Germany. The considerable boost to income in the first few years after German unification – a good part of which was financed by western transfer payments – led to East German savings ratios initially rapidly approaching a level comparable to that in Western Germany. The fact that the catching-up process subsequently faltered had a significant adverse impact on the savings activities of the population in Eastern Germany.

The deterioration of the income situation was further aggravated by the increasing burden of taxes and social security contributions. In 1998, the wage tax and social security contributions alone, accounted for around 22% of private gross income, that means 1½ percentage points above its 1991 level. Higher indirect taxes were an additional factor.

Besides the sluggish development of the economy as a whole, the declining power of self-alimentation and the upward movement of the fiscal burden, the increasing share of households with a low savings ratio also had a contractionary impact on savings in the longer term. Those households include, for example, single-person households, whose number has risen more than twice as fast as that of all households in the old Länder in the past 20 years. Firstly, this reflects the ageing of society.[10] Secondly, changes in the spending behaviour of people growing up can also be observed. Evidently, present consumption has gained ground at the expense of future consumption.

The younger generation's higher propensity to consume has probably been boosted as well by expectations of future inheritances and gifts which are regarded as a substitute for own provisions for the future. The inheritance volume alone probably amounts at present to between DM200 billion and DM250 billion annually. The importance of financial asset transfers between the generations is likely to increase further. It remains to be seen whether this will have a dampening effect on private savings and the domestic supply of capital in the future.[11]

With a view to the Anglo-Saxon countries it is justified to ask whether wealth effects might not also have played a role in the decline in savings in Germany in the 1990s. In my opinion, such influences can be more or less neglected in Germany so far. For example, four-fifths of the increase in private financial assets from 1990–1998 was due to the accumulation of current savings and only one-fifth – on account of the limited holding of shares – was attributable to capital gains.[12] In the United States and the United Kingdom the corresponding ratio was around two-thirds. Though I am sometimes told by some of my friends that they could finance a nice holiday from higher stock prices, I am firmly convinced that the phenomenon of consuming capital gains tends to be an alien one for shareholders in Germany.

10 Demographic changes may, according to empirical evidence, have a strong impact on private savings. See also M Higgins, Demography, National Savings and International Capital Flows, *International Economic Review*, Vol. 39 (2) 1998, p. 343-369.

11 The importance of inheritances is emphasised, for example, by D N Weil, The Saving of the Elderly in Micro and Macro Data. *Quarterly Journal of Economics*, Vol. 109 (1), 1994, p. 55-81.

12 Based on disposable income the holding gains accounted for an estimated 3% on average in the years 1991-98, compared with slightly below one-fifth in the United States.

Shifts in the investment structure

The decline in savings in Germany was mainly reflected in lower private financial asset formation, which contrasted with an increasing preference for the acquisition of fixed assets. Firstly, the shortage of housing accommodation owing to the considerable inflow of immigrants in the late-1980s and early-1990s and the ensuing rise in rents was a strong incentive for capital spending in the housing sector. Secondly, this trend was further reinforced by the sustained fall in mortgage costs and the many different public sector promotional measures which favoured external financing and, moreover, directed a considerable amount of private capital into the new Länder. Whereas private gross capital spending on residential property accounted for around 7½% of disposable income in 1991, it reached 10% in the peak years of 1994-95, when residential housing construction boomed. Owing to weaker demand for residential property as investment, this ratio had gone down again somewhat by 1998, although the preference for owner-occupied accommodation had a stabilising effect.

Private financial asset formation has fallen from slightly more than 13% at the time of German unification to 10% of disposable income in 1998. Given the continuing decline of interest rates, yield-oriented investors preferred forms of saving with a comparatively favourable return or a correspondingly high potential for capital gains. Investment in shares benefited from this trend, receiving an additional stimulus from the upturn in the stock market as well as from the Deutsche Telekom going public and the introduction of new stock market segments. Purchases of investment fund certificates expanded, with the focus of investment recently shifting increasingly towards share-based funds. The turbulences on stock exchanges in the past few years have so far not had much of an effect on the growing preference for equity investments. Furthermore, a large number of corresponding commitments are being stabilised by investment savings plans.

Purchases of certificates have proved to be an ideal vehicle for diversifying private financial assets internationally. An estimated DM40 billion alone flowed into foreign share certificates or into the certificates of internationally operating German share-based funds in 1998. This was twice the amount as in the previous year. All in all, one-fifth of German private gross financial asset formation might have taken place abroad last year. Private foreign assets – as far as they can be recorded statistically[13] – thus rose to an estimated DM500 billion by the end of 1998. This figure was twice as high as at the beginning of the 1990s and corresponded to almost one-tenth of total private financial assets.

Private households invested a steady flow of funds into what is known as contractual saving. Apart from tax considerations, the driving force behind the investment of funds with insurance enterprises, was mainly uncertainty about the statutory pension system, along with the high degree of monetary stability and the comparatively attractive rates of return. Private net savings with life insurance enterprises alone almost doubled to around DM77 billion (including accumulated interest payments and profit credits) between 1991 and 1998. By contrast, the “free” financial investments, i.e. those without any longer-term contractual link, shrank by around one-quarter in the same period. Given the low interest rates this was especially at the expense of funds placed with banks or bond market investments. Credit institutions were only temporarily able to buck this trend by offering special savings instruments at attractive interest rates.

If private investments with life insurance enterprises (and pension funds) and in investment funds are taken together, this produces an investment volume of DM1,650 billion as of end-1998 – almost a doubling in volume since 1990. Its share in the statistically recordable private financial assets rose from around one-fifth to almost 30% during that period. The proportion accounted for by equities also increased to almost one-tenth. The bond portfolio has been just about able to hold its place in the ranking of investment vehicles since 1990. The overall proportion of certificates, shares and interest bearing securities in private assets has increased quite considerably from 24% to 32% during the nineties, whereas funds placed with banks continued to lose considerable ground (from 48½% to 40%).

[13] Mainly in the form of direct and indirect securities holdings.

With the increasing focus on real assets, individuals' propensity to borrow also rose temporarily in the 1990s. However, in terms of their level of indebtedness, German households remained at the lower end of the international league. As in similar earlier periods, higher external financing of private fixed asset investments was stimulated by declining interest rates and a government promotion policy which favoured borrowing. However, the peak is likely to have been passed in 1993-94. In the ensuing period, the shifts of emphasis in residential construction and the gradual reduction of tax privileges tended rather to support higher internal financing again. By contrast, the decline in interest rates has not significantly increased the propensity to raise consumer borrowings; this is also supported by relevant studies.[14]

Implications for economic policy

The long-term changes in asset formation and investor behaviour show not only that German households have a consistently strong preference for the acquisition of real estate, but also that they have become increasingly sensitive in their portfolio allocation. As far back as the early-1970s, an increased yield awareness – not least under the impact of the inflationary pressure at that time – gave rise to a greater diversification of private financial investments. As a result, investments with insurance companies or in the bond market moved to the fore in investor's preferences. In the 1990s a greater willingness to incur risks – undoubtedly encouraged by the stock market rally – and an open-minded attitude towards new developments in the capital markets has boosted the preference for securities. This benefited not only the expansion of a share-buying "culture" in Germany, but also the professionalisation and globalisation of private portfolios.

To secure a high-quality domestic supply of funds in the long term, the process of maturing among German investors should not be disturbed politically. It is equally important to encourage private savings, which in Germany – unlike in the United States – has mainly been suffering since the early-1990s from a gloomier economic situation and a variety of unresolved economic problems. A number of economic and fiscal policy considerations can be derived from this.

First of all, this includes substantial and continuous progress in the labour market. I believe that a reliable moderate wage policy, a differentiation of the wage structure and a greater flexibility of labour input remain indispensable in this context. In addition, fiscal policy has to provide enterprises and households with greater planning certainty and better incentives for performance. A more equal distribution of burdens between the generations is also essential, as are stimuli to increase private provisions for old age in order to create a third pillar alongside statutory and company pension systems.

Such ideas have now been incorporated into the Federal government's plans to reform the pension system. This might even be underpinned by specifically targeted fiscal measures.[15] With a view to enterprises, it will be particularly important, given the global challenges, to produce a sustained strengthening of the earnings base for forming sufficient risk capital, since this is the only way to create a macroeconomic counterweight to offset a decline in private savings.

The necessary reforms entail budgetary burdens. The only way to cope with them will be by ensuring that the state spending ratio is simultaneously lowered over the medium term. A sustained consolidation of public sector finance would tend to increase the savings ratio in the economy as a whole and would hence take account of future demographic change.[16] Recently, Alan Greenspan also

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[14] See H-J Hansen, The impact of interest rates on private consumption in Germany, Economic Research Group of the Deutsche Bundesbank, *Discussion paper 3/96*.

[15] See also M Feldstein, Fiscal policies, capital formation, and capitalism, in *European Economic Review 39* (1995), p. 418. "Instead of correcting the tax and transfer problems that have contributed to the low rate of capital formation and growth, the natural tendency of the political process may be to emphasize policies that appear to have favourable short-term effects but that ignore the longer term consequences."

[16] See Deutsche Bundesbank, The economic scene in Germany in spring 1999, *Monthly Report*, May 1999, p. 67.

drew attention to this point again in a statement he made on the statutory pension system to the House of Representatives.[17]

In Germany, up to now households have been the most important provider of savings. Of course, the funds provided by them, were not sufficient to satisfy the enormous financing requirements of the German unification process. This development is also reflected by the fact that net foreign assets, which were around DM500 billion at the end of 1990, have now declined to one-tenth of that volume owing to transactions and revaluations. This was primarily attributable to the dramatic expansion of the government's and banks' bond market liabilities to foreign lenders. The likewise strongly expanding direct investments and portfolio investments of domestic enterprises and individuals abroad could not keep pace with that. Thus, the public sector's securities liabilities abroad rose from around DM150 billion at the end of 1990 to DM691 billion in the middle of 1998. In the same period, the banks' securities liabilities abroad increased from slightly less than DM45 billion to almost DM450 billion. In other words, this also means that foreign investors' exposure towards Germany has risen sharply in the 1990s. In the past few years the decline in net external assets has slowed down markedly. However, this was due less to a government fiscal policy which also tended to be geared towards consolidation than it was to an easing of the credit markets triggered by enterprises. First, the slowdown in residential housing after 1994 curbed demand for construction financing. Second, for a long time stimuli from exports failed to have a significant impact on capital spending activities. A good part of the overall modest fixed investment could therefore be financed from internal funds.

Major tensions are to be feared if individuals' propensity to save remains at a low level, the consolidation of public sector budgets is not making consistent and rapid progress, while enterprises' investments are again rising more strongly. To avoid a recourse to external resources, the necessary strengthening in profitability of the private sector would then become imperative. Viewed this way, a strengthening of enterprises would not only be a contribution to improving financial conditions in Germany, but also to enhancing stability in Europe.

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[17] See A Greenspan, Statement to the Congress, in *Federal Reserve Bulletin*, May 1999, p. 304, "Only an increase in national saving or an increase in the efficiency with which we use our saving can help us meet the retirement requirements of the coming years".