

The hare and the tortoise

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Why have the world's savings gone to America rather than to Europe?

THIS survey has argued that the supply of global saving—relative to desired investment—has grown in recent years, thanks largely to shifts in Asia and in emerging economies. These shifts may help to explain why global interest rates have been low. But they do not explain the geography of current-account deficits. Why has most of this capital been absorbed by America and, to a lesser extent, other Anglo-Saxon economies such as Britain, rather than continental Europe? After all, the euro area's economy is four-fifths the size of America's; its capital markets are liquid; its currency is stable; and its legal protections are as strong as those anywhere in the world.

Yet far from absorbing the rest of the world's capital, the euro area in 2004 ran a small saving surplus (\$36 billion) of its own. Whereas America's foreign borrowing has accelerated, especially since 2001, the euro area has remained a lender. Though interest rates are low in both regions, the effect seems to have been very different. Is this evidence of Europe's sclerosis and America's dynamism, or of Europe's prudence and America's profligacy?

One answer is that European aggregates mask big differences between countries. For example, in Spain the economy has been humming and the current-account deficit has soared. Italy has been mired in recession, but thanks to its ageing population its household saving rate has plummeted and its current account is in deficit. At the other extreme, Germany has become a large exporter of savings.

More broadly, though, Europe's thriftiness, relative to America's, results from a mixture of demographics, structural rigidities, policymakers who don't much believe in Keynes and financial systems that are less consumption-friendly.

Twenty years ago, saving patterns in America and Europe were not all that different. In the mid-1980s, American households saved, on a net basis, around 9% of their disposable income. The British figure was 7%, the Spanish 8%, the French 9% and the German 12%. Despite big statistical problems in comparing household saving rates, the ranking is probably about right.

In the 1980s and 1990s, household saving rates fell both in Anglo-Saxon economies and (to a lesser extent) in

many continental European ones. Germany saw only a small decline; Italy, with its burgeoning number of pensioners, the largest. But the drop in household saving in America was far bigger than in most of Europe, for two reasons: bigger capital gains and more financial innovation.

Thanks to the long bull market in stocks, particularly after the productivity boom of the mid-1990s, Americans felt richer. A study by Annamaria Lusardi, Jonathan Skinner and Steven Venti of Dartmouth College found that capital gains explain most of the total decline in America's personal saving since the late 1980s. Thanks to a more sophisticated financial system than, say, Germany's bank-dominated arrangements, Americans could also borrow money more easily. Financial innovation has made a huge difference to Americans' access to credit in the past 20 years. Today there are over 1.3 billion credit cards in America, or more than 11 per household.

But whereas household saving rates in the two regions diverged, government saving kept overall national saving rates closer than they would otherwise have been, at least during much of the 1990s. Public finances improved on both sides of the Atlantic, but by more in America. As a result, in 2000, America's overall national saving rate, at 18% of GDP, was not far below the European average of 21% of GDP.

Since 2000, however, the gap has grown much larger. After the stockmarket bubble burst, corporate investment fell on both sides of the Atlantic. That sent Europe's big economies into a trough from which they have not really emerged, whereas in America growth was underpinned by more government and household spending. America's drop in household saving has accelerated, whereas European households, on average, have become slightly thriftier.

Americans now save less than 1% of their disposable income, compared with a euro-area average of 10%. America's budget moved sharply into deficit, whereas Europe's public finances have seen less change. As a result, America's national saving rate is now below 14% of GDP, compared with over 20% for the euro zone.

Old Europe's troubles

One important reason is demographics. "Old Europe" may not like the label, but in the demographic sense it is accurate. Europeans have fewer children than Americans and they allow much less immigration, so European societies are ageing much faster. Relative to America, this reduces Europe's allure as an investment destination and increases its citizens' desire to save.

An analysis in 2000 by PricewaterhouseCoopers, an accounting firm, suggests that demographic changes alone will push up continental Europe's private-sector saving rates by 2-3% of GDP between 1995 and 2015. There is some evidence that the impact of demographics on saving has accelerated recently.

But demography is not quite destiny. Economic reforms could do a lot to make "old Europe" a more attractive place for investment, offsetting the effect of ageing societies. With an average unemployment rate of 9%, the euro area has plenty of spare workers.

Europe has, in fact, made significant progress on economic reform in recent years. Germany's labour market has become more flexible and the country's social benefits have been trimmed. France's pension system has been overhauled. The trouble is that the reforms will take time to translate into economic growth. In the meantime they are making things worse. People save more because they are worried about the future. In Germany, in particular, there is evidence that the uncertainty created by economic reform has boosted the household saving rate. The more people save, the less they spend. The lack of consumer demand, in turn, reduces the incentive for firms to invest.

Yet continental Europe, by and large, has provided far less macroeconomic stimulus than America. Although the euro area's overall budget position went from a surplus of 0.1% of GDP in 2000 to a deficit of 2.7% of GDP in 2004, almost all of this deterioration was due to economic weakness rather than deliberate loosening of the fiscal reins. Allowing for the automatic deterioration in the budget that comes from a slowing economy, the euro area saw no change in its fiscal stance at all, compared with a structural loosening worth 5.5% of GDP in America and 4.5% of GDP in Britain.

So why did Europe hold back? Respect for rules is one reason. The Stability and Growth Pact, which in theory limits the size of euro members' deficits to 3% of GDP, has been severely weakened, but it still restricts the euro-zone governments' room to run big deficits. More important, European policymakers tend to regard fiscal expansions as reckless and ineffective.

That is partly because their long-term fiscal outlook is so dire. Thanks to their generous social safety nets and rapidly ageing populations, Europe's governments face a bigger debt problem than America's, and because their tax rates are already high, this will be trickier to resolve. Italy is in the worst shape: its government already owes the equivalent of 120% of GDP. France's debt ratio is 73%, Germany's 70%. According to projections by the European Commission, by 2030 Germany's debt will more than double, to 157% of GDP, thanks to demographics alone.

In America, in contrast, the underlying fiscal position—prior to the recent loosening— was much more favourable. In 2000, the bean-counters in Congress were predicting budget surpluses as far as the eye could see. America, in other words, had much more room to be Keynesian.

Some European economists claim that fiscal policy is ineffective on their home ground. They argue that European households are more "Ricardian" than Americans, tending to make up for bigger government deficits by saving more themselves. In a study of saving patterns in the 1990s, the OECD concluded that fiscal shifts had a greater effect on private saving in Europe than in America. When budget deficits fell, as they did in the late 1990s, so, too, did private saving, although not at the same rate. Thus, Europeans argue, even if they had taken the Anglo-Saxon route, they might not have got much out of it.

Money isn't everything

If the reluctance to use fiscal stimulus is understandable, the effect of monetary policy is more puzzling. Initially, the European Central Bank (ECB) cut short-term interest rates more slowly and reluctantly than did the Federal Reserve. Now, thanks both to the ECB's rate cuts and the global surfeit of saving, European interest rates are at record lows. Yet the effect on spending has been much less dramatic in Europe than in America, and seems to have been getting weaker. Calculations by economists at HSBC, for instance, show that the stimulus to output from a 1% cut in short- and long-term interest rates has been falling steadily (see chart 13).

European monetary union is one reason. The single currency has had the effect of translating the same low nominal rates into different real, ie, inflation-adjusted, interest rates in different countries. Where inflation is lower than average, as in Germany, real interest rates are higher and monetary conditions therefore tighter.

A more important reason for the relative ineffectiveness of monetary policy in Europe compared with America has to do with the interaction of interest rates, house prices and consumption. In America, lower interest rates fuelled a house-price boom. Flexible mortgages allowed consumers to tap some of their housing wealth. Rising house prices boosted consumption more than higher share prices did in the 1990s, partly because far more people own houses than shares, partly because Americans regarded house-price gains as more permanent than similar gains in share prices.

Germany is at the other extreme. Lower interest rates failed to translate into higher house prices, and even if they had done so, the effect would have been much smaller because far fewer people own their own homes, and restrictive mortgage contracts make it much harder for consumers to refinance their loans at a lower rate.

The rest of the euro area lies in-between. Spain, for instance, looks similar to America. House prices have soared, consumption has boomed and the country is running a large current-account deficit. France has seen house price appreciation, but less of that has been translated into consumption, and the current-account deficit is smaller



than Spain's.

In sum, continental Europe had weaker policy levers with which to respond to a drop in investment demand, and it used those levers more reluctantly. As a result, it has been caught in a low-growth, high-saving equilibrium, at least compared with America. An optimist might argue that the euro area has avoided the excesses of America's profligacy while gradually hammering away at its own structural rigidities. If that is correct, today's stagnation should eventually give way to faster growth—and a smaller saving surplus.

There is some evidence to support this view, particularly in Germany. Although that country's economy is still looking weak, with output flat in the second quarter, there have recently been signs that it could be poised for an upturn. After several years of cost-cutting and financial restructuring, German firms have become leaner and more profitable. Unemployment has been falling slightly, although from a high level, and indicators of business optimism have been rising. If Germany were to turn, the whole region would start to look much more cheerful.

But the failure of the German election on September 18th to produce a clear-cut result has dampened any optimism about that country. A government without a strong popular mandate will find it much more difficult to continue with those much-needed economic reforms. So the more pessimistic, and probably realistic, view is that Europe is doubly vulnerable. Germany is still addicted to foreign demand. Some countries, such as Spain, have become reliant on rises in house prices. Italy remains stagnant. And the lack of growth in Europe is taking an increasing political toll.

Within recent months, the French and Dutch voted "no" on the European constitution, plunging the European Union into a bout of self-doubt. Italy's prime minister, Silvio Berlusconi, has called the euro "a disaster", and several of his cabinet members have suggested that Italy should leave. None of this inspires confidence that continental Europe will do much to rebalance the world economy in the near future, or that countries with surplus saving will rush to invest their money in euros.