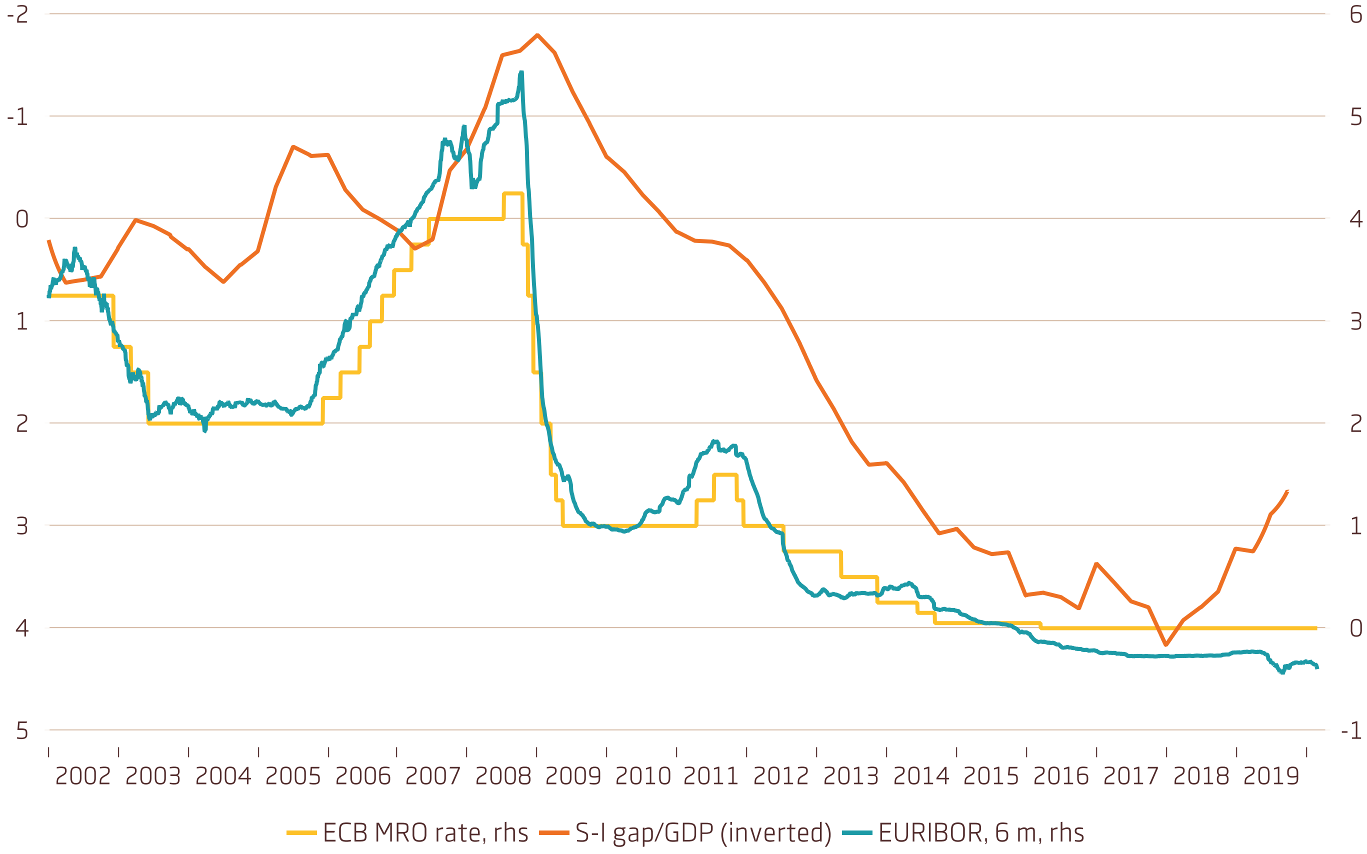
Too much money for too little demand in the euro area?

Interest rates are expected to increase when the gap between savings and investments diminishes

Euro area savings-investments gap and interest rates

%, gap 4 qma



Sources: Swedbank Research & Macrobond

- Increased gap between savings and investments (i.e., the demand for money—the S-I gap) has lowered interest rates over the long term in the euro area.
- Households have made the largest contribution to the S-I gap, while the largest impact on the increased gap comes from the government sector.
- By euro area member states, the biggest impact on the S-I gap has come, by far, from Germany.
- The improved competitiveness of the euro area's (primarily, Germany's) exports of goods has substantially contributed to the S-I gap.
- Recently, the S-I gap has narrowed slightly, but this has not yet been sufficient to raise interest rates.

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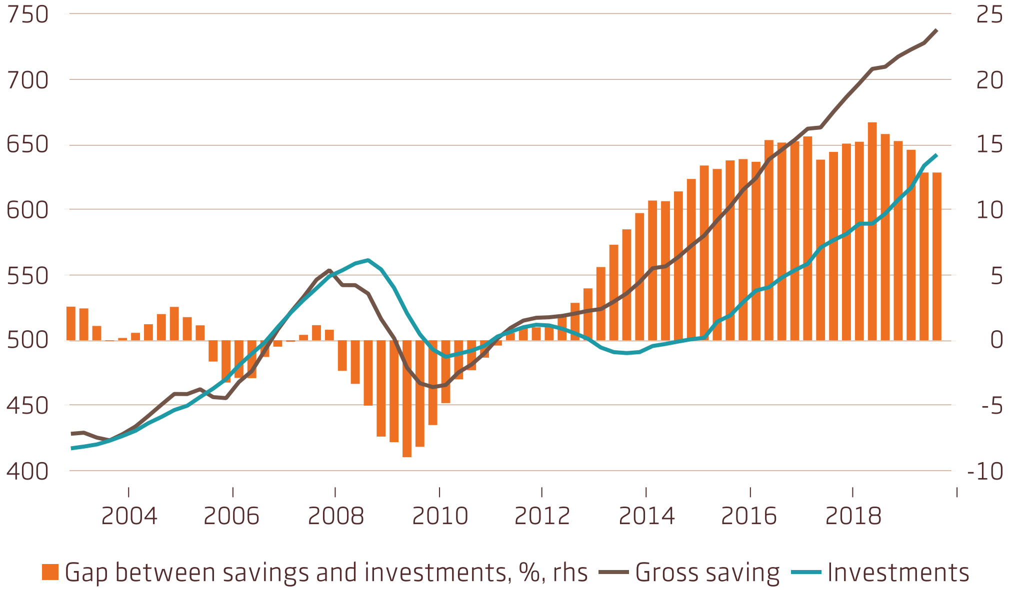
The gap between savings and investments (S-I gap) widened substantially in 2012

Interest rates are expected to start raising when savings and demand for money are better balanced

Euro area savings and investments

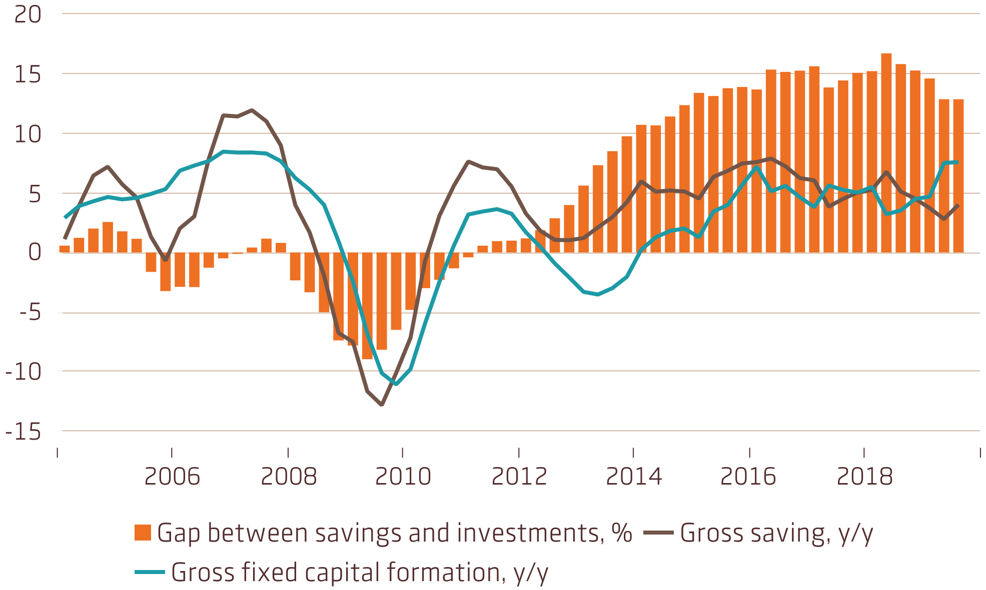
bln EUR, %; 4 qma



Sources: Swedbank Research & Macrobond

Euro area savings and investments

% of gross saving, y/y %; 4 qma



Sources: Swedbank Research & Macrobond

Last September, Swedbank published its Macro Focus „Euro area: Quo Vadis R*?“ (See https://www.swedbank-research.com/english/macro_focus/2019/19-09-01/quo_vadis_r_star_final.pdf), which suggested that, due to ageing, the natural rate of interest is likely to be dragged down in the long term before it starts to recover when the composition of savers and dissavers changes.

The current analysis elaborates further the gap between savings and investments by institutional sectors and by euro area member states.

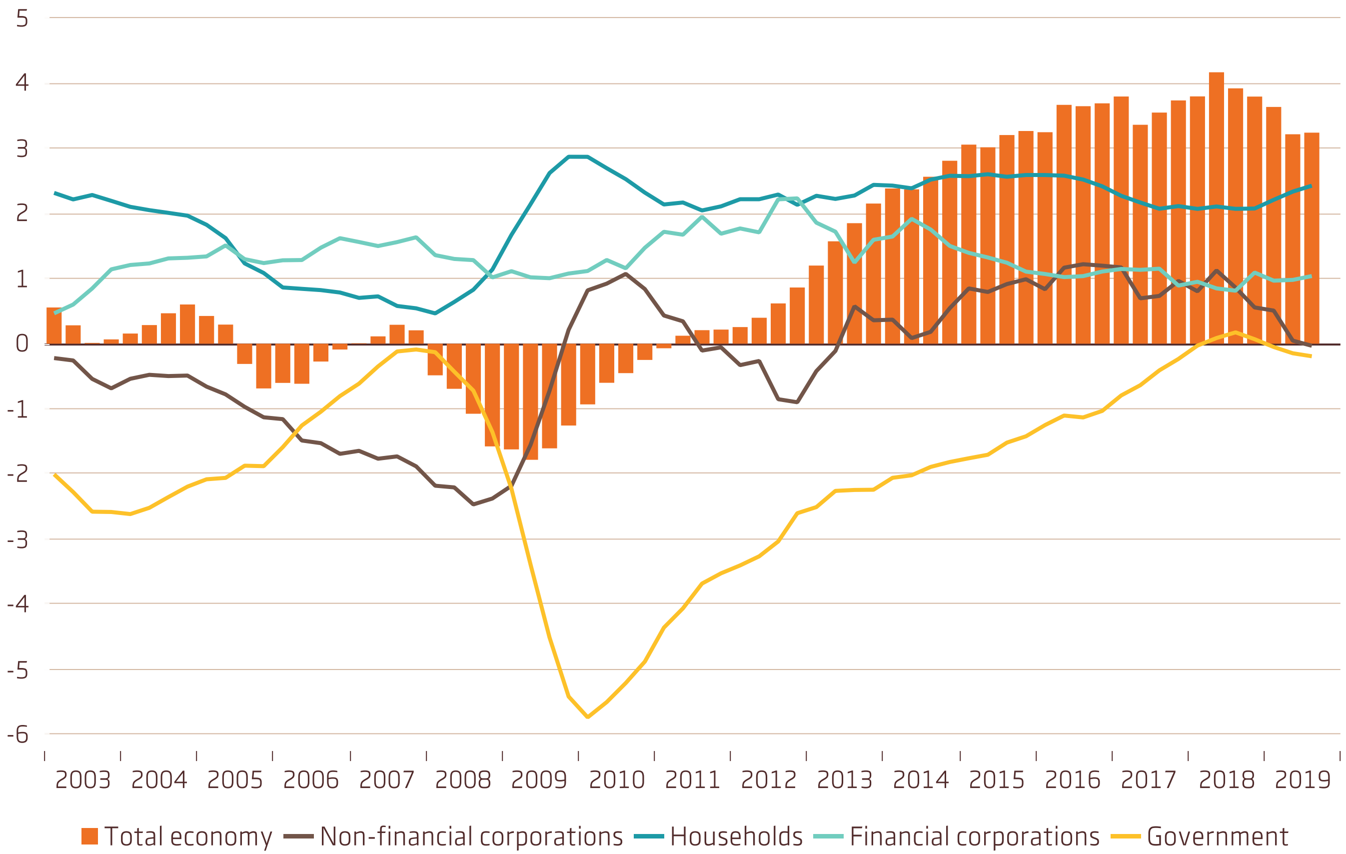
The gap between savings and investments has widened substantially in the euro area since 2012. However, looser ECB monetary policy, together with the asset purchase programme, has supported investment. Although the S-I gap has narrowed during the last year and a half--as investment growth has picked up, while savings’ growth has gradually slowed, --this has not yet been sufficient to raise the Euribor. A stronger rise in interest rates requires a greater narrowing of the gap between savings and demand for money for investments.

Government sector has contributed the most to the increased S-I gap in the euro area

The largest impact on the recent contraction of the S-I gap of the total economy comes from corporations

Euro area savings-investments gap by institutional sectors

% of EA19 GDP, 4 qma



Sources: Swedbank Research & Macrobond

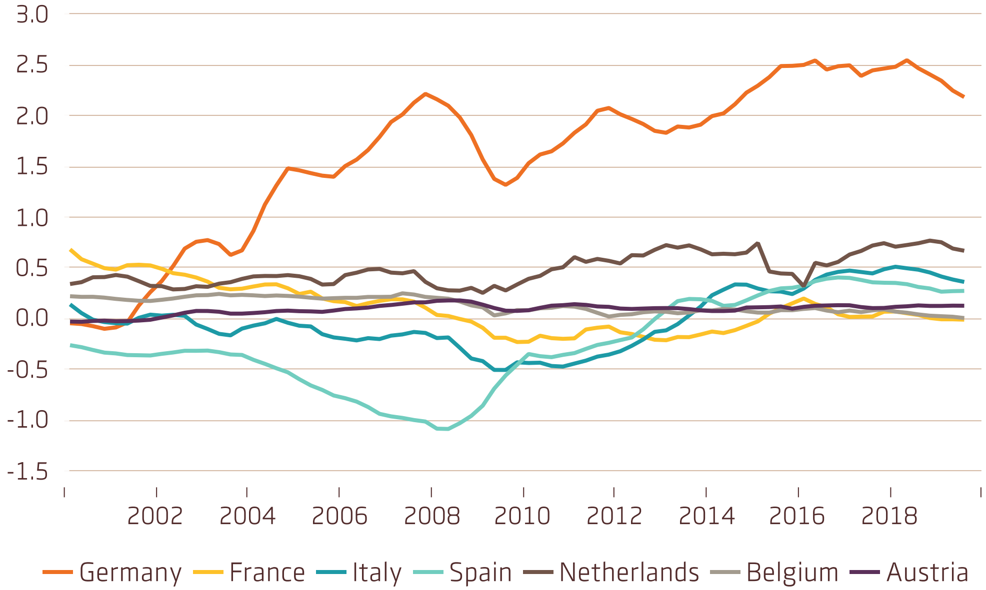
- By institutional sectors, the largest impact on the S-I gap has come from households, which consume less than their disposable income. However, over the long-run comparison, the euro area households' average saving rate has slightly decreased.
- The largest impact on the increase in the gap however, has come from the general government's larger excess savings over investments; the austerity policies have contributed to the improvement of the government budget balance.
- The growth of nonfinancial corporations' savings is gradually slowing, while investments have picked up recently. This has resulted in the contraction of the sector's S-I gap.

Germany has the largest impact on euro area S-I gap

Austerity policies in Southern Europe have contributed substantially, as well

Euro area savings-investments gap by member states

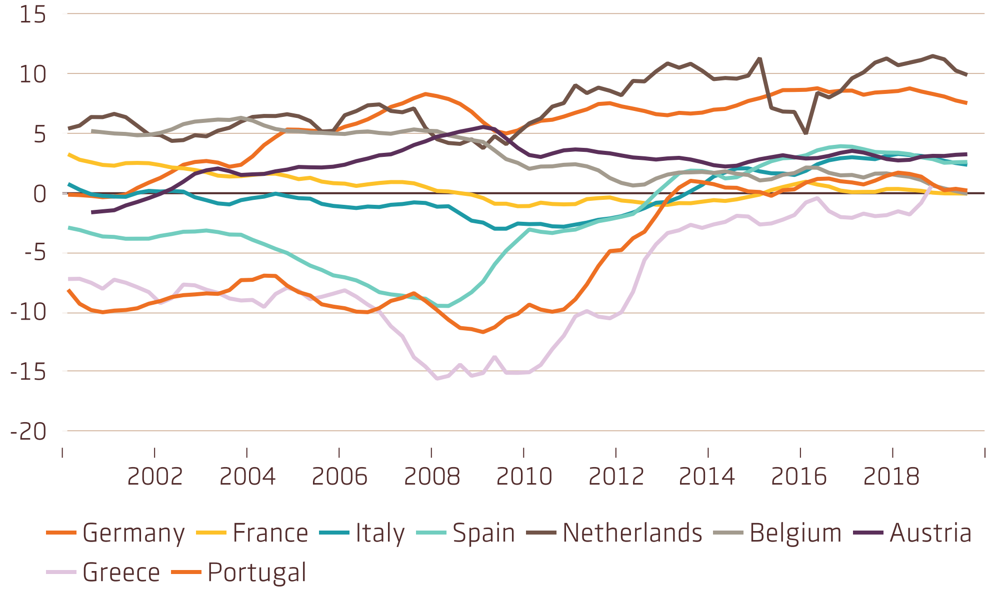
% of EA19 GDP; 4 qma



Sources: Swedbank Research & Macrobond

Savings-investments gap by member states

% of the Member State GDP; 4 qma



Sources: Swedbank Research & Macrobond

By euro area member states, the greatest impact on the euro area S-I gap has come – not surprisingly – from Germany. However, the largest S-I gap in relation to the member state's GDP originates from the Netherlands. Portugal, Greece, and Spain have substantially improved their government budget balances through their austerity policies, while excess investments (or expenditures) compared with savings (a negative S-I gap) in these countries have balanced with the fastest pace.

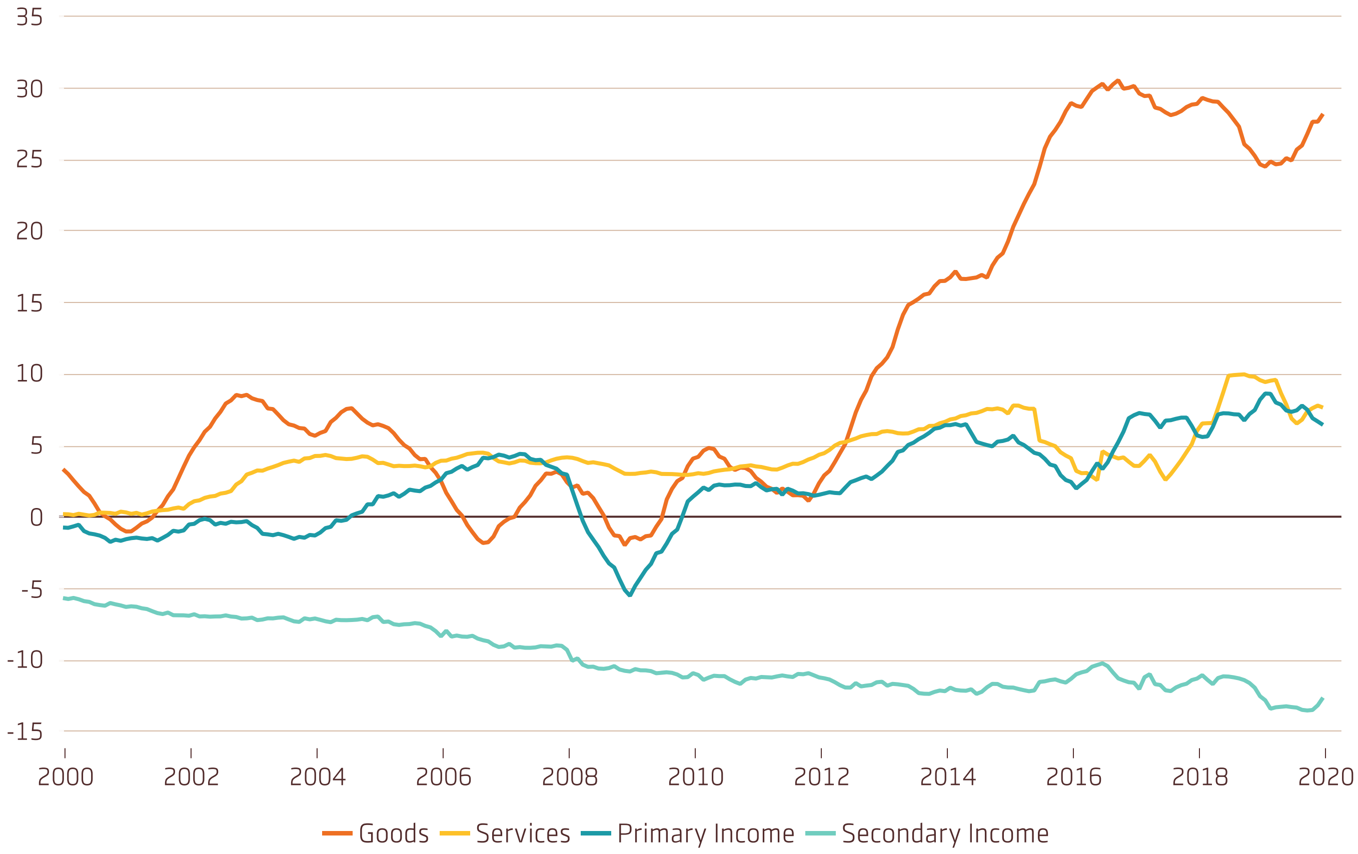
The slow GDP growth and worsened economic sentiment can limit the demand for investments and, thus, can keep the S-I gap large in the euro area. Although the euro area, as a whole, has considerably improved its government budget balance and has room for fiscal stimulation, the situation by member states is diverse: some of them have still large fiscal deficits, while in some countries the government budgets are in surplus.

Euro area export competitiveness has contributed to the increased S-I gap

Germany has made the major contribution to the euro area's net exports of goods

Euro area current account net transactions

bln EUR; 12 mma



Sources: Swedbank Research & Macrobond

- The improved euro area competitiveness has increased net exports of goods and thereby has made the greatest contribution to the larger S-I gap and current account surplus.
- Thus, a substantial share of the euro area S-I gap has come at the expense of other countries in the world.
- Again, Germany accounts for the major share, with its significantly undervalued REER (real effective exchange rate), while there are large differences in REERs within the euro area.
- Although, in Germany, the largest impact on the S-I gap has come from households, the government sector has contributed the most to the widening of the S-I gap in the last eight years.

Conclusions

1. For interest rates to rise from the current negative levels in the euro area, the gap between savings and investments (the S-I gap) should contract substantially. Total savings should decrease, while the increased demand for money should raise interest rates. The ECB asset purchases have contributed to the increase in investments, while the increased money supply has kept interest rates low.

2. The current account balance is a mirror image of the S-I gap. Germany has, by far, the largest impact on the euro area current account surplus, supported by its undervalued REER. The increased surplus of the euro area current account balance has come from net exports of goods. According to the IMF, the euro area has a small REER undervaluation, while the ECB estimates that the euro's REER is close to equilibrium. At the same time, there is a large heterogeneity in REERs within the euro area and therefore, the type of policy response needed differs by member states. Net external debtor countries should improve their external competitiveness, while net creditors should boost domestic demand.

3. The government budget balance has improved in the euro area in the last 10 years and has increased savings over investments for the total economy. Again, the largest impact in this institutional sector comes from Germany, followed by the Netherlands; meanwhile, there are still several member states with too-large budget deficits. Therefore, the call for more fiscal expansion cannot be universal in the euro area.

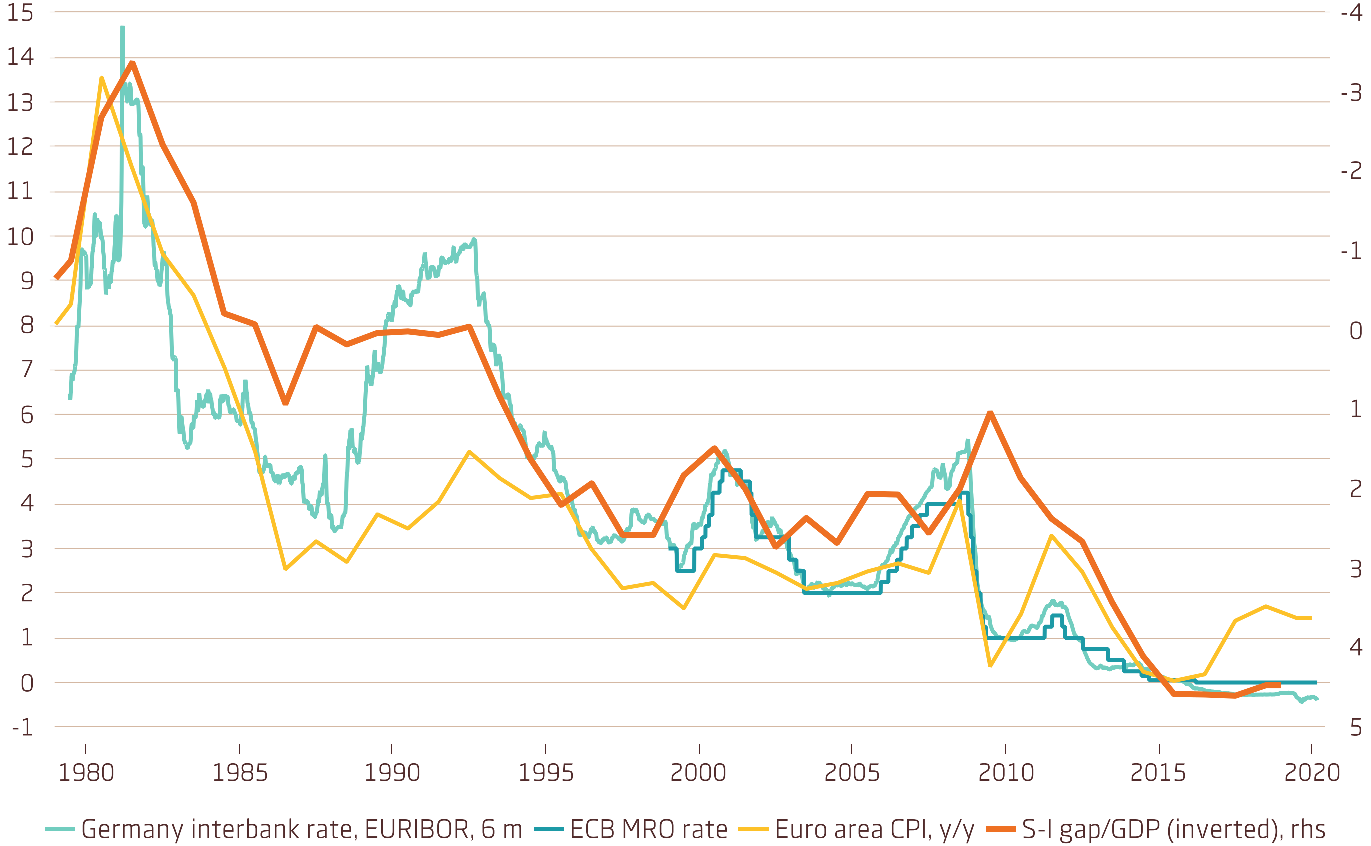
4. Because we assume that households should keep a certain level of savings as a buffer for unexpected expenditures or economic shock, it wouldn't be wise to suggest a substantial reduction of households' S-I gap – currently the largest by institutional sectors - in the euro area. However, the households' saving rate differs considerably by member states.

5. As the natural rate of interest has fallen substantially over the long term, we assume that the contraction of the current account surplus and the S-I gap is likely to have a relatively small effect on the increase in interest rates in the euro area. Population ageing increases savings over the demand for money. Further quantitative analysis is needed to find the exact impact of the contraction of the S-I gap on interest rates.

Appendix

The increasing savings-investments gap is a secular trend

Euro area savings-investments gap (S-I gap) and interest rates
Percentage



Sources: Swedbank Research & Macrobond

◊ Excess savings over the demand for money has lowered the inflation rate and interest rates over the long run.

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