

## A Sovereign Wealth Fund to Lift Germany's Curse of Excess Savings

Daniel Gros and Thomas Mayer

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*We suggest in this paper that the risk-adjusted rate of return on German savings could be improved by creating a sovereign wealth fund for Germany (designated DESWF), which could invest excess German savings globally. Creation of a DESWF should of course complement—and not substitute—for policies helping current account adjustment and funding through private sector capital flows.*

For most of the time since the early 1950s, national savings in Germany have tended to exceed national investment, resulting in a current account surplus. Most of these excess savings have been intermediated by the domestic banking system, which has had difficulties investing these German surpluses abroad given that it is prohibited by law from taking any exchange rate risk. This tended to keep the surplus within limits most of the time (less than 1-2% 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% of GDP, or over one-quarter of savings. Since the start of the euro crisis, German private savers have repatriated their investments – effectively unloading their exposure onto the public sector as German banks have deposited hundreds of billions of euro at the Bundesbank. These funds are being lent by the ECB to banks in the euro area periphery (at 75 bps) – ensuring effectively a negative real return.

In the period before EMU, German excess savings exerted upward pressure on the nominal exchange rate of the D-Mark. As the exchange rate has appreciated unevenly, with periods of relative stability interchanging with periods of rapid appreciation, the real economy suffered numerous exchange rate shocks. In periods of rising exchange rates, slowing export growth tended to reduce the current account surplus but it also dampened 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.

This pattern was interrupted in the wake of unification when consumption and construction booms in the new Länder led to overspending. The 1990s were thus characterised by current account deficits, which persisted during the first years of EMU, although monetary union had the effect of stabilising Germany's nominal effective exchange rate. Since inflation remained well under control, the real effective exchange rate even exhibited a trend towards depreciation. During the early 2000s, however, the impact of unification was finally overcome and the old pattern of excess savings reasserted itself and the current account surplus returned, rising to about 6% of GDP. As a result, the country has cumulated surpluses of about €1,200 billion over the last

Daniel Gros is Director of CEPS and Thomas Mayer is Senior Fellow at the Center for Financial Studies (CfS) at Frankfurt University and Senior Advisor to Deutsche Bank. An abbreviated version of this paper is published in the Financial Times, 28 August 2012.

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decade (calculated to Q1 2012). Until the beginning of the euro crisis, the 'funding', or rather the investment of the current account surplus was no problem. The absence of exchange rate risk encouraged German capital flows to other EMU member countries. The common currency had eliminated the impediments to larger current account surpluses which had existed during the DM era.

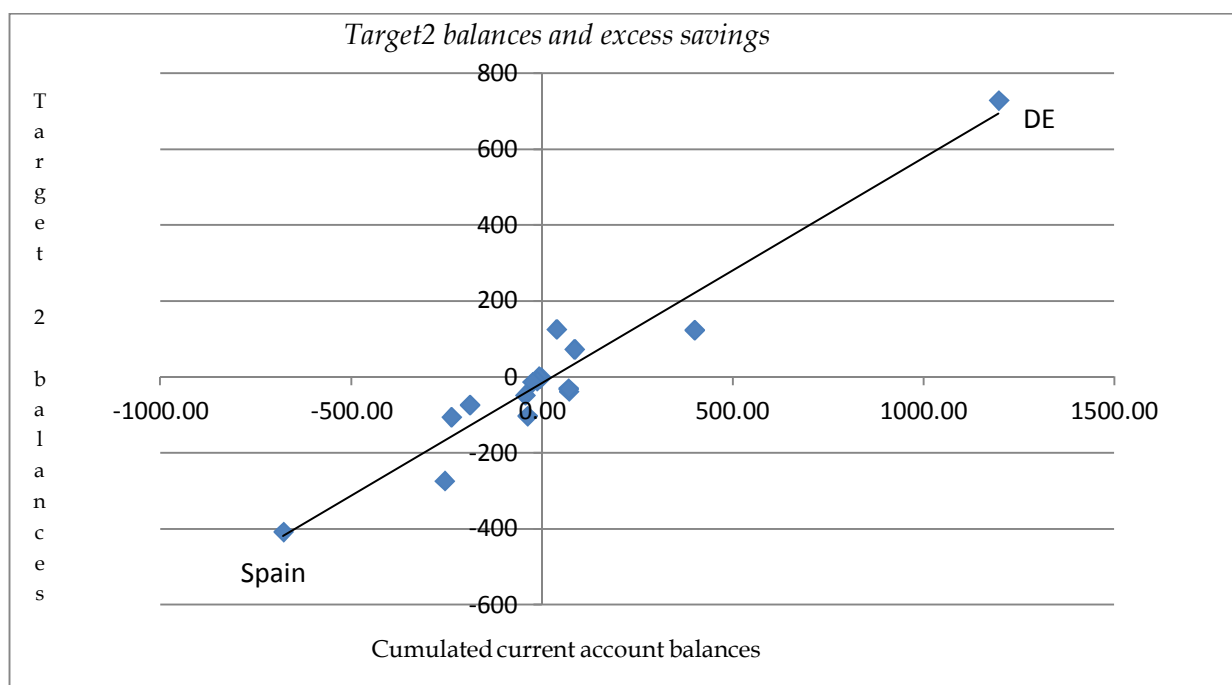
### The Eurosystem steps in

As the sovereign debt and banking crisis took the euro area in its grip, the appetite of German private investors for euro area public and private debt diminished sharply.

Investment outside the euro area was not an alternative given that, as mentioned earlier, a large part of German savings are intermediated by banks, which cannot take any exchange rate risk. Moreover, the experience with supposedly AAA securities in the US (based on subprime mortgages) and the losses in Iceland and Eastern Europe increased the aversion of German institutional investors to investment abroad. Hence, German savers and financial institutions

developed a strong home bias.<sup>1</sup> To avoid a breakdown of the financial system, the public sector has now had to intermediate German savings surpluses. Apart from limited loans by the German government (and other governments of countries with large external surpluses) to Greece directly and via the euro rescue fund (EFSF soon ESM) to the three countries with a 'Troika' programme, the Eurosystem became the main intermediary of savings from surplus to deficit countries. Its role is reflected in the imbalances within the interbank payment system Target 2, which broadly correspond to EMU countries' cumulated current account positions since the introduction of the euro (see the illustration below; for a detailed analysis of the Target2 balances, see Sinn & Wollmershäuser, 2012).

German life insurance companies and the (relatively small) pension funds manage investments of about 1 200 billion euro (about 50% of GDP). However, over 85% of that investment is domestic with only 15% international, of which less than 5% outside the euro area. It is thus clear that the private sector has de facto been either unable or unwilling to invest the German savings surplus abroad.



<sup>1</sup> Moreover, in 2010, Germany recorded total net capital exports of €145.8 billion and net capital exports to its EMU partners of €603.5 billion, suggesting that its financial institutions not only moved German savings to other EMU countries but also intermediated capital flows from abroad to them.

## The Eurosystem is not alone

The role of the Eurosystem in intermediating large private-sector savings surpluses should not be regarded as abnormal. On the contrary, there are very few examples of countries with consistently large external surpluses being intermediated for long periods exclusively by the private sector. In most countries running persistent current account surpluses (say, above 3% of GDP for more than 5 years), the government or the central bank has accumulated large foreign assets either through a sovereign wealth fund or through foreign exchange intervention. In raw-material exporting countries, where the external surplus is generated by the royalties that go to the government, the sovereign wealth fund is the natural choice. In countries where the external surplus arises from excess savings in the private sector, foreign exchange intervention is the usual route to absorb the risk arising from the large net foreign asset position the private sector is accumulating. Saudi Arabia and Norway provide the classic examples of natural resources-based surpluses intermediated by the public sector through a sovereign wealth fund.

Switzerland and Japan can illustrate the tendency of countries with structural private-sector surpluses to rely on the central bank. Both countries have (or, as in the case of Switzerland, had) officially fluctuating exchange rates. Most of the time the authorities of these countries did not intervene, forcing the private sector to intermediate at least part of their persistent current account surpluses. However, this approach led at irregular intervals to extreme exchange rate movements which then induced the authorities to make large interventions to avoid 'excessive' exchange rate movements. In those contexts, 'excessive' meant that the exchange rate that would have established a balanced current account was politically unacceptable at home.

If one averages over periods of calm (no intervention) and those with spikes in the exchange rate (followed by interventions), one finds that over longer periods the sum of the interventions is of a similar order of magnitude as the sum of the current account surpluses over the same period. This observation is supported by a recent study by Joseph Gagnon (2012) of the Peterson Institute for International Economics, who finds that for developed countries foreign exchange intervention 'finances' about two-thirds

of current account surpluses on average in the longer term. The similarities to the Target2 positions are obvious.

However, the use of central banks to intermediate structural private-sector savings surpluses becomes less and less attractive in the current zero interest rate environment. Central banks are usually obliged to invest only in short-term securities of the highest investment ratings. However, the interest rates on this type of security (essentially short-term government bonds or government-guaranteed securities) paper from the few remaining AAA countries are now zero, if not slightly negative almost everywhere. Some countries have thus recently started to encourage their central banks to diversify their investment policies. For example, China has also now established a fund that will invest part of its more than \$3,000 billion of foreign exchange reserves in other ways, including in very non-liquid assets, such as foreign direct investment.

## From exchange rate to credit risk

Central banks in countries with strong currencies are always reluctant to undertake large foreign exchange interventions because they know that they are running a foreign exchange rate risk. But within EMU, the TARGET2 balances of national central banks within the cross-border payment system of the ECB are the equivalent of foreign exchange interventions. Here the risk is of a different nature: namely that of the default of a peripheral country. Politically this makes a world of a difference. Consider the case where a central bank loses a bundle on foreign exchange rate interventions (e.g. Switzerland where the central bank recorded in 2011 losses of about €20 billion or close to 4% of GDP during its unsuccessful attempt to stem the rise of the Swiss Franc). This made headlines in some newspapers, but because these losses existed only on the balance sheet of the central bank, which can cover its losses with the printing press, the topic was soon relegated to the specialized press. By contrast, one can easily imagine the political uproar in Europe if the ECB were to make losses of €400 billion (an equivalent amount in relation to euro area GDP) on its lending to banks in peripheral countries. Given the loss-sharing provisions in the ECB, this would translate into losses of about €100 billion for the Bundesbank. As a share of GDP this would be similar to the foreign exchange losses of the Swiss National Bank, but if this scenario materialized, it

could well mean the end of the euro and European integration.<sup>2</sup>

The forerunner of EMU, the European Monetary System, had elaborate rules concerning who was obliged to intervene in the foreign exchange markets, which were generally asymmetric, putting the burden mainly on the weaker currency countries. The more these countries tried to disinflate by keeping their exchange rate against the DM from devaluing, the more the system became dominated by the Bundesbank. The system then broke down in the early 1990s when the Bundesbank had to tighten policy in the face of the post-unification boom in Germany while the other countries were entering a recession. By contrast, within the euro area, the TARGET2 balances, which are the equivalent to foreign exchange interventions in the EMS, work automatically in a symmetric manner. By design, the aggregate stance of the system is determined by the ECB, not the Bundesbank. In terms of the stance of monetary policy, EMU is thus a symmetric system.<sup>3</sup> At least in this regard, one could say that the French and other politicians who pressed for EMU to break the power of the Bundesbank have achieved their goal.

### Diversification is key

If there is indeed a role for the public sector to intermediate very large surplus savings, then the question arises whether this intermediation is done in an efficient way. From a German perspective, intermediation by the Eurosystem on balance is inefficient. On the one hand, any credit risk incurred by the Bundesbank through the accumulation of Target2 claims against the ECB is

shared with other EMU countries through the distribution of any losses according to the share of countries in the capital of the ECB. On the other hand, the Target claims represent a portfolio that is geographically undiversified and only a little diversified across asset classes. In the event, the Target2 claims are only backed by the securities of banks in deficit countries delivered as collateral for ECB credits under the various credit facilities. A large part of these securities is probably of dubious quality.

Moreover, the ECB offers German banks, and hence indirectly the country's savers, at present a nominal interest rate of zero (which may even move into negative territory in the future), and it demands only 75 bps on its lending to banks in the euro area periphery. A 'margin' of 75 bps seems totally insufficient to cover the risks taken in the ECB's operations. Also, the zero nominal interest rate offered by the ECB's deposit facility translates into a negative real return for German savers of around 2% per annum when the ECB's target inflation rate prevails in Germany. And it could be even less when German inflation rises above the ECB's target (as would seem necessary to allow internal real exchange rate adjustment in EMU). Finally, the ECB (by its nature as a central bank) is not able to offer German savers any longer-term investment vehicles. This is a key drawback given the lack of long-term savings vehicles available now because most German government debt has been absorbed by foreign central banks (e.g. from Switzerland and China) and sovereign wealth funds.

### An SWF to handle Germany's excessive savings?

An alternative to the present system of intermediation of the German savings surplus, which would avoid the above-mentioned disadvantages, would be a German Sovereign Wealth Fund (DESWF).<sup>4</sup> Imagine that a

<sup>2</sup> A loss of €400 billion for the ECB represents an extreme scenario as it would require a full-scale default of at least three to four of the peripheral countries with close to zero recovery. The magnitude of the potential losses resulting from lending abroad is thus actually lower within the euro area, but their political impact would be radically different.

<sup>3</sup> The system can even become asymmetrical in favour of deficit countries when the ECB extends loans at a fixed rate against a wide range of collateral and full allocation of bids to banks in deficit countries, which use these loans to fund the countries' balance-of-payments deficit vis-à-vis other EMU countries. In this case, money created in the deficit countries flows through the ECB's cross-border payment system to the surplus countries, where it will eventually push up the price level when it finds its way into the real economy.

<sup>4</sup> This idea could of course be applied also by other countries with structural surpluses. Switzerland would be a prime candidate: instead of buying low-yielding euro assets, the Swiss National Bank should be empowered to invest the country's gigantic surpluses (13% of GDP) globally. Over the last year the Swiss National Bank has bought hundreds of billions of euros, most of which were invested in German assets. The way the Swiss authorities are keeping the exchange rate of the Swiss Franc low at present is thus

government agency would offer German savers a secure vehicle paying a guaranteed positive minimum real interest rate, with a top-up when real investment returns allowed. The vehicle would invest the funds in a portfolio that is highly diversified by geography and asset classes. Positive real returns can be expected in the long run based on positive real global growth. Since, in this case, a significant amount of funds would flow outside the euro area, the euro would depreciate. This would help crisis countries presently struggling to revive growth through exports and to close their external deficits so as to recoup their international credit-worthiness. Target imbalances would gradually disappear and German claims abroad would move from nominal claims on the ECB to diversified real and nominal claims on various private and public foreign entities in a variety of asset classes.

Investments into the German sovereign wealth fund could be restricted to longer-term commitments, thereby helping to achieve positive real returns through participation in global growth and the creation of a funded old-age pension scheme as a supplement to the existing German pay-as-you go scheme. The DESWF would of course carry the investment risk, including the exchange rate risk, but its ability to deploy large amounts of funds globally with a long-term investment horizon would put it into a better position to handle these risks than individual investors or private financial institutions. The latter either pass the exchange rate risk on to their customers or, if they cannot do this, avoid it because of regulatory requirements or in order to save equity capital that would be needed as risk buffer.

The Norwegian Government Pension Fund could serve as model (for details, see Velculescu). The purpose of the fund, now standing at close to \$600 billion is to accumulate government savings from oil royalties to meet future public pension expenditures. The targeted real return of the fund is 4% per annum. Between 1997 and 2011, the actual real return was 2.7% on average. In view of the difficult investment environment during this period, this seems to be a respectable

contributing materially to the build-up of the Target imbalances, thus exacerbating the tensions within the euro area. The creation of a Swiss Sovereign Wealth Fund would thus constitute a further important element of stabilization.

achievement, much higher than the slightly negative real return that can be expected from long-term German government bonds (see Press Release of the Norwegian Ministry of Finance of 30 March 2012).

Another model might be the GIC of Singapore (another country with structural current account surpluses). On its \$300 billion investments, this fund has achieved on a rolling basis over the last 20 years a real return of close to 4%. Even over the last 5 years of the financial crisis, the (nominal) rate of return in USD has been 3.4% (see SWFinstitute, 2012).

A German SWF would be funded by German private-sector savings instead of government savings and hence have some similarity to a life insurance company.<sup>5</sup> However, in contrast to private life insurance companies, its focus would be on foreign investment outside the euro area to intermediate German surplus savings and acquire foreign assets on behalf of its domestic investors, a task for which existing private life insurance companies are presently ill-equipped (and to some extent even not allowed to undertake, given the constraints on foreign investment inherent in EU directives like Solvency II).<sup>6</sup>

There is no investment without risk. One could of course object to our proposal for an DESWF on the grounds that it will create risk for the government. But at present a large part of German savings is de facto invested via a German state institution (the Bundesbank) in the euro area periphery – which is not exactly the most promising investment area right now. By diversifying the destination of German savings globally, the overall risk for the country should actually be reduced. Moreover, critics could argue that it would be preferable to have private sector

<sup>5</sup> The Netherlands is running an even larger current account surplus as a percent of GDP than Germany. But its pension funds are de facto operating like a sovereign wealth fund as they are investing almost one-half of their assets, now worth about 130% of GDP, outside the euro area.

<sup>6</sup> German life insurance companies and the (relatively small) pension funds manage investments of about €1,200 billion (about 50% of GDP). However, over 85% of that investment is domestic with only 15% international, of which less than 5% is outside the euro area. It is thus clear that the private sector has de facto been either unable or unwilling to invest the German savings surplus abroad.

funding of the German current account surplus rather than a sovereign wealth fund. We would agree, but see at present no possibility to quickly reopen private sector channels for capital flows; and hence see the risk that the inefficient way of funding through the Eurosystem becomes engrained with the consequence of escalating political controversies. Finally, critics will argue that the first best solution would be German current account adjustment. We wholeheartedly agree but have little hope that what has remained elusive for so long in the past will now happen fast under even more difficult circumstances.

How large should the DESWF become? Under present circumstances, we would argue that it should aim to invest around one-half of the German current account surplus outside Europe, which would amount to a flow of about €80 billion per annum, which is equivalent to somewhat more than 3% of the country's GDP. Should the current account surplus continue at the present magnitude, the DESWF could grow to €800 billion, or 30% of Germany's GDP within the next ten years.

Our concern in this brief has been to present the macroeconomic arguments for the establishment of an SWF by Germany. We leave to others the elaboration of the legal and institutional details. We believe that the DESWF does not need to become a large institution. It could outsource the investment decisions to competing private institutions (in the form of so-called "Spezialfonds"), which is a practice adopted by other successful SWFs around the globe.

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