German balance of payments in 2001

The distinct cooling of the global economic climate, which has been emanating from the United States, restrained German exports discernibly in 2001. Despite the more difficult external environment, however, German exporters fared relatively well. During the same period Germany's import demand declined so sharply that, on balance, the country's foreign trade made a positive contribution to growth. The export surplus reached a record of just over €94 billion, exceeding the previous year's level by €35 billion. Germany's current account was therefore slightly in surplus for the first time since the beginning of the 1990s. Following a deficit of €22½ billion in 2000, the surplus in the year under review amounted to €2½ billion. The change in the world economy also left its mark on the financial transactions with non-residents. Capital flows in both directions weakened markedly. The changes in the real and financial transactions with non-residents will be addressed in detail below and the underlying determining factors explained.

Current account

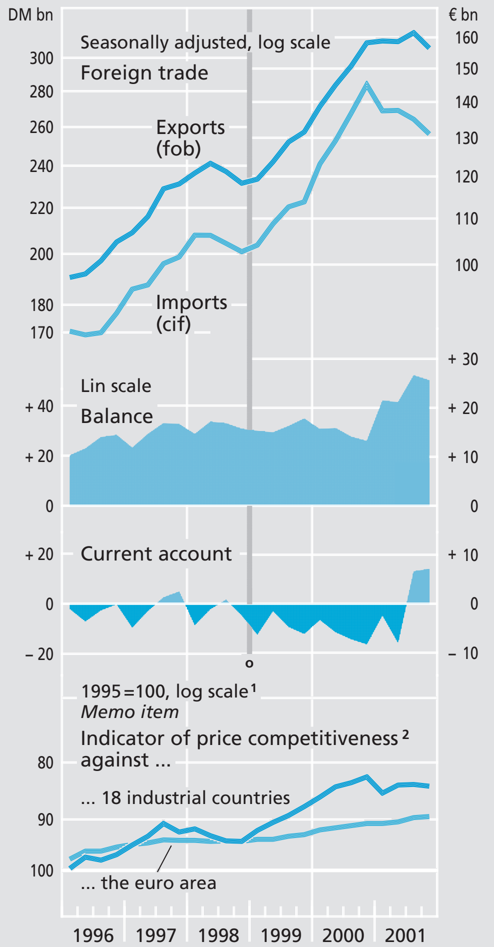
Exports

Germany's exports of goods rose by 6½% in value in 2001. However, much of this increase was due to an overhang arising from the sharp growth in exports towards the end of the previous year; during 2001 export turnover did not rise much above its level at the end of 2000. In real terms – that is, after eliminating price effects – year-on-year export growth, at 5½%, was relatively strong for the same reasons. Overall, German exporters therefore succeeded in defending their position on foreign markets despite the greater difficulties posed by the appreciable deterioration in the economic climate and tended to expand further. At all events, German exports held up well given the sharp deceleration in the growth of the world trade volume, which in 2001 slowed down to an estimated ½% compared with the previous year.

Regional breakdown of exports

This was also true of Germany's export markets within the euro area, which account for more than 40% of German exports. Measured in terms of turnover growth, however, stronger stimuli came from trade with partners outside the euro area. For example, the exports of goods to the other countries of the euro area increased by just under 4% last year whereas deliveries to the central and east European countries in transition, which account for approximately 10% of German exports, grew by more than 16½% and therefore far above the average. Over extensive periods last year, however, German exporters also had substantial sales successes in the US market. Despite the economic slump in the United States, German exports of goods there increased by 9%. Exports to the group of oil exporting countries increased particularly strongly. These showed a growth rate of 27%, which was even more dramatic than in 2000. Much as they had done in previous economic cycles, these countries evidently waited for a time before using the increased income from higher oil prices to step up their demand for foreign goods significantly. By contrast, German trade with Asia deteriorated considerably in 2001. After rising by almost 30% in the previous year, German industry's turnover in the emerging markets of South-East Asia increased by only 2% in 2001. To a large extent this was probably a reflection of the harsh adjustment processes in the IT sector, which hit these countries

Foreign trade and current account



o From 1999 data in euro. — **1** Inverted scale: rise in curve (fall in values) denotes increase in competitiveness. — **2** Based on the price index of total sales.

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particularly badly. The persistently difficult macroeconomic developments in Japan actually resulted in a slight fall in sales for German exporters in that market (-1%).

Breakdown of exported goods

The changed demand and sales conditions in the information and communication technologies sector clearly left their mark on the export business of German producers. For example, the exports of goods from this sector, which comprises a wide range of goods, fell by 1½% compared with the previous year when there had been a particularly sharp growth rate of 30%. However, not all of the products attributable to the IT sector were equally affected by the changed market conditions in this sector. Whereas there was a 7½% expansion in the exports of, for example, medical and precision instruments, there was a sharp decline in the turnover of data processing equipment (-10%) and communications equipment (-4%), which account for 8% of Germany's exports of goods. In the previous year these two categories of goods had shown extremely large increases in sales of 36½% and 46% respectively. The fall in the prices of these products explains at best a small part of the loss in turnover. Exports of chemical and mechanical engineering goods were also much weaker than before. They increased by approximately 3½% and just under 4% respectively. By contrast, exports by the car industry were comparatively favourable. They rose by 9%. Evidently the deteriorating economic circumstances had not affected demand for German motor vehicles on foreign markets so quickly and so severely. Longer delivery times, in particular,

Regional trend in foreign trade

2001

Group of countries/country	€ billion	Percentage change from previous year
Exports		
All countries	637.3	+ 6.7
of which		
Euro-area countries	274.9	+ 3.8
Other EU countries	76.5	+ 5.6
United States	67.3	+ 9.0
Japan	13.1	– 0.9
Central and east European countries in transition	69.9	+ 16.7
OPEC countries	13.7	+ 27.2
Emerging markets in South-East Asia	24.5	+ 2.1
Imports		
All countries [1]	543.1	+ 0.9
of which		
Euro-area countries	230.4	+ 5.7
Other EU countries	56.4	+ 0.8
United States	45.5	– 3.5
Japan	22.6	– 15.8
Central and east European countries in transition	68.4	+ 9.0
OPEC countries	8.2	– 19.8
Emerging markets in South-East Asia	27.8	– 8.9

1 The import totals for "All countries" include revisions for the period from January to November 2001, which are not yet available in a regional breakdown.

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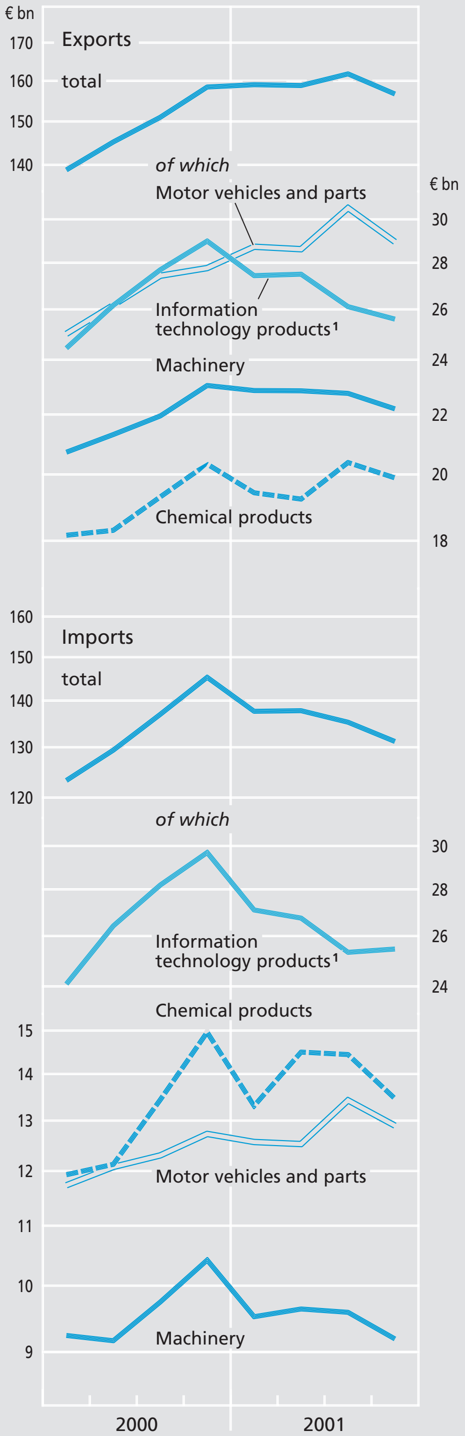
Foreign trade by selected categories of goods

Seasonally adjusted, quarterly, log scale



1 Electrical and optical equipment.

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might have contributed here to the delayed effects of the downturn in demand.

Imports

The more sluggish economy had a particularly strong retarding effect on the imports of goods in the course of last year. Although there was a slight year-on-year increase in the value of imports (+1%), much of this rise was due to higher import prices, with the result that real imports were at more or less the same level as in the previous year when they had grown by 9% in an environment of dynamic macroeconomic growth.

Regional breakdown of imports

Almost all major supplier countries were affected by the weaker German demand for imports. However, imports from the OPEC countries declined particularly sharply (-20%) as oil prices fell at the same time. Large declines were also recorded in the imports from Japan (-16%) and the emerging markets of South-East Asia (-9%), a development which was probably due essentially to the slump in demand from the IT sector. The reduction in imports from the United States, by contrast, was relatively moderate at 3½%. Imports from the central and east European countries in transition were a noteworthy exception to the generally downward trend; here, too, the growth rate showed a distinct levelling-off, but, despite that, 9% more goods were imported from these countries than in the previous year. This relative stability, which, incidentally, was also observed in the case of German exports to these countries, is an illustration of the close interplay which has now evolved in Germany's cross-border sales and production transactions with the countries in transition and from which both sides benefit. What is also remarkable is the comparatively moderate weakening in the growth of goods imported from the other euro-area countries, with the result that German imports from the euro area exceeded the previous year's level by just over 5½%. This means that German foreign trade had a rather stabilising effect on the rest of the euro area.

Breakdown of imported goods

The close integration of industrial production within Europe together with the relatively good order book situation in the German car industry might have favoured this development last year. At all events, that is consistent with the fact that on the import side, too, the demand for motor vehicles and vehicle parts was relatively brisk (+4%). Although the growth in imports of chemical products was also remarkably high (+6%), this was essentially due to the overhang from the sharp growth in turnover in 2000. By contrast, the significant fall in demand in the IT sector is reflected in a substantial decline in the imports of goods in this sector. For example, imports of this category of goods in 2001 were 4% below the previous year's level. As in the case of exports, it was particularly the imports of data processing equipment (-8%) and communications equipment (-4½%) that were significantly below their previous year's levels. Imports of mechanical engineering products also declined, falling 2% year on year, probably not least because of the very low investment in Germany.

Balances within the current account

Owing to the significant fall in imports as a whole and the distinct easing of prices on the crude oil markets, on the one hand, and the relatively satisfactory – if likewise weaker – export performance, on the other, Germany recorded a substantial increase in its export surplus in 2001. At €94 billion, it not only exceeded its previous annual level by €35 billion but was also far greater than the record surpluses recorded towards the end of the 1980s. The deficit on invisible current transactions with non-residents rose at the same time but the increase – of €12 billion to €87 billion – was fairly moderate. Part of the large net income from foreign trade had an impact on the current account, with the result that the latter ran a surplus, amounting to €2½ billion, for the first time since the beginning of the 1990s. In 2000, by contrast, there had been a deficit of €22½ billion.

Service transactions

For some years now the deficit on services has been the largest contributor to the overall deficit on invisibles. In 2001 the services account closed with a deficit of just under €48 billion, which was approximately €3½ billion more than in 2000. Two-thirds of net expenditure on services are attributable to foreign travel, the deficit on which was approximately €1 billion more than in 2000. Last year, however, it was primarily developments in the other categories of services that contributed to the rise in the deficit on the services account. The services combined in the "Other services" category have been playing a major role here for some years. These comprise a broad range of transactions such as those concerning patents and licences, research and development, engineering and other technical services, including IT services, as well as assembly work and administration. There was a further deficit on these, this time of almost €4½ billion to almost €26 billion.

Major items of the balance of payments

€ billion

Item	1999	2000	2001
I Current account			
1 Foreign trade			
Exports (fob)	510.0	597.5	637.3
Imports (cif)	444.8	538.3	543.1
Balance	+ 65.2	+ 59.1	+ 94.2
2 Services (balance)	– 41.5	– 44.4	– 47.8
of which Foreign travel (balance)	– 30.6	– 31.6	– 32.8
3 Factor income (balance)	– 9.0	– 3.3	– 12.6
of which Investment income (balance)	– 8.1	– 2.4	– 11.1
4 Current transfers (balance)	– 25.7	– 27.1	– 26.7
Balance on current account 1	– 17.9	– 22.6	+ 2.3
II Balance of capital transfers 2	– 0.2	+ 6.8	– 1.0
III Financial account 3			
Direct investment	– 51.3	+ 157.7	– 12.8
Portfolio investment	– 10.8	– 159.4	– 15.8
Financial derivatives	– 1.7	– 4.2	+ 6.7
Capital transactions 4	+ 37.8	+ 40.2	– 24.3
Balance on financial account	– 26.1	+ 34.3	– 46.1
IV Change in the foreign reserves at transaction values (increase: –) 5	+ 12.5	+ 5.8	+ 6.0
V Balance of unclassifiable transactions	+ 31.6	– 24.4	+ 38.7

1 Includes supplementary trade items. — **2** Including the acquisition/disposal of non-produced non-financial assets. — **3** For details see the table "Financial transactions" on page 43. — **4** Including Bundesbank investment and other public and private investment — **5** Excluding allocation of SDRs and changes due to value adjustments.

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Moreover, the surplus on cross-border financial services was halved at just under €½ billion. By contrast, the surpluses on transport services and on merchanting trade were each approximately €1 billion larger at just over €4 billion and €5½ billion respectively. The balance on insurance services also improved by a similar amount, resulting in a surplus of just under €1 billion on these.

Foreign travel

As already mentioned, net expenditure on cross-border travel rose slightly to just under €33 billion. At the same time, the pattern of German travel expenditure shifted further, on a year-on-year comparison, in favour of European destinations at the expense of the long-haul journeys that had been in great demand a few years ago. These changes become even more pronounced if they are measured in terms of real foreign travel expenditure (ie at constant prices) because the increases in price related to currency depreciation, especially in the case of many distant destinations, have a negative effect. Incidentally, the greater degree of general restraint in travelling on holiday and on business is fully consistent with the scenario in previous periods of cyclical weakness when both individuals, owing to the greater uncertainty about incomes, and enterprises, with the aim of reducing costs, restricted their expenditure on travel. In the second half of last year developments were also likely to have been influenced by the after-effects of the terrorist attacks on New York and Washington.

Factor income

Net expenditure on cross-border factor income amounted to €12½ billion last year, which was almost €9½ billion more than in

2000. Germany's net investment income payments to foreign investors amounted to €11 billion last year, exceeding the previous year's outlay by €8½ billion. Part of this was due to larger payments on direct investment loans from non-residents. These loans had increased significantly in 2000. At the same time, there was a fall in the earnings of German proprietors from their direct investments.

Transfers

The current public and private-sector transfers to non-residents declined, by contrast, last year, falling by €½ billion net to €26½ billion. It was smaller net payments to the EU budget, in particular, that reduced the deficit on public-sector transfers by €2 billion to €17 billion. By contrast, current private-sector transfers rose by €1½ billion net to €9½ billion. This was partly due to indemnification payments to former forced and slave labourers. These indemnification payments, which are being handled by the Foundation "Remembrance, Responsibility, Future", began in May 2001. A total sum of approximately €1 billion was awarded and paid out internationally last year. This was divided equally between the private and public-sector transfers in the balance of payments in line with the equal contribution made by each sector.

A deficit of €1 billion was recorded in the case of capital transfers. This deficit has therefore been reduced again to its "usual" size. In 2000 a surplus of almost €7 billion had arisen in this item mainly as a result of the settlement of auctioned UMTS licences, some of which were obtained by foreign telecommunications companies.

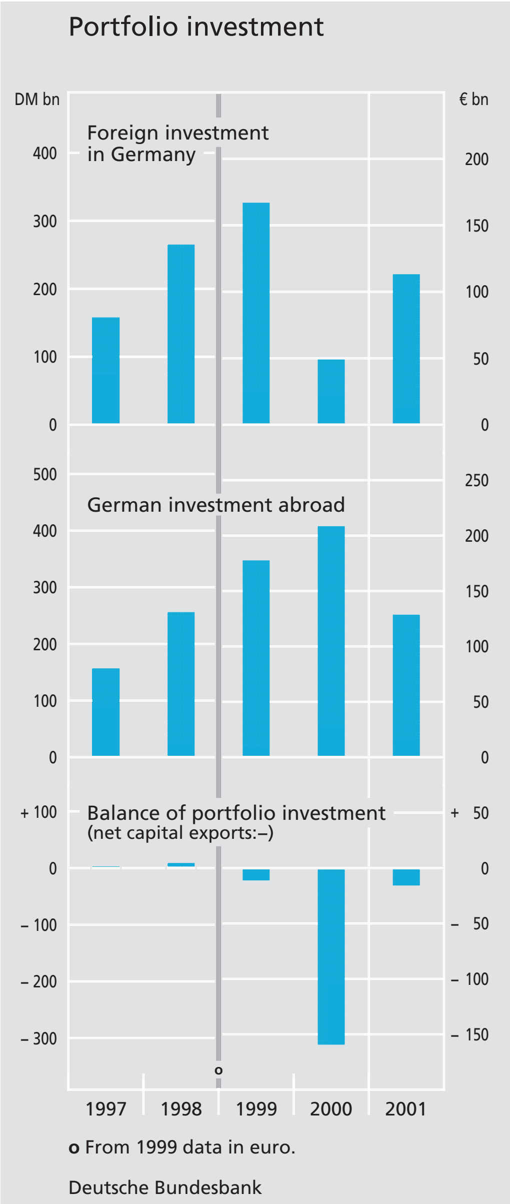
Financial transactions

Trends in financial transactions

Last year's developments in German financial transactions reflected the downturn in the world economy as well as the slowness with which the uncertainty of internationally oriented investors following the terrorist attacks in the United States began to dissipate. In view of the sometimes sharp price fluctuations on the financial markets and the rather unfavourable earnings prospects of many enterprises, these internationally operating investors were decidedly cautious. Consequently, capital flows to and from Germany weakened discernibly compared with those of previous years, and the balances of the various segments of the financial account moved within fairly narrow limits. On aggregate, however, Germany recorded net capital exports amounting to €46 billion in 2001. This means that the statistically recorded outflows of funds greatly exceeded the inflows on current account and those resulting from the reduction of the foreign reserves. This discrepancy indicates that there are serious problems in recording transactions with non-residents and makes analysis, particularly of the financial account, more difficult.

Portfolio investment

One of the problem areas regarding the accurate and complete capture of cross-border operations is no doubt portfolio investment where individual instruments and investment strategies are becoming increasingly complex, the periods during which securities are held have become much shorter and turnover has risen rapidly in the past few years. Last year saw yet another increase in turnover; owing to the greater risk awareness of financial mar-



ket participants, however, this rise – of about 17% – was much less pronounced than in previous years. Investors' restraint can be seen even more clearly in the gross capital flows. For example, the amount invested by German savers abroad, namely €128½ billion, was no more than just over half as much as they had invested the year before and was also much less than in 1998 and 1999. Conversely, foreign investors acquired more German securities in terms of value, at €113 billion, than they had done in 2000 (€49 billion). However, this rise is due solely to the fact that in 2000 a large corporate acquisition greatly reduced foreign portfolio investment in Germany because of reclassifications. Compared with 1998 and 1999, then, a fairly considerable downturn emerges in foreign securities acquisitions in Germany last year. All in all, net capital exports of €16 billion arose through securities transactions in 2001 compared with €159½ billion in 2000 and €11 billion in 1999.

German investment in ...

... foreign shares

If account is taken of the instruments chosen by German residents when investing in foreign securities, it becomes clear that it is the demand for foreign shares that has suffered most as a result of the downturn in world economic growth and the gloomier profit prospects of many enterprises. Investors' confidence was further shaken by the September terrorist attacks in the United States, with the result that, for a time, there was an outright flight from investment in equities into the safety of bonds and notes. All in all, German investors acquired foreign shares worth only €16 billion last year; this was the lowest result since 1996. However, it is worth noting that, despite its marked economic difficulties, the United States continued to account for the bulk of the shares purchased by Germans abroad. Evidently most German investors expected that the US economy would make a rapid recovery. The growing signs of a turn for the better and the price movements in US equities proved them right up to a point; at all events, US shares performed significantly better last year (the Dow Jones Industrial

Average: -7%) than, for example, European (EuroStoxx: -19½%) or Japanese shares (Nikkei: -23½%).

... foreign investment fund certificates

German savers presumably also invested less in foreign shares indirectly, ie through foreign investment companies, last year than they had done 12 months before. This is suggested, firstly, by the fall in the purchases of foreign investment fund certificates (€19 billion compared with €32½ billion in 2000); secondly, investor interest shifted to money market funds, according to the Federal Association of German Investment and Asset Management Companies.[1]

... foreign bonds and notes

The bond markets benefited from the restraint in equity investment. German investors bought long-term foreign debt certificates worth a total of €94½ billion last year; this was €22 billion more than in 2000. As has been the case since the start of EMU, most demand was for bonds denominated in euro (€88 billion). A large amount of these investable funds (approximately €63 billion) flowed into other euro-area countries, whose government bonds had a slight yield advantage over German government paper. However, the interest rate differential declined in the course of last year and amounted to only 16 basis points – on average – at the end of 2001.

Contrary to what happened in 2000, foreign currency bonds also played a slightly greater

1 Strictly speaking, this statement applies only to German and foreign investment funds of German origin. However, it can presumably be applied to the foreign investment fund certificates acquired by German investors.

Financial transactions

€ billion, net capital exports: –

Item	1999	2000	2001
1 Direct investment	– 51.3	+ 157.7	– 12.8
German investment abroad	– 102.7	– 54.0	– 48.3
Foreign investment in Germany	+ 51.4	+ 211.8	+ 35.6
2 Portfolio investment	– 10.8	– 159.4	– 15.8
German investment abroad	– 177.4	– 208.5	– 128.7
Shares	– 68.0	– 104.8	– 15.8
Investment fund certificates	– 14.1	– 32.5	– 19.1
Bonds and notes	– 94.7	– 72.8	– 94.7
Money market paper	– 0.7	+ 1.6	+ 1.0
Foreign investment in Germany	+ 166.6	+ 49.1	+ 112.9
Shares	+ 21.9	– 34.5	+ 88.9
Investment fund certificates	+ 5.8	+ 10.9	+ 1.1
Bonds and notes	+ 97.6	+ 69.2	+ 54.9
Money market paper	+ 41.3	+ 3.5	– 32.0
3 Financial derivatives 1	– 1.7	– 4.2	+ 6.7
4 Credit transactions	+ 40.2	+ 42.4	– 22.9
Credit institutions	+ 53.0	+ 13.8	– 76.3
Long-term	– 7.5	– 24.5	– 43.2
Short-term	+ 60.4	+ 38.3	– 33.1
Enterprises and individuals	+ 40.4	+ 5.4	+ 10.4
Long-term	+ 1.8	+ 4.9	+ 7.3
Short-term	+ 38.6	+ 0.5	+ 3.0
General government	– 3.6	– 19.2	+ 16.4
Long-term	– 8.7	– 1.2	– 0.3
Short-term	+ 5.1	– 17.9	+ 16.8
Bundesbank	– 49.5	+ 42.4	+ 26.6
5 Other investment	– 2.4	– 2.1	– 1.4
6 Balance of all statistically recorded capital flows	– 26.1	+ 34.3	– 46.1
Memo item Change in the foreign reserves at transaction values (increase: –) 2	+ 12.5	+ 5.8	+ 6.0

1 Securitised and non-securitised options and financial futures contracts. — **2** Excluding allocation of SDRs and changes due to value adjustments.

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role again in the portfolio decisions of German investors last year. All in all, German residents spent €6½ billion net on debt securities of this type, especially those denominated in US dollars. At the same time, they sold, for example, bonds denominated in yen and Australian dollars. The concentration of purchases in the autumn of 2001 suggests that US government paper in particular benefited from investors' increased need for liquidity and security following the terrorist attacks in New York and Washington. Another factor was that holding gains could be expected on the US bond market as a result of the interest rate cuts by the US central bank, and, as it turned out, the US yields on ten-year bonds in the autumn of 2001 fell below the German level for a time.

Foreign investment in ...

Conversely, the more subdued speculation about euro-denominated bond rates may have been another reason why German debt securities attracted somewhat less international investor interest last year. That applied primarily to public bonds where sales exceeded purchases by foreign investors for the first time since 1981 (€5½ billion). Even so, the high standing of Federal bonds, especially in times of crisis, was evident in the autumn when foreign demand for these secure and highly liquid instruments showed a temporary marked increase. Foreign turnover in German public bonds also rose significantly last year and almost regained the record levels of 1997 and 1998.[2]

... German public bonds

... German private bonds and money market paper

As in the previous two years, the bonds of private-sector borrowers were in greater demand from non-residents last year than domestic government paper (€60½ billion). However, sales of this paper, predominantly bank bonds, benefited from, among other things, large sales and redemptions of money market paper (€32 billion), most of which had likewise been issued by German credit institutions. Evidently foreign investors were restructuring their portfolios, and short-date German paper, ie paper with maturities of one year or less, were being replaced by slightly longer-date instruments which, in the eyes of foreign investors, probably had a more favourable risk-return profile.

... German shares

There was also remarkably heavy demand from non-residents on the German shares market. Overall, non-residents invested a record €89 billion in German equities. It is true that an exchange of shares in connection with a corporate acquisition accounted for about one-third of this. Even if this single transaction is eliminated, however, foreign interest in German shares was very considerable, especially as price increases on the German share market were, as already mentioned, below those on other markets. It is possible that investors from outside the euro area took advantage of the favourable circumstances to build up their holdings of shares in Europe. This is suggested by the fact that large amounts of investable funds flowed into the share markets not only in Germany but also in the euro area as a whole (EMU: €237½ billion).

Direct investment

The end of the recent wave of mergers and the slower growth in the world economy had

2 At the end of June 2001 non-resident investors held German public bonds with a market value of €394 billion.

a protracted impact on direct investment last year. According to Unctad estimates, global direct investment amounted to US$760 billion in 2001; that was about 40% less than the record in 2000. A similar tendency can be observed in the case of Germany where the acquisitions of participating interests by non-residents in particular fell significantly.

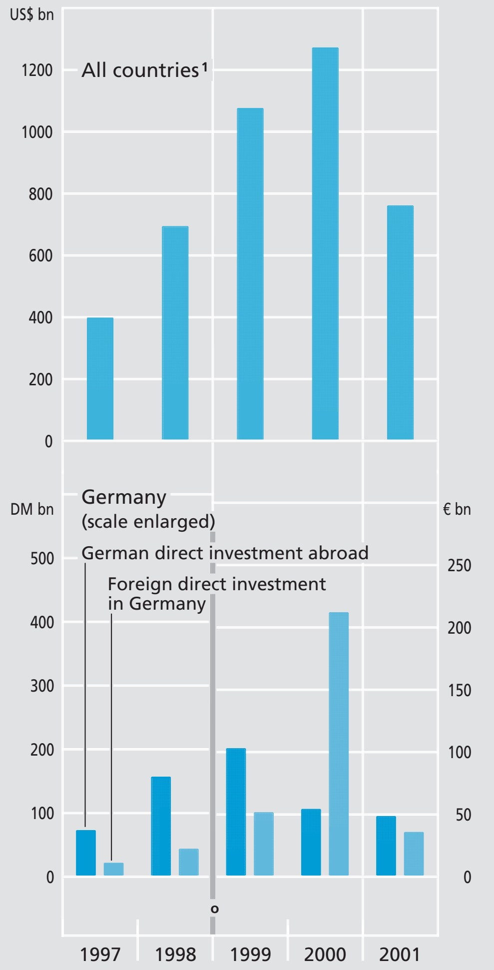
Foreign direct investment in Germany

Foreign proprietors provided their branches domiciled in Germany with investable funds amounting to a total of €35½ billion last year compared with €212 billion in 2000[3] and €51½ billion in 1999. In the main, they increased the capital base of their branches and subsidiaries in 2001; contrary to what happened in the previous year, the granting of intra-group credits played only a minor role. It was mainly enterprises from the other euro-area countries that built up their presence in Germany in 2001; about 70% of inward investment came from these countries.

German direct investment abroad

German direct investment likewise declined last year even if not quite as sharply as foreign investment in Germany. However, the peak of German enterprises' outward investment had already been reached in 1999. In 2001 German enterprises invested €48½ billion abroad compared with €54 billion in 2000 and €102½ billion in 1999, with the result that in net terms €13 billion was exported from Germany through direct investment in 2001. The main item in Germany's direct investment abroad last year was the acquisition of a US telecommunications enterprise. Although this acquisition had been agreed in 2000, it could not take place until the cartel authorities had completed a fairly lengthy investigation and only after that could it be statistically recorded. German direct investment abroad was reduced by comparatively large sums which were borrowed by German parent companies from their foreign affiliates (€23 billion) and which are shown as deductions in the direct investment statistics. Among other things, these involve transactions with foreign sub-

Direct investment worldwide and in Germany



1 Sum of inward direct investment of all countries; data estimated for 2001. Source: Unctad. — o From 1999 data in euro.

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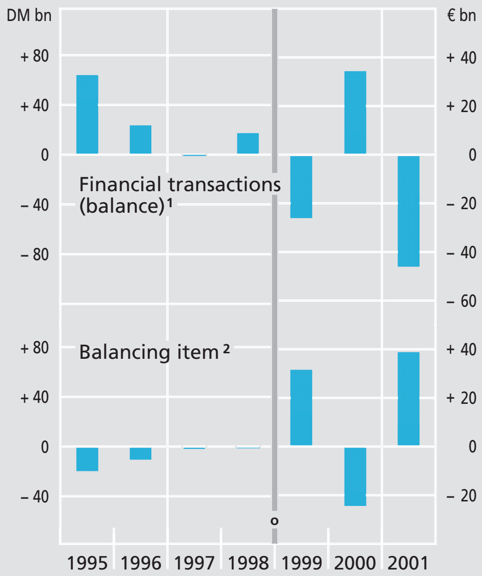
3 A large transaction in which a foreign enterprise took over a German firm had a very considerable influence on foreign direct investment in 2000.

Financial transactions and balancing item



1 Net capital exports:–. — 2 Balance of statistically unclassifiable transactions. — o From 1999 data in euro.

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sidiaries which look after the issue of debt certificates for the international market and pass on the proceeds from the issue to their parent company. As most of these financing companies are domiciled in neighbouring euro-area countries and owing to the large investment in the United States mentioned above, the regional breakdown of German direct investment was seriously distorted in 2001. For example, German enterprises withdrew funds (of €23½ billion) from other euro-area countries while they invested heavily in the United States for the most part (€49 billion). For some years now there has also been a sizeable flow of investable funds (2001: €3½ billion) into the central and east European countries in transition, which have also become fairly important for German foreign trade.

Credit transactions of non-banks

In net terms, German non-banks drew on foreign sources of finance through statistically recorded credit transactions last year. For example, enterprises and individuals imported €10½ billion net; in the process they greatly expanded the credit they raised from banks abroad in particular. Evidently they took advantage of the integrating financial market provided by EMU. They also received funds from abroad through advance payments on foreign trade business and a reduction in the remaining volume of their own trade credits. External public-sector operations also led to an influx of funds (€16½ billion net). This was due mainly to the fact that funds which public authorities had placed with foreign banks in September 2000 were used at the beginning of 2001 for an early redemption of debt certificates issued by the Currency Conversion Equalisation Fund.

Credit transactions of the banking system

The non-securitised credit transactions of the banking system as a whole (MFIs including the Bundesbank) resulted in fairly large outflows of funds, by contrast. It was particularly the German credit institutions that sharply expanded their non-securitised external investments in 2001. For the first time for several years the asset-side business, ie the granting of advances and loans to foreign customers, grew faster in terms of value than the liability-side business. Consequently, the German banks exported €76½ billion net in 2001 compared with capital imports of €14 billion in 2000. At the same time, however, €26½ billion in foreign funds accrued to the Bundesbank. As is usual since the start of monetary union, this was primarily the result of balances arising within the large-value payment

Impact of the introduction of euro banknotes and coins on the German balance of payments

The changeover to the euro was already having an impact on the German balance of payments before the euro banknotes and coins were introduced on 1 January 2002. In the course of 2001, for example, large amounts of Deutsche Mark banknotes were being returned to Germany from abroad. Cross-border movements of banknotes have an effect on the balance of payments if they result in a change in Germany's liabilities to non-residents. In practice, however, it is virtually impossible to record these currency flows fully because most of the Deutsche Mark banknotes going abroad were taken there by travellers. Statistics exist only on Deutsche Mark banknote flows to and from other countries which were handled by the banking system, and past experience has shown that it is primarily returns that are recorded here; at all events, there is a certain element of uncertainty about these statistics. Gaps in recording would be acceptable provided the cross-border currency movements cancelled out relatively quickly within the balance of payments.[1] However, problems for the balance of payments statistics arise when, over a period of time, a fairly sizeable stock of German banknotes is built up abroad or is greatly changed – and that is precisely what has happened. There was a considerable demand from non-residents for Deutsche Mark banknotes, especially in the 1980s and the beginning of the 1990s. Estimates at the time – although these were subject to a high degree of uncertainty – put the stock of Deutsche Mark banknotes abroad at between DM65 billion and DM90 billion.[2] It is likely that most of this money has since been returned to Germany, and some of it certainly during 2001. Depending on how this money was repatriated, some of it may have had an impact on the balancing item in the German balance of payments.[3] Further return flows of Deutsche Mark banknotes can be expected during the first few months of 2002; these, too, will have some effect on the balancing item.

With the changeover to euro banknotes and coins throughout the euro area, it has become generally impossible to achieve a complete statistical recording of currency movements. As a rule, this will result in balancing items. Two examples may illustrate the problem.

- German banks' cross-border cash consignments within the euro area result in changes in the external position of the domestic banks involved, and these changes are recorded in the financial account. As the euro banknotes dispatched are not statistically recorded in full, there will generally be no corresponding counter-entry. This alone will result in a balancing item in the German balance of payments.

- Another statistical gap arises in connection with foreign travel. When German residents meet their travel costs in euro, this is normally reflected in the German current account, that is to say, provided it is statistically recorded in the collection of travel data. But here, too, there is no counter-entry in the German balance of payments, and so once again there will be a balancing item.

The problems addressed ultimately mean that in future there will be (additional) "systemic" gaps in the recording of cross-border transactions. To that extent, the balancing item's function to provide a warning about potential errors in the balance of payments will be impaired. Consequently, the margins of uncertainty in the other balance of payment items will also tend to increase, and balance of payment analysis will become even more difficult.

1 An example of this would be travel expenditure by German tourists abroad (= service imports) which, following the return of the Deutsche Mark banknotes, would result in corresponding credits in favour of foreign banks at German credit institutions (= capital imports). — **2** See F Seitz, *The circulation of the Deutsche Mark abroad,* Economic Research Group of the Deutsche Bundesbank, Discussion paper 1/95, May 1995. — **3** The decline in the Deutsche Mark banknotes held by non-residents and not recorded in the balance of payments has tended to reduce the (positive) balancing item. In other words, if it had been possible to capture these cash returns, the balancing item in 2001 would have been even larger.

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system TARGET, which ultimately mean an increase in the Bundesbank's liabilities to the ECB.

Foreign reserves of the Bundesbank

The foreign reserves of the Bundesbank, which are shown separately in the balance of payments, declined as a result of transactions by €6 billion last year. A decline of a similar amount had been recorded in 2000. The Bundesbank has therefore reduced its foreign reserves further. Including the amount transferred to the ECB at the beginning of 1999, the foreign reserves – at transaction values – have declined by €24½ billion since the start of EMU.[4]

Balancing item of the balance of payments

If the interrelationship of the statistically recorded transactions with non-residents in the balance of payments are carefully examined, it becomes clear that the balances with a plus sign – current account surplus (€2½ billion) and the decline in the foreign reserves (€6 billion) – are accompanied by much larger balances with a minus sign in financial transactions (€46 billion) and capital transfers (€1 billion). This results in a balancing item of €38½ billion in the balance of payments. This item reflects the incomplete and imprecise recording of cross-border transactions. In view of the various sources of the data and the increase in reporting thresholds, it is practically impossible to expect that the transactions shown in the balance of payments will be completely in equilibrium. Since the start of monetary union, however, the balancing item has been tending to increase, a development which, to a large extent, can presumably be explained by the sharp rise in cross-border transactions, especially financial transactions.

Future problems in analysing balance of payments ...

The problems associated with the balance of payments statistics will probably not decline in future either. On the contrary, with the introduction of euro banknotes and coins, avoiding balancing items is likely to become even more difficult than before because the introduction of the single currency provides another reason for systemic gaps in recording (see the notes on page 47). It will also limit the means of assessing the quality of the data and the consistency of the statistical figures in the balance of payments as a whole. The Bundesbank is therefore making an enormous effort to retain and improve the reliability and completeness of the remaining statistics by other means. For example, the more detailed breakdown planned for the safe custody account statistics will make it easier in future to check the plausibility of portfolio transactions. Analysing portfolio transactions security by security, as planned, will also make it possible to identify missing reports and reporting errors in this segment more quickly than hitherto and to take remedial action. Finally, the Coordinated Portfolio Investment Survey which has been initiated by the International Monetary Fund and in which Germany is also participating will provide stock data which will augment existing information on securities transactions. All these measures are ultimately designed to ensure data quality in portfolio investment.

... and efforts to improve data quality

4 The decline is hardly noticeable in the holdings valued at current market prices because revaluation gains were achieved through the rise in the US dollar exchange rate and gold price. At the end of 2001 the foreign reserves amounted to €93.2 billion compared with €93.9 billion at the start of monetary union.