German balance of payments in 2003

Last year the German economy was exposed to changing international influences. Whereas in the first half of the year geopolitical tension, the SARS lung disease and cyclical concerns put a strain on the international environment, the subsiding of negative factors and the visible global economic recovery subsequently led to perceptibly brighter sentiment. This improvement in outlook was not lastingly affected by the sharp appreciation of the euro either, even though the shifts in the exchange rate structure in some cases had a discernible effect on international current and financial transactions. The trade surplus in 2003, with both exports (+1½%) and imports (+2½%) rising, fell slightly from the previous year's record heights. By contrast, the current account balance improved somewhat as the deficit in invisible current transactions continued to diminish. As regards financial transactions, the favourable interest rate and exchange rate situation for euro-area investment and domestic investors' reluctance to incur risk led to large net capital imports in Germany, particularly via securities transactions. However, those inflows contrasted with substantial outflows of funds in non-securitised credit transactions.

Current account

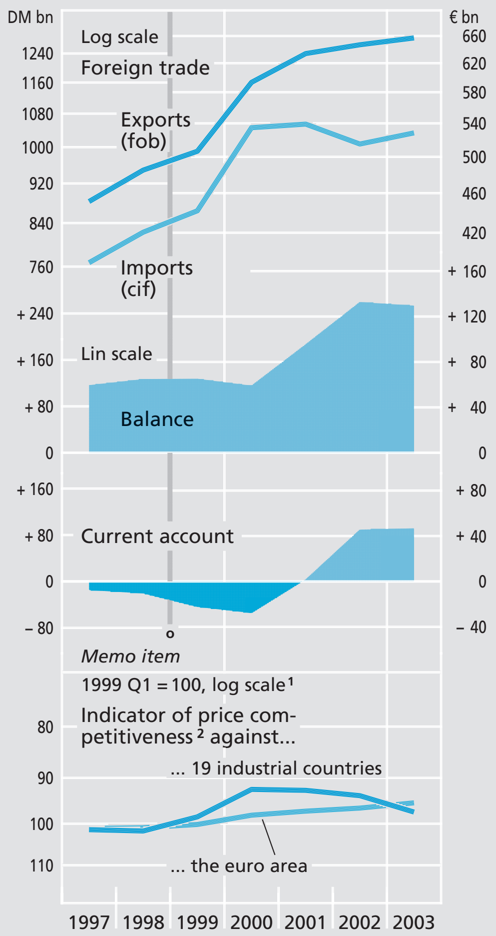
External environment

German exporters initially encountered rather difficult sales conditions in 2003. Early in the year, the Iraq war and the SARS lung disease weighed heavily on the world economy and world trade. It was most notably the persistently muted global demand for capital goods which affected Germany's foreign trade during that period. These influences dampened German exporters' foreign sales, on the whole. In the second half of the year the absence of these negative factors caused the world economy to recover distinctly, and sentiment among German exporters – measured, for instance, in terms of Ifo export expectations – became increasingly brighter. Growing demand on German export markets enabled German exporters to post a discernible rise in foreign orders from first-half levels, and this led to a distinct expansion in exports.

Euro appreciation and price competitiveness

Under these circumstances the gradual disappearance over the entire year of Germany's competitive edge in terms of prices, which had been created by the relatively low value of the euro, did not have a negative impact on the revival of export business. Throughout 2003 the euro appreciated by 20½% against the US dollar and by 11½% on a weighted average against the euro area's most important partner currencies. The dampening stimuli from the euro's appreciation, however, were cushioned by the fact that a large share of Germany's exports (43½%) go to other euro-area countries. In this area, German companies were able to build on their price and cost advantages. On a weighted average against Germany's 19 most important trading partners, German exporters' price competitiveness therefore fell by only 3% during the course of 2003. Therefore, on a long-term comparison, domestic enterprises' price competitiveness can currently be regarded as close to neutral even after the euro's appreciation.

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.

Deutsche Bundesbank

Exports

On the whole, German exporters were not able to completely maintain their position on foreign markets in the past year. In terms of value, German exports in 2003 were up by a mere 1½% on the year. Given largely unchanged export prices on average, they likewise rose only marginally faster in real terms and thus more slowly than world trade.

It was particularly exports of goods to other euro-area countries which proved to be a stimulus. They rose by 3½% in nominal terms, and by just over 3% in real terms, from 2002 levels. German exporters benefited not just from the pickup in economic activity in the euro area as the year progressed but also from a slight improvement in their price and cost situation compared with companies in other euro-area countries. On the whole, German exporters are therefore likely to have extended their euro-area market share somewhat in 2003.

By contrast, last year German exporters were forced to surrender some of their share in exports to non-euro-area countries. Nominal exports stagnated. In addition, stiffer competition caused domestic exporters to grant price concessions on their respective non-euro-area export markets, with developments in specific sectors of activity having had a negative impact on results in some cases. At constant prices German exports to non-euro-area countries rose by just under 1%.

Diverging market conditions outside the euro area – with at times strong market growth, on the one hand, and sharp movements in exchange rates, on the other – has led to major differences in Germany's exports to individual countries. As in previous years, do-

Regional trend in foreign trade

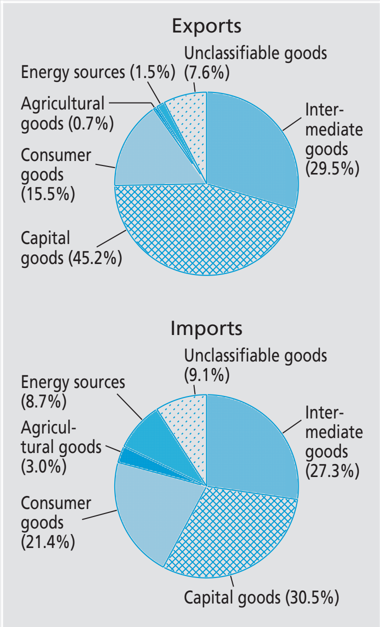
2003

Country/group of countries	Percentage share	Percentage change in absolute value from previous year
Exports		
All countries	100.0	1.6
of which		
Euro-area countries	43.3	3.6
Other EU countries	12.2	3.1
United States	9.3	– 9.7
Central and east European countries in transition	12.1	6.1
Japan	1.8	– 5.9
Emerging markets in South-East Asia	3.7	– 2.9
China	2.8	24.9
OPEC countries	2.1	– 4.7
Imports		
All countries	100.0	2.6
of which		
Euro-area countries	41.0	2.9
Other EU countries	9.5	– 1.5
United States	7.3	– 3.3
Central and east European countries in transition	14.3	8.0
Japan	3.6	– 3.8
Emerging markets in South-East Asia	5.0	– 0.3
China	4.7	17.3
OPEC countries	1.4	4.7

Deutsche Bundesbank

Foreign trade by selected categories of goods

2003



Deutsche Bundesbank

mestic exporters reported remarkable success in sales to China (+25%), which saw particularly strong economic growth during the past year. Sales to central and east European transition countries likewise grew vigorously (+6%). Sales to other EU countries, which also make up a significant share in German exporters' foreign business, went up by 3%. By contrast, German companies saw a sharp drop in sales to the United States (-9½%) and the South-East Asian emerging market countries (-3%), whose currencies are in some cases (nominally or effectively) pegged to the US dollar. Trade with OPEC countries (-4½%) and Japan (-6%) behaved similarly.

Breakdown of exported goods

Nearly all sectors felt the impact of the increasingly difficult selling conditions on foreign markets in 2003.[1] It was particularly the producers of capital goods (German exporters' most important product range, at 45% of exports) that suffered under last year's continued sluggishness in global investment activity. The muted foreign demand had a particularly adverse effect on exports of machinery. In terms of value, deliveries of information and communication technology (ICT) products also fell sharply; however, further price reductions in this product segment were a major factor. By contrast, car manufacturers increased their export revenue slightly from 2002 levels. Chemical product manufacturers likewise saw some growth in their foreign business.

Imports

Nominal imports of goods were up by 2½% in 2003 and thus slightly more sharply than exports. At the same time, the appreciation of the euro against the currencies of important trading partners caused import prices to fall by a total of 2.2%. It is true that, despite the euro's appreciation against the US dollar, it was most notably energy imports which became more expensive on average over the past year. However, most other imported goods were cheaper, sometimes by a considerable margin. Imports therefore grew faster in real terms (+5%) than in terms of value. Shifts in price relationships between Germany and other countries, which caused domestic buyers to tend to substitute foreign products for domestic products (terms of trade improved by 2%), undoubtedly contributed to the sharp import growth relative to domestic

1 The picture of the breakdown of exported and imported goods is distorted slightly by the large percentage of goods which so far have not been classifiable in any group of goods.

demand, which had experienced a long period of stagnation last year. Moreover, the acceleration in exports in the second half of 2003 was probably the main factor which boosted import activity, since experience shows that the share of imported intermediate goods in the production of export goods is relatively high. In some cases, however, the rise in imports is also attributable to the quantitative replenishment of energy stocks.

Breakdown of imported goods

Along with energy imports, foreign demand for motor vehicles and vehicle parts likewise rose in the past year, a sign of the increasing integration of domestic car production with other countries. By contrast, in terms of amounts, imports of chemical products were down on 2002. Sales by foreign machinery manufacturers in the German market, too, were down somewhat on the year in the light of more subdued domestic investment activity. In addition, foreign sellers of ICT goods saw their sales on the German market drop distinctly. However, it was particularly lower prices which reduced the value of imports in this product category; for instance, imports of data processing equipment were 11½% cheaper and those of communications equipment 8½%.

Regional structure of imports

On the imports side, too, trade with China was particularly buoyant; imports were up by 17½%. Imports from the central and east European transition countries rose as well (+8%) following a relatively weak year. Moreover, euro-area enterprises recorded a distinct rise in their turnover in business with German importers (+3%). Since the prices for imports from the euro area fell slightly last year, this increase in turnover merely reflects volume effects. In nominal terms, imports from OPEC countries likewise rose in 2003 (+4½%), the increase in energy prices being an important factor. By contrast, imports from companies in Japan (-4%), the United States (-3½%) and the South-East Asian emerging economies (-½%) went down. These developments, however, are more likely to have been affected by the exchange-rate-related decline in import prices in euro terms than by a real decline in sales.

Balances of trade and current account

In 2003 a trade surplus of €129½ billion was generated. Since the value of imports rose only slightly faster than export proceeds, the surplus was merely €3 billion below the previous year's record. At the same time, the deficit on invisible current transactions went down by €5 billion to €76 billion. This led to a current account surplus of €47 billion or 2.2% of nominal GDP. This figure had been somewhat lower in 2002, at €45½ billion.

Factor income

The lower deficit on invisible current transactions which comprise services, factor income and current transfers is due largely to movements in cross-border factor income. The past year saw net expenditure of €12½ billion following €17 billion a year earlier. Developments in investment income contributed in large part to this decline, whereas cross-border employee compensation remained virtually unchanged. As regards investment income, revenue went up by €2 billion to €93 billion, while expenditure went down by €2½ billion to €105½ billion. The increase on the revenue side was focused on income from direct investment, which could potentially in-

Major items of the balance of payments

€ billion

Item	2001	2002	2003
I Current account			
1 Foreign trade			
Exports (fob)	638.3	651.3	661.6
Imports (cif)	542.8	518.5	532.0
Balance	+ 95.5	+ 132.8	+ 129.6
2 Services (balance)	– 50.3	– 36.4	– 34.8
of which			
Foreign travel (balance)	– 38.0	– 35.4	– 36.1
3 Factor income (balance)	– 10.7	– 16.8	– 12.5
of which			
Investment income (balance)	– 10.4	– 16.7	– 12.4
4 Current transfers (balance)	– 27.4	– 27.9	– 28.8
Balance on current account 1	+ 1.7	+ 45.7	+ 46.8
II Balance of capital transfers 2	– 0.4	– 0.2	+ 0.3
III Financial account 3			
Direct investment	– 17.6	+ 29.1	+ 9.1
Portfolio investment	+ 26.5	+ 43.9	+ 59.0
Financial derivatives	+ 6.8	– 0.9	– 0.5
Credit transactions 4	– 42.0	– 140.9	– 122.6
Balance on financial account	– 26.2	– 68.7	– 55.0
IV Change in the foreign reserves at transaction values (increase: –) 5	+ 6.0	+ 2.1	+ 0.4
V Balance of unclassifiable transactions	+ 18.8	+ 21.2	+ 7.4

1 Includes supplementary trade items. — **2** Including the acquisition/disposal of non-produced non-financial assets. — **3** Net capital exports: –. For details see the table "Financial transactions" on page 47. — **4** Including Bundesbank investment and other public and private investment. — **5** Excluding allocation of SDRs and changes due to value adjustments.

Deutsche Bundesbank

dicate that the profitability of German enterprises' foreign branches is improving. By contrast, dividends from portfolio investment and interest earned on bonds and loans fell. Not only interest rate movements but also exchange rate movements might have played a significant role: the euro's rise led to a sharp reduction in income on foreign currency assets (converted into euro). Since, in terms of amounts, more German external assets than external liabilities are denominated in foreign currency, this exchange rate effect did not have the same impact on the expenditure side,[2] where lower interest payments on loans were virtually offset by higher interest expenditure on public bonds and increased yield payment on direct investment.[3]

Services

As was already the case in earlier years, the largest subsegment in the deficit on invisibles was the deficit on services (€35 billion). However, this deficit like the factor income deficit also fell further, by around €1½ billion. This was due mainly to lower expenditure on cross-border services, which fell distinctly further than revenue. Developments in the individual subsectors of services varied considerably. Payments on transport services, in particular, went down. In addition, payments by residents to non-residents for patents and licences and for research and development were down. The euro's appreciation may have also contributed to a tendency on the part of imports of services to become cheaper.

2 At the end of June 2003 39% of German external assets and 18% of German external liabilities were denominated in foreign currency.
3 The latter were driven mainly by a decline in German direct investment enterprises' reinvested profits, which on balance were negative, as in the preceding years.

Travel

Travel has traditionally been a key element of the services account. A decline in the deficit in 2002 was followed last year by a slight rise to €36 billion. Despite having less scope for expenditure, residents apparently increased their foreign travel on holiday and on business again. Germany's travelling expenditure was up by €1 billion, or around 1½%, on the year after falling sharply in 2002. Several European holiday countries in particular benefited from the increase in travelling, including Austria, the Benelux countries and Germany's central and east European neighbours. Following the dollar's sharp depreciation, however, the United States also apparently proved to be an attractive destination once again. There was less demand last year for trips to Italy, Spain and Portugal, though. Other holiday destinations, too, saw their popularity decrease, bucking the general trend. The Iraq war, uncertainty caused by terrorist attacks and the SARS epidemic all probably played a role. Affected destinations include Turkey, Egypt, Tunisia and some Asian countries.

Insurance services

Insurance services deteriorated the worst within the services account in 2003. Germany's expenditure more than doubled, for one thing (+€1½ billion). This was due not to premium payments by residents to non-resident insurers which remained constant but mainly to declining revenue from claims payments by foreign reinsurance companies.[4] Another thing was that German revenue from cross-border insurance services fell by €1½ billion since German reinsurers' revenue from premiums fell further than claims payments.

Transfers

The deficit on current transfers to non-residents rose by just less than €1 billion to €29 billion last year. This was attributable mainly to increases in public transfers, which rose by €2½ billion net due to an increase in net payments to the EU budget. Reduced EU payments to Germany, especially in the area of agricultural market regulation, as well as higher German payments to the EU based on national product were both contributory factors. By contrast, the EU share in German revenue from value added tax remained virtually unchanged.

In contrast to public sector transfers, the balance on private sector transfers improved by €1½ billion; in 2003 it ran a deficit of €10 billion. The decline was attributable to the other transfers item, among other things; this includes, above all, severance pay and gambling revenue but also penalties and warranty payments (€1½ billion). Moreover, indemnification payments by private sector entities such as the Foundation "Remembrance, Responsibility and Future" went back down (€½ billion) following large disbursements in the two preceding years.

Financial transactions

Trends in financial transactions

Events on the international financial markets were also determined by the changing political and economic situation in 2003. For example, share prices fell to a cyclical low

4 The difference between premiums received and actual claims payments during a period is held to be a cross-border service in the insurance industry. Short-term volatility in insurance services may occur if the agreed premiums lag behind changes in claims patterns.

worldwide in the second quarter of 2003, and the yields on bonds issued by first-class borrowers declined under the pressure of growing concerns about deflation to levels which had last been observed at the end of the 1950s. When uncertainty subsided later in the year and the economic outlook gradually brightened, internationally oriented investors again faced the future with greater optimism. This was reflected in a rapid rise in share prices and – inversely – in a fall in prices for fixed-interest paper. At the same time, the euro appreciated in leaps and bounds right up to the end of the year. The international influences outlined above were also manifest to some extent in the capital flows to and from Germany, which likewise underwent a transformation in the course of the year. Whereas in the first few months of last year some internationally operating investors had reduced their globally oriented portfolios, especially in the case of equities, they switched back around the middle of the year to investing considerable amounts internationally. If the year is considered as a whole, however, the increased need for security felt by international investors was part of the reason why there was a further decline in the gross flows of capital in both directions. All in all, net amounts of capital flowed into Germany as a result of portfolio investment and direct investment in 2003 whereas large net capital outflows were recorded in non-securitised credit transactions.

Portfolio investment

The largest net capital imports in ten years (€59 billion) were recorded in portfolio investment although large amounts of funds also flowed into Germany in the previous two years (€44 billion in 2002 and €26½ billion in 2001). Even so, the substantial net inflows conceal considerable reluctance on the part of financial market participants to make cross-border investments, a development which does not become apparent unless the decline in the gross amount invested is examined.

German investment in …

The more cautious approach to making financial decisions is particularly evident among German investors, whose portfolio investment abroad amounted to €32½ billion and was therefore only half what it had been in the previous year. German investors were particularly sceptical about the dividend-bearing paper of foreign firms. For the first time since 1995, for example, German residents became net sellers on the international equity markets and reduced their holdings of foreign shares by €7½ billion. It was evidently not so much the influences exerted by the foreign exchange market that contributed to this development but rather the change in expectations about the business cycle and earnings. This argument is supported by the fact that it was mainly holdings of shares issued in the euro area which were liquidated (€5 billion) while US equities – despite the weakness of the dollar – were bought by German investors on balance. Given the prevailing stock market situation, German investors seemed to be directing their attention more at their home market, and this was reflected in their declining interest in funds domiciled abroad; experience has shown that these funds invest the bulk of the capital accruing to them on the international share markets. At all events, German investors added foreign investment

… foreign shares

fund certificates worth no more than €4½ billion to their portfolios after acquiring as much as €7 billion of this type of paper last year.

... foreign bonds and notes

German investors' demand for foreign debt securities was also much lower, however, and was restricted essentially to euro-denominated bonds issued by governments in the euro-area partner countries. Whereas German residents had invested €48 billion in longer-term euro-denominated bonds and notes in 2002, they added no more than €31½ billion worth of such paper to their portfolios in 2003. In the first three years of monetary union, when stocks were undergoing substantial adjustment to the new situation, German investors actually bought an average of €84 billion worth of such paper. It is possible that this significant fall in demand is also a sign of a growing degree of homogeneity within the euro-area capital market where the differences between federal (German) bonds and the bonds of euro-area partner countries are increasingly dwindling. This hypothesis is borne out at least to some extent by the fact that the differential between the yields on government bonds within the euro area declined by a further 7½ basis points to 10 basis points on an annual average of 2003. A net amount of money market paper, ie fixed-interest securities with a maturity of less than a year, was actually sold last year (€2 billion).

Foreign investment in ...

The generally more cautious attitude in the international financial centres could also be seen in the comparative reluctance of non-residents to invest in the German securities

Financial transactions

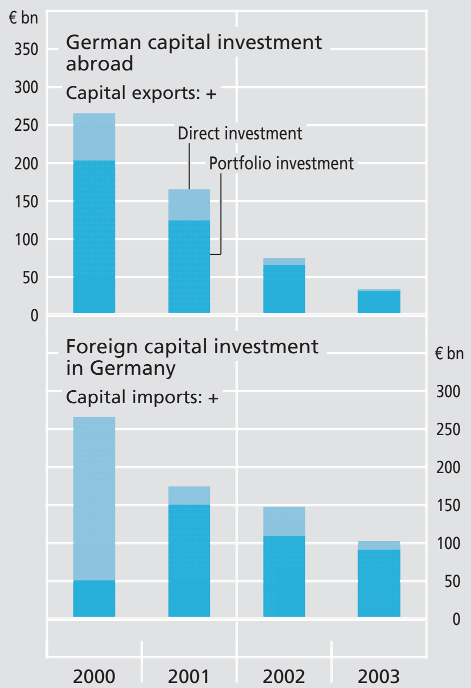
€ billion, net capital exports: –

Item	2001	2002	2003
1 Direct investment	– 17.6	+ 29.1	+ 9.1
German investment abroad	– 41.2	– 9.2	– 2.3
Foreign investment in Germany	+ 23.6	+ 38.3	+ 11.4
2 Portfolio investment	+ 26.5	+ 43.9	+ 59.0
German investment abroad	– 124.4	– 65.8	– 32.3
Shares	– 10.6	– 4.8	+ 7.6
Investment fund certificates	– 20.2	– 7.0	– 4.3
Bonds and notes	– 95.1	– 49.1	– 37.8
Money market paper	+ 1.5	– 5.0	+ 2.1
Foreign investment in Germany	+ 150.9	+ 109.8	+ 91.3
Shares	+ 86.8	+ 15.7	+ 24.2
Investment fund certificates	+ 1.0	– 0.7	– 1.5
Bonds and notes	+ 80.3	+ 83.5	+ 69.2
Money market paper	– 17.2	+ 11.3	– 0.6
3 Financial derivatives 1	+ 6.8	– 0.9	– 0.5
4 Credit transactions	– 40.7	– 139.4	– 120.0
Credit institutions	– 76.3	– 102.1	– 110.1
Long-term	– 43.2	– 13.4	– 37.1
Short-term	– 33.1	– 88.7	– 73.1
Enterprises and individuals	– 7.9	– 7.5	– 17.1
Long-term	+ 9.2	+ 4.1	– 4.6
Short-term	– 17.1	– 11.6	– 12.4
General government	+ 16.9	+ 5.5	+ 4.9
Long-term	+ 0.0	+ 0.1	+ 5.6
Short-term	+ 16.8	+ 5.5	– 0.6
Bundesbank	+ 26.6	– 35.4	+ 2.2
5 Other investment	– 1.3	– 1.5	– 2.6
6 Balance of all statistically recorded capital flows	– 26.2	– 68.7	– 55.0
Memo item Change in the foreign reserves at transaction values (increase: –) 2	+ 6.0	+ 2.1	+ 0.4

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

Deutsche Bundesbank

Financial transactions



Deutsche Bundesbank

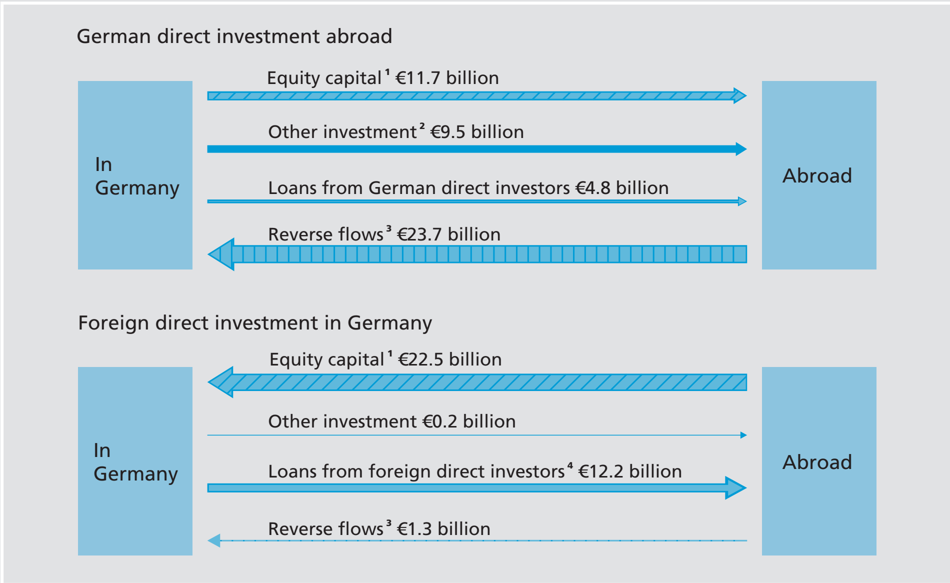
markets. Non-residents acquired securities worth €91½ billion in Germany in 2003, but that was much less than in the previous year (€110 billion). There was a particularly sharp decline in demand for federal bonds – paper which is normally very popular with foreign investors owing to its first-class credit rating and high degree of liquidity. For example, foreign savers increased their holdings of public interest-bearing paper by no more than €20½ billion, just over 40% of the previous year's amount (€50½ billion). One reason for this may have been that non-residents reassessed their international investment options as global security risks subsided and, especially in the third quarter, withdrew funds which they had invested in German government bonds as a safe haven at the beginning of the year. By contrast, the interest rate swing on the international bond markets probably played rather a minor role in this decision because private bonds had been in great demand throughout the year. For example, foreign investors acquired €49 billion worth of this paper in 2003 whereas in the previous year they had added privately issued debt securities worth only €33½ billion to their safe custody accounts. This switch in demand from public to private bonds and notes was probably also due to the interest rate advantage that bank debt securities had over German government paper even though this spread was reduced by a further 11 basis points in the course of the year. All in all, the acquisitions of long-term fixed-interest securities amounted to €69 billion compared with €83½ billion a year earlier. German money market paper which was evidently used for a time during the year to take account of temporary interest rate and cyclical uncertainties found no foreign buyers on balance over the year as a whole (-€½ billion).

... German bonds and notes

... German shares

German shares, by contrast, benefited from the changing expectations about the business cycle and the declining uncertainty in terms of the implicit volatility of the DAX even when compared with the equities issued in major partner countries. Although foreign investors had still been selling German shares at the beginning of the year, they rediscovered the German stock exchange when the dynamic rally set in and bought German shares worth €24 billion net. This was €8½ billion more than in the previous year. This also means that within the euro area, too, Germany appears to have been a particularly attractive location for equity investment in

Direct investment in 2003



1 Including reinvested profits. — **2** Primarily real property. — **3** Borrowing by the parent company from its foreign branches; in the case of foreign direct investment in Germany net redemption payments by the foreign parent company to its German branches. — **4** Redemption payments.

Deutsche Bundesbank

2003. This development is certainly also to be seen in connection with the fact that the DAX, after emerging from the cyclical low in mid-March 2003, rose by 44% by the end of the year whereas the Dow Jones index and the Nikkei index increased by only 28% and the EuroStoxx index by 32%.

Direct investment

It was not only in the field of portfolio investment that gross capital flows declined; in the field of direct investment, which usually responds comparatively slowly to cyclical and geopolitical changes, new investment in both directions was also lower last year. Evidently the cyclical revival which gradually emerged and the share prices which increased in the course of the year were still not being reflected in a renewed upturn in cross-border direct investment. Possibly memories of the heavy losses which internationally oriented enterprises – especially those in the innovative high-tech and telecommunication sectors – had sustained as they extended their international reach in recent years were still having an effect on their decision-making. For example, the mergers and acquisitions of internationally operating enterprises – precisely in these aforementioned economic sectors – sank last year to a fraction of record levels reached around the year 2000. However, the general downward movement predominated not only in the case of German direct investment but also in that of the euro area as a whole even if the data so far available suggest that the declines in the latter case were less pronounced. All in all, net funds flowing into Germany in the form of direct investment amounted to €9 billion in 2003, which was €20 billion less than in the previous year.[5]

German direct investment abroad

New investment by German enterprises abroad declined particularly sharply to €2½ billion (2002: €9 billion). As in previous years, there were countervailing developments in the provision of funds, and the amounts were also smaller. While, on the one hand, German enterprises increased their capital investment in branches abroad by €13 billion, they received substantial net funds, mainly in the form of short-term financial credits, from their foreign subsidiaries, on the other. Again as in previous years, the credits, amounting to €23½ billion, consisted principally of reverse flows. These are loans which are granted by the subsidiary domiciled abroad to the parent company in the home country and are entered in the balance of payments as disinvestment. Furthermore, German enterprises and individuals spent €9½ billion on property and real estate, notably in the United Kingdom and France, which likewise count as direct investment. Possible reasons for the fairly low level of German direct investment were the persistently poor performance of German enterprises and the uncertain world economic outlook during much of the year; this evidently induced German enterprises to restrict their cross-border M & A activities.

Foreign direct investment in Germany

Interest in cross-border investment also waned significantly in the case of financial flows in the opposite direction, ie foreign direct investment in Germany. Non-resident enterprises invested a total of €11½ billion in Germany, which was just over two-thirds less than in 2002. The main reason for this was that, although the supply of equity capital remained stable (at €28 billion), there was a swing in the credit transactions between affiliated enterprises from capital inflows in 2002 (€22 billion) to what is now a fairly high level of capital outflows (€11 billion). However, it must be remembered when interpreting these figures that, owing to the revision of the Corporation Tax Act (*Körperschaftsteuergesetz*), parent companies that are obviously foreign transformed corporate loans into equity capital, thereby undertaking an accounting exchange on the liabilities side (see the explanatory notes on page 49). Last year Germany was the most attractive location for enterprises from France and the United States.

Credit transactions of non-banks

As in the previous year, there was a net shift of capital abroad as a result of the statistically recorded credit transactions of non-banks in 2003 (€12 billion compared with €2 billion in 2002). The main reason for this development is to be found in the operations of German enterprises (and individuals): they parked the proceeds from securities issues with foreign banks and thereby recorded a net increase of €17 billion in their external assets. General government, by contrast, imported funds amounting to €5 billion. This was essentially due to large loans against borrower's notes

5 According to initial estimates by UNCTAD for 2003, direct investment in the group of developed countries did not decline further but, instead, stabilised at a low level. However, there were diverging trends in the individual countries. For example, there was a threefold increase in the inflows of capital to the United States in the year under review whereas fairly substantial declines continued to be recorded in the EU, especially in France and Germany.

New provision on corporate borrowing and its effect on direct investment

At the end of 2003, there were unusual developments in foreign direct investment in Germany. For example, last December, non-resident proprietors repatriated long-term loans in the amount of €14½ billion, which they had previously made available to their branches domiciled in Germany. At the same time, they reinvested a large part of these funds as equity capital in their affiliated companies in Germany, a development which increased these affiliated companies' equity ratio.

These transactions were carried out in the light of the amendments to the Corporation Tax Act (*Körperschaftsteuergesetz*), which entered into force on 1 January 2004. These amendments removed the previous tax privileges with regard to corporate borrowing enjoyed by German shareholders but not by foreign shareholders in German corporations and abolished the special tax privilege for holding companies. Pursuant to the previous regulation, domestic holding companies – irrespective of their financing structure – could offset all interest payments on loans granted by their German parent company as operational expenditure and thus reduce their tax burden. The interest payments of German holding companies majority-owned by foreign companies, however, could be offset against tax only in the event of a debt-equity ratio of up to 3:1. If the capital ratio was less than 25%, the cost of debt was deemed to be a hidden distribution of profits under tax law. From a fiscal point of view, the intention was to limit tax shortfalls arising from this kind of corporate borrowing as the interest income of the non-resident parent company is not subject to German taxation.

The regulation in force since the beginning of 2004 applies equally to all German and foreign shareholders. According to the new regulation, payments for borrowed funds that exceed an exemption limit of €250,000 are, as a rule, to be regarded as a hidden distribution of profits and are therefore taxable if the borrowed funds are greater than one-and-a-half times the pro rata share of own funds at any time during the fiscal year. The extended safe haven for holding companies is no longer applicable. This is causing foreign shareholders to increase the equity base of their German holding companies from a previous level of 25% to at least 40% of the sum of own funds and borrowed funds.

In order to adapt the financing structure of their German holding companies to the legal framework applicable from 1 January 2004, foreign parent companies reduced their share of borrowed funds at the end of 2003 by calling in long-term loans and simultaneously engaging in new equity investments.

Deutsche Bundesbank

which were provided by foreign investors and which count as credit transactions.

Credit transactions of the banking system

Much like a mechanical balance sheet counterpart, as it were, large net capital exports by the banking system (€108 billion compared with €137½ billion in the previous year) coincided with an increase in the current account and the net capital imports in the other statistically recorded segments of the financial account. Operations at the short end of the market, amounting to €73 billion, accounted for most of the increase in the net external assets of the credit institutions. As in previous reporting periods, the granting of advances and loans to non-residents was the primary reason for this; corresponding deposits and borrowing operations grew more slowly. By contrast, the Bundesbank's external transactions that are classified as credit transactions were almost in balance (€2 billion). The small positive balance was due primarily to larger deposits by foreign commercial and central banks at the Bundesbank and was not, in contrast to the situation in previous years, in connection with the payment transactions of the ESCB.

Foreign reserves of the Bundesbank

The foreign reserves which are shown separately in the balance sheet declined at transaction values by €½ billion in 2003. When considered over the year as a whole, however, the valuation changes in the Bundesbank's balance sheet had a much greater effect. The foreign reserves depreciated by €8½ billion compared with the final balance sheet result in the previous year and stood at €76½ billion at the end of 2003. This was the result of the weak US dollar, whose exchange rate loss was only slightly offset by the increase in the value of gold.