German balance of payments in 2004

The favourable state of the global economy and the strong growth of world trade in the past year also boosted German exports. It was only in the second half of the year that rising oil prices and the strong euro put a slight damper on foreign demand. On balance, domestic exports rose by 10% in 2004, ie faster than at any time since 2000. Since import growth (7½%) did not keep pace with that of exports, the trade surplus reached a record €156½ billion. The surplus on current account likewise expanded distinctly (to €84 billion), causing aggregate "net exports" to contribute more than 1 percentage point to the 1.6% GDP growth in 2004. The disadvantage of the current account surplus, however, is high net capital exports, which show the extent to which Germany is supplying non-residents with savings from residents. Special factors led to outflows of FDI capital, whereas securities transactions recorded a flow of funds into Germany from abroad. This report discusses developments in current and financial transactions with non-residents in 2004. It also examines methodological changes in recording investment income and in collecting foreign trade data as well as problems associated with recording cash transactions.

Current account

External environment

Positive factors prevailed in the external environment in 2004. In the past year, the global economy – despite sagging in the second half of the year – grew an estimated 5%, its fastest pace of growth since the mid-1970s. At the same time, world trade grew by around 9% in real terms. However, exchange rates put a burden on German exporters, particularly through the sharp rise of the euro at the beginning and end of 2004. In terms of the price competitiveness indicator, which comprehensively reflects the price and cost situation of the German economy relative to other countries and also includes the variety of situations within the euro area, Germany's competitive position worsened only slightly on an annual average (-½%); it was still just over 2½% better than its long-term average.

Exports

German exporters benefited from their wide regional diversification and their broad product range. They were therefore able to participate successfully in the brisk growth of global trade and the global economy. In terms of value, German exports of goods went up by 10% in 2004 compared with their 2003 level. In real terms, too, they rose almost as much since export prices edged up only moderately (+½%).

Regional breakdown of exports

Exports to the other euro-area countries grew just as strongly in 2004 as those to non-euro-area countries (+10½%).[1] This is remarkable given that economic dynamism was stronger outside the euro area than within. Apparently, German exporters active in neighbouring euro-area markets benefited from cost and price developments that put them at an advantage over other euro-area competitors. The large increases in exports to Ireland (15½%), Spain (13½%) and Greece (13%) attest to this. These countries displayed, in addition to relatively buoyant economic growth, price and cost patterns that were quite unfavourable in some cases; in the case of Greece, moreover, an increased demand for goods, including German products, in connection with the Olympic Games in Athens may have played a role. These countries together, however, account for little more than one-seventh of Germany's euro-area exports, thereby limiting their contribution to German export growth. The demand from Austria, the Benelux countries, France and Italy for German products, which made up more than four-fifths of Germany's euro-area exports, therefore had a much greater impact. In the euro area – which accounted for no less than 43½% of Germany's total exports – Germany's exporters were once again able to enlarge their market share in 2004.

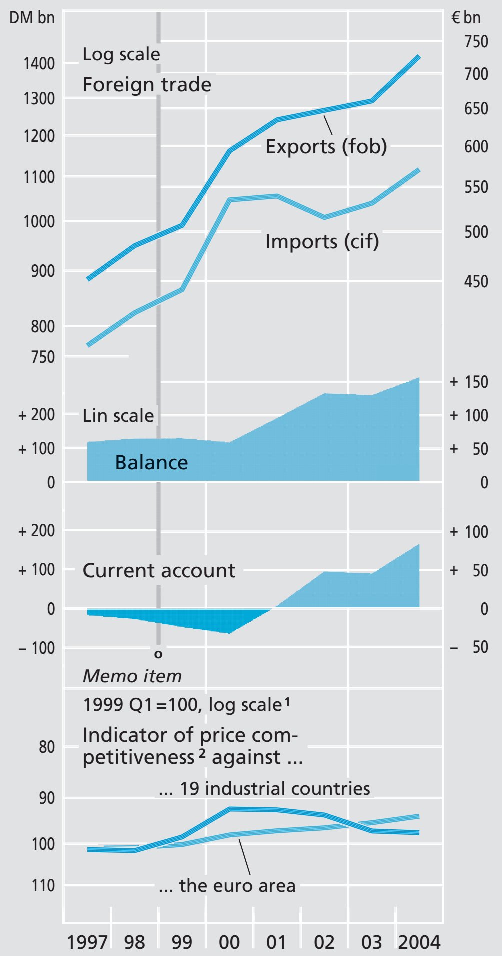
Outside the euro area, Germany's exports of goods, despite a healthy nominal growth rate of 10½%, probably increased less strongly than the total foreign trade of non-euro-area countries (a final assessment is currently not possible owing to incomplete world trade data). This would imply that in 2004 German exporters once again lost ground to their foreign, specifically Asian, competitors in non-

1 The 2004 figures for imports and exports broken down by country and region and by sector published by the Federal Statistical Office are around €2½ billion and €3 billion higher respectively than their totals. The latter were revised downwards in early February 2005; the regionally and sectorally disaggregated values have not yet been revised, however.

euro-area countries. Especially the growth in value of exports to the United States (still Germany's second most important trading partner), at 5% on the year, was rather modest when held up against strong US growth. In this case, it was certainly the earlier appreciation of the euro against the US dollar which made business more difficult for exporters, as exemplified by the sales trend for automobiles. Nominal exports to Japan likewise grew comparatively moderately (+7%). Finally, it is also striking that Germany's exports to those EU member states that have not yet introduced the euro likewise showed below-average growth (+8½%). However, statistical classification problems in connection with EU enlargement in May 2004 could have played a role (see box on page 28).

In many other countries, however, German exporters achieved double-digit export growth. As in 2003, they took advantage of China's rapid economic growth and the related brisk demand for imported goods (particularly machinery) to increase their exports (+15%). Germany also delivered a much larger amount of goods to the Russian Federation and the OPEC countries, whose export income rose sharply thanks to higher energy prices, than in 2003 (+23½% and +19½% respectively).

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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Breakdown of exported goods

Nearly all sectors were involved in the strong foreign demand in 2004.[2] However, the two most important product categories in the German export industry, capital goods and intermediate goods, accounting for just under 45% and nearly 30% respectively, benefited greatly from global economic growth. There was a particularly strong demand for domestically manufactured metal products (+13%), information and communication technology (ICT) products (+10%), chemicals (+10%) and mechanical engineer-

2 The picture of the breakdown of exported and imported goods is heavily distorted by the large percentage of goods which so far have not been classifiable in any group of goods. The rates of change for groups of goods, therefore, cannot be compared with the overall rate.

Statistical effects of EU enlargement on external trade statistics

The volume of trade with the ten new EU member states as reported in the German external trade statistics has declined significantly since their accession to the EU in May 2004. This applies to the traffic of goods in both directions, although more so to imports. Statistical recording effects are likely to be the main reason for this development. These are the result of the trade in goods with the newly acceded countries no longer being recorded on a secondary statistical basis through customs declarations, but through direct enterprise surveys under the Intrastat reporting system.

Transit transactions

Before the enlargement of the EU, goods which were imported into Germany from the Czech Republic or Poland, for example, and then exported to other EU member states were generally registered as imports and exports. This was at least the case if they were cleared at the German border for free circulation in the EU. In such cases, both an extra-trade import declaration and an intra-trade shipping report were made. Since the customs barriers were lifted, such movements of goods are regarded as transit traffic and are therefore no longer recorded in the statistics. This is, however, only the case if the goods are shipped to third countries without being detained in Germany or if they are detained only for reasons related to their transportation. The total value of the import declarations which are no longer made owing to the "transit effect" is likely to be considerable in the case of imports from the newly acceded countries.

Under-recording

Although enterprises were explicitly advised that as of May 2004 trade in goods with the new EU countries would be subject to the reporting requirement for intra-trade statistics, it cannot be ruled out that, at least temporarily, many respondents have failed to report. Late reports should reduce the related under-recording by the time the final trade figures for 2004 are established in the fourth quarter of 2005.

Processing[1]

In the processing business with the new EU member states a sharp decline was recorded on the imports side between May and December of last year. It may be assumed that some of these inflows of goods are still being declared, although probably as simple sales/purchases as processing is no longer subject to specific customs monitoring since the lifting of the customs barriers. It is not possible to quantify the exact extent of any under-recording as processing is not included in the intra-Community delivery/purchase reports for turnover tax purposes and thus the usual means of monitoring advance turnover tax returns is not available.

Exempt goods

Unlike in extra trade, in the intra-trade statistics a company-specific reporting threshold is applied to the exports and imports of an enterprise in one year. There may be above-average cut-off effects in trade with the new EU countries, with the result that the customary add-on estimates for this region are no longer sufficient. This applies in particular to Germany's direct neighbouring countries Poland and the Czech Republic as the "minor border traffic", which in many cases does not reach the reporting threshold, presumably plays a greater role in these cases.

Moreover, in the intra-trade statistics certain goods (which are specified in an "exclusion list") are generally exempt from declaration, ie irrespective of reporting thresholds. This includes trade of a temporary nature (for example, trade fair goods, hire goods, transactions on an operational leasing basis). Finally, individuals are also generally exempt from the disclosure requirement.

In contrast to the threshold-specific exemptions, the exemptions mentioned above related to specific goods or reporting parties are not offset by corresponding add-on estimates.

In conclusion, it may be assumed that the reported marked drop in the imports of goods in 2004 was due to statistical recording effects. A reliable estimate is, however, difficult to obtain at the current time. In an initial rough estimate, the Federal Statistical Office puts the discrepancy at approximately €3 billion. The impact of the changeover on goods exports should be smaller.

1 Processing is a customs procedure whereby goods (raw materials or semi-finished goods) are imported at a preferential rate of duty in order to be re-exported after (further) processing (inward processing) or, in the case of goods used to effect processing, temporarily exported from the customs territory and then re-imported at a special rate of duty (outward processing).

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ing products (+9%). By contrast, the automotive industry saw only below-average export growth (3%) from its 2003 level; this accordingly caused its percentage of total German exports to decrease by nearly 1½ percentage points to 18½%. There was a sharp drop-off in automotive exports particularly to the Chinese market (-22½% in terms of value). The fact that the Chinese authorities ordered the banking system to be more restrictive in extending (private) loans may have hampered local sales of German cars. In addition, the sale of motor vehicles to the United States, which in 2004 still accounted for 15% of German car exports, was on the decline in terms of value. Therefore, the main factor in the moderate result for this key German export sector may have been – along with the unfavourable exchange rate movements for exports to the dollar area – the difficult situation on the US automotive market.

Imports

Following somewhat moderate growth a year earlier, imports of goods grew in 2004 by 7½% in nominal terms. In real terms, too, imports showed a rather sharp rise, as the prices of imported goods went up by only just over 1% on average for the year. This increase is due mainly to a considerable hike in energy and commodity prices which more than made up for the reduction in import prices for capital and consumer goods. Given the stagnation of domestic demand, one major explanation for the strong rise in imports is the positive trend in exports. Because of the high – and still rising – percentage of imported intermediate inputs used to manufacture

Regional trends in foreign trade

2004

Country/group of countries [1]	Percentage share	Percentage change in imports or exports from previous year
Exports		
All countries	100.0	10.0
of which		
Euro-area countries	43.6	10.5
Other EU countries	20.5	8.7
of which		
New EU member states [2]	8.4	8.5
United States	8.9	5.1
Russian Federation	2.0	23.5
China	2.9	15.0
Japan	1.7	6.8
Emerging markets in South-East Asia	3.7	9.4
OPEC countries	2.3	19.3
Developing countries excluding OPEC	8.4	10.6
Imports		
All countries	100.0	7.5
of which		
Euro-area countries	40.8	8.7
Other EU countries	19.5	3.4
of which		
New EU member states [2]	10.1	1.0
United States	7.0	2.6
Russian Federation	2.8	14.0
China	5.7	26.4
Japan	3.7	7.2
Emerging markets in South-East Asia	5.2	10.6
OPEC countries	1.5	14.0
Developing countries excluding OPEC	9.6	7.6

1 For 2004 the data under “All countries” contain revisions that are not broken down by region. — **2** Acceded on 1 May 2004.

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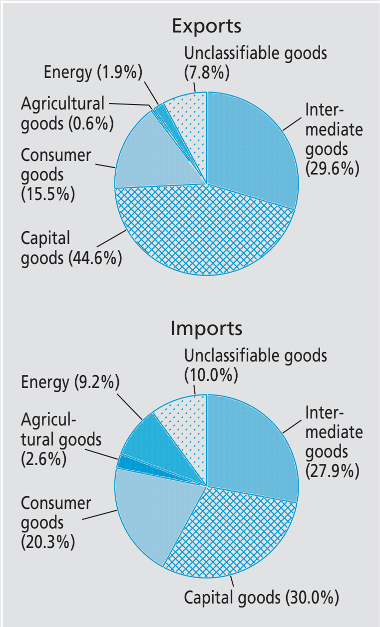
Foreign trade by selected categories of goods

2004



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exported goods, increases in exports are leading directly to increases in imports.[3]

Breakdown of imported goods

The strong growth of imports of intermediate inputs is evidence of the positive influence being exerted by export developments. All in all, last year these imports grew by 5½% in nominal terms.[4] Domestic enterprises sharply increased, in terms of value, their purchases of iron and steel products and chemicals, in particular. However, price increases may have played a significant role. Energy imports also grew more strongly than average, at 10½% in nominal terms. They declined in real terms, however, as energy imports were, on average, 12% more expensive in 2004. As energy exports likewise increased significantly – mostly as a consequence of the re-export of energy imports – the value of net energy imports hardly increased, however. In addition, unlike in the 1970s, the decrease in purchasing power associated with the rise in energy prices in 2004 remained within fairly narrow bounds. In terms of GDP, this loss amounted per se to only ¼%, compared with 1½% of GDP in 1974 and 1¼% in 1980. This is a reflection not only of the much smaller energy price rise in 2004 but also of the less energy-intensive nature of manufacturing in Germany.

In contrast to the imports of intermediate inputs, imports of capital goods – in line with the tentative revival of investment activity in Germany – rose only slightly (+1% in nominal terms). In terms of value, purchases of machinery from other countries barely changed. ICT products were characterised – in nominal terms – by countervailing developments: communications technology imports grew by 12½%, while import values for information processing equipment declined slightly (-2%). After adjustment for price increases, however, real German demand for the gamut of foreign information technology goods increased against the background of decreasing global ICT prices and therefore lower import prices in Germany.

Imports of consumer goods from abroad in 2004 were down on the year even in absolute

3 In 2000, the percentage of imported goods in the manufacture of exported goods was already over 40% according to Federal Statistical Office calculations. It is especially high in the clothing industry and in the manufacture of office machinery and computers. Germany's key export sectors (automotive industry, the manufacture of machinery and equipment and the chemicals industry) have large (but below-average) shares of imported inputs.
4 See footnote 2.

terms, reflecting declining private consumption in Germany. Households' restrained propensity to purchase was largely reflected in lower imports of typical consumer goods such as textiles, clothing and leather goods as well as furniture, jewellery and games and toys. Imports of motor vehicles and motor vehicle parts (although partly classifiable as capital goods) stagnated in the past year.

Regional breakdown of imports

Both imports from the euro area (+8½%) and those from non-euro-area countries (+7½%) increased distinctly in nominal terms in 2004 relative to the previous year.[5] Part of the rise is attributable to price increases which, at 2% for imports from the euro area, were much higher than those of non-euro-area imports (½%). Of the euro-area countries, it was particularly Austria, Belgium and the Netherlands that benefited from Germany's fairly strong demand for imports. Imports from Finland, Greece and Portugal, by contrast, declined. Detrimental shifts in those countries' price competitiveness and falling ICT product prices presumably played an important role in this connection.

Outside the euro area, too, the regional structure of imports showed two different patterns. Owing to the weakening of the US dollar against the euro, the increase in the value of goods imported from the USA was below average (+2½%). The purchases – as recorded in the official statistics – from the new EU member states, which had increased very sharply in the past not least because of the large volume of German FDI in those countries, likewise showed only a very moderate rise in 2004 (+1% in nominal terms). This was probably due to a change in the statistical recording method following EU enlargement, as up until April 2004 imports from these countries had largely shown double-digit year-on-year growth rates (see box on page 28).

By contrast, imports from trading partners in Asia mostly showed above-average growth. South-East Asian emerging market economies recorded double-digit export growth to Germany (+10½%). Imports of goods from China, which now make up 5½% of all German goods imports, expanded even faster (+26½% in nominal terms). This has made China the sixth-largest country of origin for German imports. China's success on the German market has been mainly in machinery, information processing equipment and communications technology. As imports of these groups of products from the USA have been stagnant or in a slight decline, it is possible that US goods may have been substituted by more cheaply manufactured products from Asia.[6] The value of imports from OPEC countries and the Russian Federation likewise rose strongly (+14% each); however, this rise was chiefly price-related.

Trade and current account balances

In 2004 Germany had a record trade surplus of €156½ billion, which was €27 billion more than in the previous year. The deficit on invisible current transactions fell anew, to €60½ billion following €76½ billion a year earlier. Overall, the current account surplus increased

5 See footnote 1.
6 In the past few years, US enterprises have pumped a large volume of FDI into China and moved a portion of labour-intensive production there.

Changeover to the accruals principle of accounting for interest income

The IMF Balance of Payments Manual[1] and the ECB Guideline[2] stipulate that interest earned on debt securities (bonds and notes as well as money market instruments) and other debt instruments should not be recorded in the current account only at the time of payment, but should be distributed evenly across the interest period.[3] This is aimed at recording income in the current account as it accrues in terms of value to the owner of a security or other debt instrument during the reporting period. In addition to recording interest as income in the current account on an accruals basis, an offsetting entry is required under the relevant instrument in the financial account pursuant to the principle of double-entry accounting. This captures the income-driven increase in assets. When interest is finally paid, it is not recorded as income in the current account, instead a liquidation should be recorded under the interest-bearing financial instrument in the financial account, offsetting the payment stream.

As the German reporting system is not suitable for directly recording income on an accruals basis, this has to be estimated. Pursuant to the provisions of the IMF and the ECB, this is to be done by applying suitable reference rates to the relevant assets. Such a detailed computation necessitates a new database in which the securities holdings are shown on a security-by-security basis. A database of this kind is currently being developed. As well as a separate method for back-calculating interest income from the period between 1971 and 2003, another procedure therefore had to be applied for 2004 and 2005.

A simplified back-calculation method was used to convert interest payments statistics from the period between 1971 and 2003 to accruals-based statistics. The interest payments that were originally recorded were divided equally across theimmediately preceding interest period – usually a twelve-month period. Thus, a monthly figure calculated on an accruals basis comprises one-twelfth of the interest payments of the month concerned and one-twelfth of the interest payments of each of the following eleven months. This is based on the assumption that the majority of securities considered have annual coupon dates. Only in the case of money market instruments were three-monthly coupons assumed on the assets side and six-monthly coupons on the liabilities side.

Under the described back-accounting procedure, no figures can be calculated yet for 2004. Thus, the interest income series had to be estimated using aggregated stocks and reference rates. As an expedient, the monthly stock data were derived from the annual international investment position and the monthly balance of payments transactions. After a year, the interest flows calculated in this way for 2004 can be adjusted on the basis of the data from 2005. The same applies to the following years.

For technical reasons, it has not yet been possible to make the offsetting entries in the financial account necessitated by changes in the current account. Instead, the resulting discrepancies have been recorded under the position of statistically unclassifiable transactions (balancing item).

A comparison of the old time series and the new ones calculated in accordance with the accruals principle shows income discrepancies in single billion figures for some individual years. In most of the years, the interest recorded on an accruals basis is slightly higher than the interest actually paid (see chart on page 33). This is related to the fact that external assets and liabilities tend to rise, which, in connection with the timely accrued accounting entry, leads to higher interest income for the respective years.

1 IMF, Balance of Payments Manual, Fifth Edition, 1993. — **2** ECB, Guideline ECB/2004/15, 2004. — **3** A divergent rule applies to dividends. They are not subject to the accruals principle, instead they must be recorded at the time at which they are payable. This applies both to shares held in securities portfolios and to shareholdings in the form of direct investments. By contrast, reinvested earnings from direct investments are to be recorded in the period in which they are earned. In the German balance of payments reinvested earnings are calculated as a residual in that the dividends actually distributed in the respective reporting month are deducted from the – in part estimated – profits for the relevant financial year which are distributed across the relevant reporting year.

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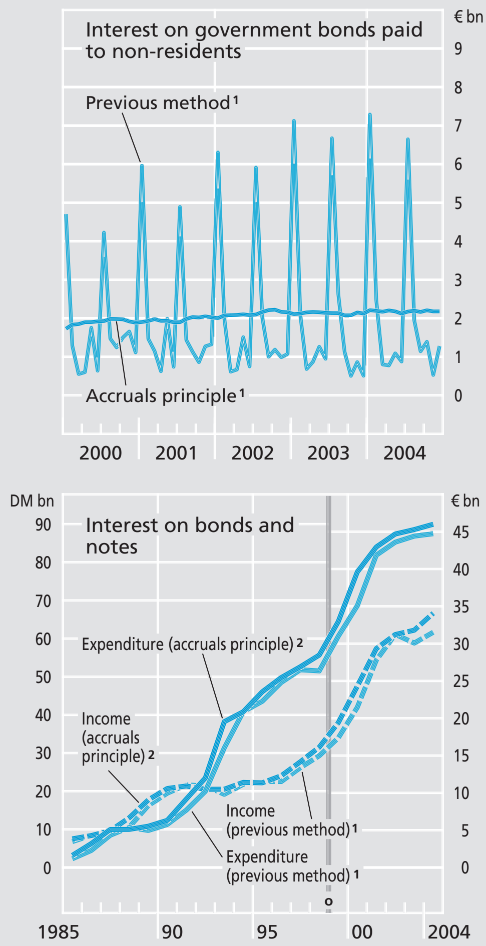
to €84 billion, or nearly 4% of nominal GDP. The previous year's surplus, at €45 billion, had been much lower.

Factor income

The lower deficit on invisible current transactions – which comprise services, income and current transfers – is due largely to positive developments in cross-border factor income. Income flows nearly offset one another completely in the past year, following net expenditure of €13½ billion in 2003. The improvement affected mainly investment income, which is now assigned more closely to its time of origination (see box on page 32). In 2004, as in the previous year, revenue rose in this segment (+€9½ billion to €101½ billion) while expenditure fell (-€4 billion to €102 billion). The increase on the revenue side was attributable in part to much higher FDI income, which could potentially indicate that the profitability of German enterprises' foreign subsidiaries and branches is improving. In addition, there was also an increase in dividend and interest income from portfolio investment abroad, which domestic investors have stepped up perceptibly in the past few years. In the area of expenditure, it was mainly German investment income payments relating to FDI and interest payments on foreign loans which went down.

Accruals principle*



* See explanations in box on page 32. — 1 Based on previously published data, not taking into account the revisions contained in this *Monthly Report*. — 2 Series also contain revisions necessitated by corrections and late reports. — o From 1999, in euro.

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Services

The largest contribution to the shortfall in invisible current transactions originated from the deficit on services, perpetuating a multi-year trend. At €32 billion in 2004, however, it was €2 billion lower than a year earlier. The decline was attributable to a sharp rise in revenue from services rendered across borders. However, the individual sectors presented a differentiated picture. Whereas transportation services – the second most important service area overall – yielded increasing surpluses in line with the rise in world trade, insurance services generated losses. Falling income of German reinsurance companies, in particular, made itself felt here.

Travel

Travel occupies a position of special importance among services. The deficit on foreign

Major items of the balance of payments

€ billion

Item	2002	2003	2004
I Current account			
1 Foreign trade			
Exports (fob)	651.3	664.5	731.1
Imports (cif)	518.5	534.5	574.4
Balance	+ 132.8	+ 129.9	+ 156.7
2 Services (balance)	– 35.5	– 34.0	– 32.0
of which			
Foreign travel (balance)	– 35.2	– 36.8	– 35.8
3 Income (balance)	– 14.7	– 13.7	+ 0.1
of which			
Investment income (balance)	– 14.7	– 13.6	– 0.1
4 Current transfers (balance)	– 28.1	– 28.7	– 28.4
Balance on current account [1]	+ 48.2	+ 45.2	+ 84.0
II Balance of capital transfers [2]	– 0.2	+ 0.3	+ 0.4
III Financial account [3]			
Direct investment	+ 37.6	+ 27.3	– 25.2
Portfolio investment	+ 63.8	+ 64.9	+ 20.8
Financial derivatives	– 0.9	– 0.1	– 4.2
Credit transactions [4]	– 143.2	– 138.4	– 91.1
Balance on financial account	– 42.8	– 46.3	– 99.8
IV Change in the foreign reserves at transaction values (increase: –) [5]	+ 2.1	+ 0.4	+ 1.5
V Balance of unclassifiable transactions	– 7.2	+ 0.3	+ 13.9

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 36. — **4** Including Bundesbank transfers and other public and private investment. — **5** Excluding allocation of SDRs and changes due to value adjustments.

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travel, at €36 billion, was even somewhat higher than the overall deficit on services. German residents continued to prefer the traditional vacation countries of Austria, France, Italy and Spain. Belgium, Luxembourg and Poland saw above-average increases in the number of German travellers – as countries that share a frontier with Germany, they have benefited from a sharp increase in cross-border shopping trips for some years now – as did Turkey. The Asian countries, too – following a sharp drop in 2003 owing to the SARS epidemic – were once again in demand as travel destinations. The same applies to African countries, among which Egypt, in particular, experienced a sharp spike in tourism after some years had elapsed since it was hit by terrorist attacks. Germans' expenditure on travel to the United States increased, too, thanks to the favourable euro-US dollar exchange rate for euro-area travellers. By contrast, expenditure by German private and business travellers in Portugal and Denmark fell markedly.

Transfers

The deficit on current transfers, at €28½ billion, hardly changed from 2003. Lower public transfers were offset by higher private transfers. The former was attributable mainly to lower net payments to the EU budget (€12 billion). At the same time, however, private transfers (€11 billion net) rose slightly. The indemnification payments from the "Remembrance, Responsibility and Future" foundation, which are made in equal parts by the private and public sectors, were, at just over €1 billion, slightly higher than a year earlier.

Financial transactions

Trends in financial transactions

The prospects for the global economy were perceived in different ways on the international financial markets in 2004. While improvements in the earnings outlook of many enterprises and rising equity prices towards the end of the year were suggestive of a positive assessment of the global economy, the downward trend in long-term capital market rates partly reflected concerns about the sustainability of the upswing. As a result, the yield differentials shifted in favour of investments denominated in US dollars accompanied by the Fed's progressive lifting of the key interest rates in the USA. However, the US currency did not noticeably benefit from these developments. The renewed rise in the US current account deficit put pressure on the dollar. Conversely, the euro appreciated (effectively by around 2% in the course of the year). Against this background, it is not possible to identify a uniform trend in German financial transactions either. In the context of a renewed rise in gross transactions, Germany in the end recorded net capital imports in portfolio investment, which contrasted with large net capital exports in direct investment and, in particular, in credit transactions. Total net capital exports (at €100 billion) were even higher than the current account surplus recorded in 2004, which meant that the balance of payments closed with a balancing item in the amount of €14 billion, attributable not least to recording problems in connection with cross-border cash operations (see box on page 37).

Portfolio investment

In the period under review, portfolio transactions per se led to net capital imports of €21 billion; the level was thus well below that recorded in 2003 (€65 billion). However, the decline in net flows in 2004 conceals a rise in gross transactions as domestic and foreign investors diversified their portfolio investment after being noticeably cautious in their cross-border investment in 2002 and 2003 in the light of weaker global economic activity and major uncertainty.

German investment in ...

In 2004, German investors added large amounts of foreign securities to their portfolios (€113 billion). This was more than double as much as they had invested in such paper in 2003 (€47½ billion), but was still below the average level of German portfolio investment abroad since the start of monetary union (€121½ billion). In the period under review, German investors therefore resumed only tentatively the previous trend towards international risk diversification – despite the favourable economic outlook. This hypothesis is also borne out by the fact that their interest focused only on longer-term bonds whilst avoiding equities.

... foreign bonds and notes, and ...

German savers invested a total of €100 billion in foreign bonds and notes, predominantly in euro-denominated government securities issued by borrowers in other euro-area countries (€90½ billion). The latter are very popular above all with financial managers at domestic banks not only because of their slight yield advantage over German Federal bonds (11 basis points on an annual average); they are also free of exchange rate risks which, in view of global current account imbalances,

Financial transactions

€ billion, net capital exports: –

Item	2002	2003	2004
1 Direct investment	+ 37.6	+ 27.3	– 25.2
German investment abroad	– 16.1	+ 3.2	+ 5.9
Foreign investment in Germany	+ 53.7	+ 24.2	– 31.1
2 Portfolio investment	+ 63.8	+ 64.9	+ 20.8
German investment abroad	– 62.9	– 47.4	– 112.9
Equity	– 4.7	+ 7.4	+ 6.2
Mutual fund shares	– 7.1	– 4.1	– 12.0
Bonds and notes	– 47.5	– 54.0	– 99.9
Money market paper	– 3.7	+ 3.3	– 7.2
Foreign investment in Germany	+ 126.7	+ 112.3	+ 133.7
Equity	+ 15.9	+ 24.2	– 5.2
Mutual fund shares	– 0.7	– 1.8	+ 5.1
Bonds and notes	+ 82.9	+ 67.1	+ 147.7
Money market paper	+ 28.6	+ 22.8	– 13.9
3 Financial derivatives 1	– 0.9	– 0.1	– 4.2
4 Credit transactions	– 141.6	– 135.4	– 87.8
Monetary financial institutions 2	– 104.1	– 111.6	– 89.0
Long-term	– 15.4	– 38.5	– 3.8
Short-term	– 88.7	– 73.1	– 85.3
Enterprises and individuals	– 7.7	– 31.0	+ 5.6
Long-term	+ 3.8	– 3.4	+ 0.6
Short-term	– 11.5	– 27.5	+ 5.1
General government	+ 5.5	+ 4.9	+ 1.0
Long-term	+ 0.1	+ 5.6	+ 0.4
Short-term	+ 5.5	– 0.6	+ 0.6
Bundesbank	– 35.4	+ 2.2	– 5.3
5 Other investment	– 1.6	– 3.0	– 3.4
6 Balance of all statistically recorded capital flows	– 42.8	– 46.3	– 99.8
Memo item Change in the foreign reserves at transaction values (increase: –) 3	+ 2.1	+ 0.4	+ 1.5

1 Securitised and non-securitised options and financial futures contracts. — **2** Excluding the Bundesbank. — **3** Excluding allocation of SDRs and changes due to value adjustments.

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may have deterred investors from engaging in foreign currency exposures in the period under review. On balance, owing to the associated exchange rate risk, German residents purchased long-term US foreign currency bonds worth only €6½ billion. They presumably expected interest rates to fall and therefore hoped to benefit from price gains. The fact that on balance they withdrew deposits from money market funds (€1½ billion) – which are largely shielded from price movements – and acquired only a small volume of money market paper (€7 billion) is consistent with this picture.

... foreign equity

By contrast, German investment in foreign equities in 2004 was clearly eclipsed by interest in the bond markets despite the fact that the share prices of European and US listed companies went up by 10½% and 9% if measured, respectively, against their market indices (Dow Jones Euro Stoxx and S&P 500). On balance, German investors sold €6 billion worth of foreign equity. Investment companies domiciled abroad, by contrast, recorded inflows of funds from Germany. The volume of mutual fund assets under their management expanded more strongly (€12 billion) following the moderate transaction-related increase in 2003 (€4 billion). Some of the fund resources are likely to have flowed into the international stock markets through this channel.

Foreign investment in ...

Foreign investors also sold equities – in this case those of German enterprises (€5 billion) – despite analysts' favourable profitability assessments, which were steadily revised upwards during the course of the year. Corres-

Recording cross-border cash transactions in the balance of payments

Due to the principle of double-entry accounting, the cross-border transactions recorded in the balance of payments should theoretically offset each other. As the two sides of a transaction are, however, derived from different sources, in practice discrepancies arise. These may be due to reporting errors, statistical reporting thresholds or problems related to the allocation to different time periods. Moreover, the changeover to the accruals principle for the accounting of interest income coupled with the absence for the time being of an offsetting entry in the financial account have also temporarily resulted in a balancing item as explained on page 32.

Another problem concerns cross-border cash transactions, for example cash carried by seasonal and foreign workers and in financial transactions.[1] The opportunities for using cash abroad have increased considerably as a result of the introduction of euro banknotes and coins. Cash transactions of this kind and their offsetting entries are not included in the balance of payments (and the international investment position) owing to insufficient possibility to record them statistically.

Statistical information is, however, available on two sub-sectors, namely foreign travel expenditure of German residents and the shipping of euro banknotes abroad.

– Statistics on German foreign travel expenditure are compiled partly by means of surveys.[2] The figures determined in this way are recorded as service expenditure in the balance of payments. The results of the surveys provide indications of the extent to which business and private travellers make payments abroad using euro banknotes.

– When German credit institutions or the Bundesbank send euro banknotes to foreign banks, their external balances increase by the amount of the countervalue. This change is recorded as a capital export in the balance of payments.

However, even for the statistically recorded sub-components mentioned, no offsetting entry is recorded under the Bundesbank's external liabilities as this would create a distorted picture of the overall impact of cross-border cash transactions in the longer term. Consequently, they are recorded under the position of statistically unclassifiable transactions (balancing item). The two sub-sectors described here are, nevertheless, currently quite substantial: in 2003, roughly €20 billion in cash was carried abroad by German residents; the figures available so far indicate a similarly high amount for 2004. If the proportions of travel expenditures are correspondingly applied on the income side, the net effect of cross-border cash transactions in foreign travel may have been an estimated €15 billion in both 2003 and 2004. The shipping of banknotes accounted for approximately €12 billion net in 2004. These figures should be taken into account when assessing the positive balancing item of €14 billion in 2004.

1 See Seitz, F., *The Circulation of Deutsche Mark Abroad,* Economic Research Group of the Deutsche Bundesbank, discussion paper 1/95, May 1995, and ECB, *Review of the international role of the euro,* January 2005, page 56 et seq. — **2** See Deutsche Bundesbank, German balance of payments in 2002, *Monthly Report,* March 2003, pp 53-67, particularly pp 60-61.

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pondingly, given only a slight upward movement in share prices measured using the broad CDAX index (+6½%), the price-earnings ratio of German shares fell from 15½ to 13 in 2004; it was thus quite low in comparison with the relevant ratios of other major currency areas. Increased foreign investment in German equity would also have been expected in view of the euro's rise in value, which became stronger as the year progressed. The general restraint on the part of both German and foreign investors with regard to equities apparently goes beyond mere uncertainty about future price developments, as the implied volatilities of options on blue chips – which are a barometer of expected price movements – continued to decline during the year and are now being quoted at the same level as five years ago, ie in a phase of relative global certainty. The restraint shown by internationally operating investors vis-à-vis equities is also apparent with regard to domestic mutual fund shares. Although the German collective investment sector – which had a record volume of fund assets (€1,003 billion) under its management at the end of 2004 – recorded an inflow of €5 billion from abroad, both domestic and foreign investors were net sellers of share-based fund units.

... German equity and ...

... German bonds and notes

The picture is very different for German bonds and notes; foreign investors added these to their securities portfolios on a large scale. At €147½ billion, the aggregate amount invested in domestic debt securities reached a new record high. As in 2003, bonds and notes issued by private borrowers were in greater demand by foreign investors (€84½ billion compared with €44 billion) than bonds issued by the public sector (€63 billion compared with €23½ billion). The portfolio decision in favour of German bonds and notes may have had something to do with the view that these investment instruments were still acknowledged to have profit-yielding potential in terms of both the exchange rate and bond prices. Moreover, at the beginning of the year, concerns about international terrorism rekindled by the attacks in Madrid led to a temporary inflow of funds into German government bonds. The distinct preference for private bonds is noteworthy; this is also reflected in the fact that the spread between bank bonds and the benchmark Bund narrowed to 18½ basis points on an annual average. At the start of stage three of monetary union, it had amounted to 33 basis points and in 2000 even temporarily widened to 55 basis points. In the current environment of low interest rates, investors are evidently willing to content themselves with even modest yield mark-ups for non-government bonds in their "quest for yield".

Direct investment

The favourable underlying conditions in the world economy and the renewed slight upward movement in M & A activities did not work their way through to German direct investment abroad in 2004.[7] However, the drop in cross-border investment flows was partly caused by specific exceptional factors. For instance, the sale of a single enterprise in the telecommunications sector led to a reduc-

7 According to estimated figures from UNCTAD – which are still based only on the first six months of 2004 – there was a 3% rise in M & A activity last year.

tion in the direct investment stocks on both sides of the financial account. A legally autonomous firm located in Germany thereby used the proceeds from the sale of foreign equity participations to eliminate the long-term debt to its parent company domiciled abroad. Although this transaction remained neutral overall in relation to the balance of direct investments, it had a noticeable influence on gross flows. Moreover, it shows again just how complex intra-group financial transactions can be and how difficult this makes the interpretation of statistically recorded figures. All in all, in 2004, net capital exports amounting to €25 billion were recorded in the field of direct investment; net capital imports had been posted in 2002 and 2003.

Foreign direct investment in Germany

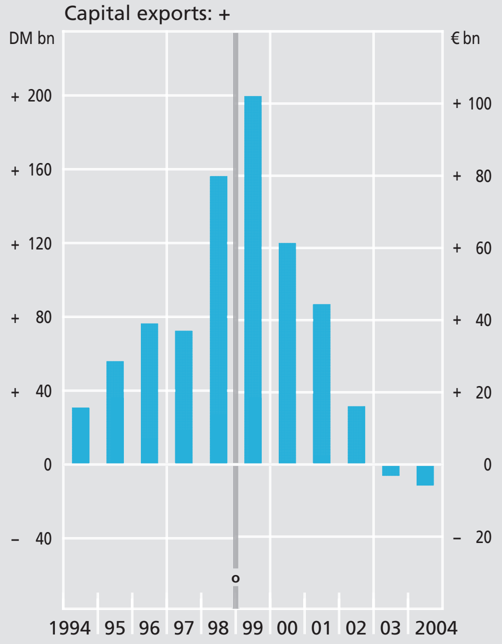
The main reason for the turnaround was that foreign proprietors withdrew €31 billion on balance from Germany in the period under review; in 2003, they had invested €24 billion in Germany. Funds were withdrawn primarily through the repatriation of loans previously granted (€46 billion). A considerable share of this was attributable to the repayments in connection with the intra-group divestment described above, but amendments to the Corporation Tax Act *(Körperschaftsteuergesetz)* also played a role (as they had already done in 2003). The amended regulation in force since the beginning of 2004 stipulates that the cost of debt can be offset against an enterprise's tax burden only if the equity base of a holding company domiciled in Germany amounts to at least 40% (rather than previously 25%) of the sum of own funds and borrowed funds.[8] A large number of foreign parent companies consequently adapted their financing structures to the new legal framework by calling in – above all long-term – loans and simultaneously increasing the equity capital of their German subsidiaries and branches. Where debt is thereby fully converted into equity, the foreign direct investment stocks in Germany remain unaffected by this accounting exchange on the liabilities side. In fact, acquisitions of participating interests (€21½ billion) fell far short of loan repayments (€49 billion). Several enterprises apparently did not fully transform their shareholder loans into equity capital and thus withdrew funds from Germany in net terms. Moreover, there were high negative reinvested profits (€6½ billion), which arise as a residual from the difference between current operating profits and dividend payments.

German direct investment abroad

The pattern of German direct investment abroad was influenced by the divestment operation mentioned earlier. All in all, domestic enterprises withdrew €6 billion worth of financial resources from foreign countries. In doing so, they almost exclusively reduced their cross-border participating interests (€26 billion) while providing their foreign subsidiaries and branches with additional funds in the form of loans (€12 billion) and trade credits (€1½ billion). In addition, they spent €7½ billion on purchasing property and real estate abroad, which likewise counts as direct in-

8 This provision applies equally to all holding companies domiciled in Germany irrespective of whether they are German or foreign-owned. With regard to the new provision on shareholder loans and its effect on direct investment, see also Deutsche Bundesbank, German balance of payments in 2003, *Monthly Report*, March 2004, p 49.

German direct investment abroad



o Data in euro as of 1999.

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vestment. The target countries in this respect included France and Italy.

A longer-term analysis clearly reveals the extent to which German direct investment activities have changed latterly. In the 1990s, German enterprises invested more and more heavily abroad, finally investing the record amount of €102 billion at the peak of the most recent wave of mergers in 1999. However, as the "new economy" euphoria subsided, German direct investment declined rapidly; direct investment assets have even been "dissolved" in the past few years. Against this backdrop, it is difficult to put the current low level of investment in Germany down to German enterprises' foreign investment recorded in the balance of payments. These enterprises have clearly reduced their investment activities in general – ie both in Germany and abroad – during the persistent stagnation of recent years.[9]

Credit transactions of non-banks

In the case of statistically recorded credit transactions, the non-securitised foreign transactions of German enterprises and individuals resulted in net capital imports in the amount of €5½ billion in 2004. Enterprises and individuals took up a small volume of loans abroad and at the same time slightly reduced their balances with foreign banks. The cross-border transactions by general government resulted in a reduction in its non-securitised assets and liabilities of virtually the same proportions (€1 billion).

Credit transactions of MFIs

The current account surplus and the net capital imports in the financial account items referred to above were offset – as counterparts, as it were – by substantial net capital exports (€94½ billion) on the part of MFIs (including the Bundesbank). German credit institutions accounted for €89 billion of this sum, almost exclusively at the short end of the market (€85½ billion). As in previous years, the accumulation of the net external asset position stemmed from the non-securitised lending operations of German credit institutions, ie the granting of advances and loans to foreign partners, which expanded far more quickly than the corresponding deposits and borrowing operations. The Bundesbank's external transactions, which are classified as credit transactions, resulted in a comparatively small

9 However, the direct investment recorded in the balance of payments may not provide a complete picture of German enterprises' investment activities abroad. In particular, any investment financed by the foreign subsidiaries and branches locally is not included.

volume of net capital exports (€5½ billion). The increase in the Bundesbank's claims on the rest of the world was connected with cross-border payment operations within the ESCB, which are settled via the gross payment system TARGET. At the same time, the Bundesbank's external liabilities, which mainly comprise deposits by foreign monetary authorities, decreased slightly.

The Bundesbank's reserve assets

The Bundesbank's reserve assets, which are shown separately in the balance of payments, declined – at transaction values – by €1½ billion in 2004. Valued at market prices, the fall – in euro terms – was even sharper owing to the weak US dollar and the decline in the price of gold. On balance, price losses amounted to €4 billion. At the end of 2004, therefore, the reserve assets stood at €71½ billion, ie just over €5 billion less than at the end of 2003.