German balance of payments in 2005

The global setting in 2005 continued to be very favourable for German exporters. World trade again expanded fairly sharply. Furthermore, exports benefited from the depreciation of the euro, which helped to improve price competitiveness. German exporters also benefited from the buoyant world demand for capital goods, which have a large share in Germany's total exports. The total value of German goods exported in 2005 rose by 7½%. With a growth rate of 8½%, however, the increase in import values was even faster. Even so, a large part of this rise was due to the considerable increase in the price of energy and industrial raw materials. As imports in terms of value were much smaller than exports, however, the surpluses in the trade balance and in the current account rose to new heights in 2005 (€160½ billion and €92 billion respectively). This also applies to the current account-nominal GDP ratio, which amounted to approximately 4%. Accordingly, Germany provided non-residents with a considerable amount of domestic savings through net capital exports. This occurred primarily through an expansion in the net external position of the banking system. However, there were also net exports of funds through portfolio investment and direct investment.

Current account

World economy maintains dynamic growth

The global setting in 2005 continued to be very favourable for German exporters. Although world economic growth was noticeably slower, at 4½%, than in the record year of 2004, it was still far above the long-term average of 3½%. World trade also expanded fairly sharply. According to estimates by the IMF, it rose by 7% in real terms but likewise remained much below the rate in the previous year (10½%). German exporters also benefited from the depreciation of the euro. The indicator of the German economy's price competitiveness, which compares the price and cost situation in Germany with that of suppliers in the euro-area partner countries and in non-euro-area countries, provides a more comprehensive picture. Whereas Germany's price competitiveness had deteriorated in the previous few years, its position showed a slight improvement of 1% against the 19 most important trading partners on an average of 2005.[1] That means it was 5½% better than on a long-term average.

Exports

German exporters also benefited in 2005 from the dynamic growth of major export markets. In addition, there was heavy demand for their range of goods. For example, the growth of orders booked was just as fast, at 9%, as in the previous year; export orders rose particularly fast in the second half of the year. Furthermore, the already very optimistic expectations of German exporters continued to improve considerably up to the end of the year. In 2005 German industry increased the value of its exports of goods by 7½% over the previous year when exports had risen by as much as 10%. The increase in exports was almost as great in real terms as in nominal terms in 2005 as the overall price of export goods had risen by no more than 1%. Evidently German exporters were passing on only part of the considerable rise in costs in the case of intermediate goods, especially raw materials, to their foreign customers.

Regional breakdown of exports

Sales to euro-area partner countries did not increase quite so rapidly, at 7%, as they did to countries outside the euro area where there was an 8% expansion. The main reason for the slightly sharper rise in exports to non-euro-area countries was that economic growth was faster there than in the euro area. The difference in export growth between the two areas would probably have been much greater if the price competitiveness of German exporters over other suppliers in the euro area had not shown a greater improvement, at 1½%, than it had vis-à-vis competitors in non-euro-area countries (½%).

German enterprises were able to increase their exports to each of the euro-area partner countries. There was an above-average rise in exports to Ireland (13%), Finland (12½%), Spain (11½%), Portugal (10½%) and Belgium/Luxembourg (8½%). Exports to France also expanded strongly (7½%). There was a lower rate of growth in exports to Austria and Italy (5½% in each case), Greece (3½%) and the Netherlands (2½%). This substantial spread is, firstly, a reflection of the different rates of growth between the euro-area coun-

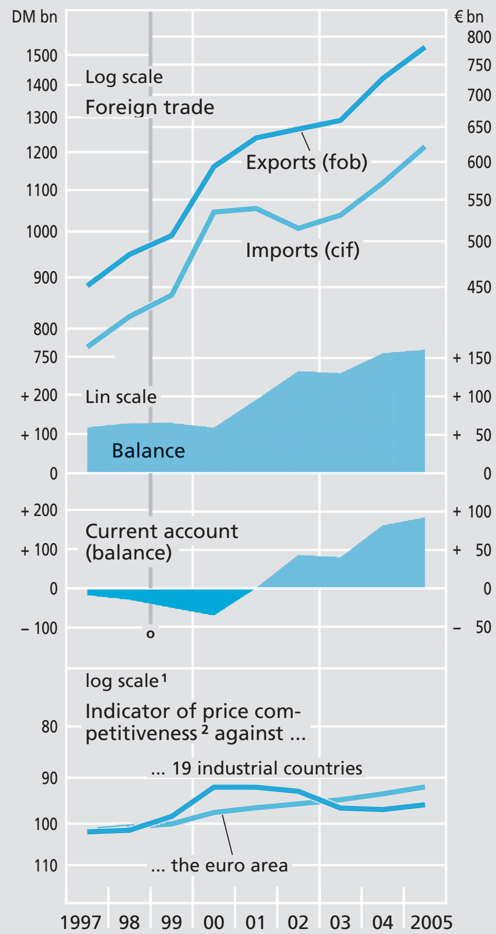
1 Based on the deflators of total sales.

tries. Secondly, the remarkable export success in the individual partner countries is linked to the fact that in these countries, with the exception of Ireland, Germany has achieved a particularly sizeable improvement in its price competitiveness. All in all, it was able to extend its market position further within the euro area in 2005.

As already mentioned, exports to non-euro-area countries grew strongly (8%), with the result that Germany's market share was maintained there. In some major non-euro-area markets shifts in the international exchange rate pattern also played a part. For example, the depreciation of the euro against the US dollar during the year was a major factor in the sharper year-on-year increase of 7% in exports to the United States even though the economic momentum there weakened slightly in 2005.

Exports to the new EU member states grew at an above-average rate (10%). Poland was the largest customer within this region; German exports to this destination grew by 16½%. By contrast, exports to the emerging market economies of South-East Asia and to China, which had grown exceptionally fast in 2004, expanded only moderately at 2½% and 1½% respectively. The increase in exports to Japan was also somewhat slower, at 5%, than in 2004 even though Japanese domestic demand grew fairly dynamically. However, the slight average annual appreciation of the euro against the yen might have played a role here.

Selected indicators on external sector



o From 1999, data in euro. — **1** Inverted scale: rise in curve (fall in values) denotes increase in competitiveness. — **2** Q1 1999 = 100; based on the price index of total sales.

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Strong growth in exports to oil-producing countries

German exporters were remarkably successful in selling to the OPEC countries (+16%) and the Commonwealth of Independent States (CIS) (17½%) in 2005. This shows that Germany benefited considerably from the strong rise in the income of these countries from energy exports in 2005, a development which was due to the continuing growth in demand for oil and the sharp increases in

Structure of and trends in regional foreign trade in 2005

Country/group of countries	Percentage share	Percentage change from previous year
Exports		
All countries	100.0	7.5
of which		
Euro-area countries	43.2	6.9
Other EU countries	20.2	6.8
of which		
New member states	8.6	9.8
United States	8.8	6.9
Russian Federation	2.2	15.3
Japan	1.7	4.8
Emerging markets in South-East Asia	3.5	2.6
China	2.7	1.4
OPEC countries	2.5	16.1
Developing countries excluding OPEC	8.5	8.1
Imports		
All countries	100.0	8.7
of which		
Euro-area countries	39.8	8.0
Other EU countries	19.1	6.9
of which		
New member states	9.5	3.1
United States	6.6	1.6
Russian Federation	3.5	32.4
Japan	3.4	– 0.7
Emerging markets in South-East Asia	4.9	1.9
China	6.4	21.6
OPEC countries	1.8	35.2
Developing countries excluding OPEC	9.3	3.7

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price.[2] The value of Germany's exports to the OPEC countries was two-and-a-half times greater than Germany's expenditure on petroleum, natural gas and mineral oil products; the corresponding ratio vis-à-vis the CIS was 1.2. Capital goods accounted for the lion's share of the demand from OPEC and the CIS. Germany's exports to OPEC and the CIS consisted mainly of machinery (share in overall exports 21% and 24% respectively), motor vehicles (19% and 12%), information and communications technology goods [ICT goods] (14½% and 17½%) and chemical products (9½% and 12%). This means that German manufacturers of machinery and of IT goods sold almost one-tenth of their total exports in these markets.

Breakdown of exported goods

Virtually all German exporting sectors benefited from the prolonged upturn in world economic growth in 2005.[3] However, it was the manufacturers of capital goods, which with a share of 45% of German exports represent the most important product range, who benefited most from the strong global growth in investment. Manufacturers of machinery succeeded in increasing their export turnover by 5%. Motor industry exports rose even faster (9½%), a development that was underpinned by increased sales in the United States, which in terms of value absorbed al-

2 These two regions supplied 41½% of German imports of natural gas, crude oil and mineral oil products in 2005. Although there were also increases in imports from Germany's other major energy suppliers (United Kingdom 3%, Norway 10½% and the Netherlands 2½%), German exporters' turnover is hardly dependent on these countries' income from their oil business.
3 The picture of the breakdown of exported and imported goods is distorted by the large percentage of goods which are still not classifiable. Consequently, the rates of change for the individual categories of goods cannot be compared with the overall rate.

most 15% of Germany's motor vehicle exports. By contrast, export earnings from ICT goods were only slightly above the 2004 level in nominal terms. However, this result was largely influenced by the fact that the manufacturers of ICT goods had again reduced their export prices considerably in 2005. In real terms these exports probably increased substantially.

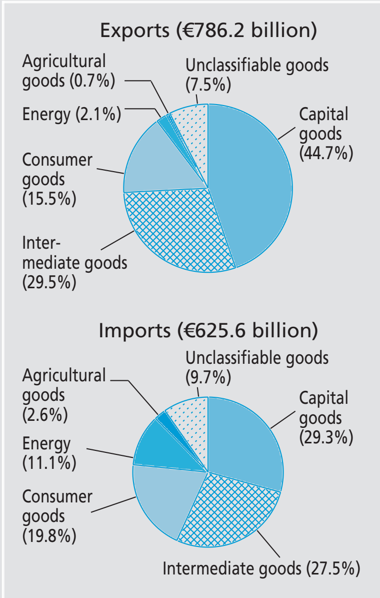
There was also an increase in the exports of intermediate goods, which make up almost one-third of German exports. Chemical products, for example, recorded a rise of 6½%. At the same time, the exporters of these products were able to pass on to their foreign customers the substantial cost increases which they had incurred as a result of the higher energy prices. Exports of metals and metal products also grew strongly (8½%). The main reason behind this development was the increase in export prices, which is due in part to the significantly higher prices of raw materials, notably iron ore. The fact that German steel producers, like those in other countries, are working at full capacity also played a role. Exports of consumer goods likewise increased.

Imports

Imports of goods rose by 8½% in value in 2005, which was somewhat more steeply than exports of goods. In real terms, however, the increase in imports was again far below that of exports as import prices rose much more strongly (4½%). The sharp rise in import prices was primarily the result of higher prices for energy and industrial raw materials. In addition, the depreciation of the euro against the currencies of major trading partners drove import prices up. Consequently, the price relationships between Germany and foreign countries deteriorated. This increased the German consumer's incentive to save on expensive energy or to substitute German products for foreign ones. This might have additionally dampened import growth in terms of volume.

The main reason for the rise in real imports, which was comparatively strong given the marginal increase in domestic demand, was the rapid growth in exports. This is largely explained by the relatively large proportion of imported intermediate goods used in the production of export goods. According to calculations by the Federal Statistical Office, the proportion of imported intermediates involved amounted to more than 40% in 2000

Foreign trade by selected categories of goods in 2005



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and will probably have increased further since then.

Breakdown of imported goods

The sharpest rise recorded in 2005 was in the value of energy imports, which increased by 32% on the year. This was due to a rise of 37½% in energy import prices and correspondingly a decline in real terms. The loss of purchasing power in Germany associated with the rise in energy prices amounted to approximately ¾% of GDP in 2005 compared with ¼% in 2004. Overall, the loss was therefore much smaller than in the period of sharp oil price increases at the beginning of the 1970s and 1980s when it reached 1½% of GDP on an annual average. The comparatively moderate loss of purchasing power now is due mainly to the considerable reduction in energy intensity, ie energy input in production, in Germany during the past few decades.

In the case of other import goods, too, there was a fairly sharp divergence between developments in their value and in their volume, which was due not least to the indirect price effects that the higher energy prices in 2005 had on products with a relatively large energy input. This affected imported intermediate goods in particular. For example, there was a 6% nominal increase in the imports of chemical products but at constant prices the increase was only marginal. The imports of metals and metal products also rose discernibly in nominal terms (6½%); yet in real terms they actually declined.

In the case of imports of important categories of capital goods, by contrast, prices rose only moderately or actually fell. Imported machinery increased by no more than 1½% in terms of value, which means that at constant prices it remained unchanged on the year. Imports of motor vehicles and motor vehicle parts rose by 3% nominally and also rose in real terms. It is precisely in the motor industry that intermediate goods imported from the new EU accession countries in central and eastern Europe are playing an ever increasing role. Imports of ICT goods in 2005 were only slightly up on the year in nominal terms. As in previous years, the output of this sector fell considerably in price worldwide, a development which also benefited German consumers. Considerably more ICT products were imported in real terms than in 2004. By contrast, the demand from German households for imported consumer goods was comparatively weak in the year under review. This was due mainly to the persistent weakness in consumer spending in Germany.

Regional breakdown of imports

Imports from the euro-area partner countries in 2005 did not increase quite so fast (8%) as the imports of goods from non-euro-area countries (9%). However, the price of the goods imported from non-euro-area countries rose more steeply (5%) than the price of goods from the euro area (3½%). The main reason for this was again the substantial price increase in the case of energy commodities, most of which are imported from countries outside the euro area. In real terms the imports from both the euro-area partner countries and non-euro-area countries rose at more or less the same rate.

Of the euro-area suppliers, the producers in Finland and the Benelux countries achieved sales increases in double figures in the German market (22½% and 17% respectively). By contrast, imports from Portugal declined significantly (10%). Imports from Italy were only just below their 2004 level. The poor performance of suppliers in these two countries was probably due mainly to the deterioration in their price competitiveness.

The growth in imports from non-euro-area countries in 2005 was strongly influenced by the very sharp energy-price-related rise in the nominal imports from OPEC (35%) and the Russian Federation (32½%). The sharp rise in imports from the United Kingdom (14½%), another of Germany's major energy suppliers, was also largely price-related. The imports of goods from China likewise increased sharply; in this case, however, the 21½% rise is not so much a reflection of increased prices but, instead, of further rapid growth in the volume of deliveries. Thus, China's share of total German imports, which amounted to no more than 2½% ten years ago, increased further to 6½% in 2005. By contrast, Germany's imports from Japan declined by ½%. Imports from the United States showed only a slight rise (1½%), a development which was probably also due to the appreciation of the US dollar against the euro. The deliveries from the emerging markets of South-East Asia likewise grew fairly sluggishly, at 2%. One explanation of this might be that German customers substituted less expensive imports from low-cost China for deliveries from this region. Following the expiry of the textile quotas at the end of 2004, China won market shares, particularly in the textiles and clothing sector, last year. This was mainly at the expense of other countries in South-East Asia but was also to the detriment of countries outside Asia. This also affected the sum total of imports from the ten new EU member states. These imports grew at a below-average rate of 3% in 2005 after increasing sharply for the most part in the years before. However, the further penetration of Chinese suppliers of textiles and clothing in EU markets has been checked by means of new import restrictions which came into force in mid-2005.

Trade and current account balances

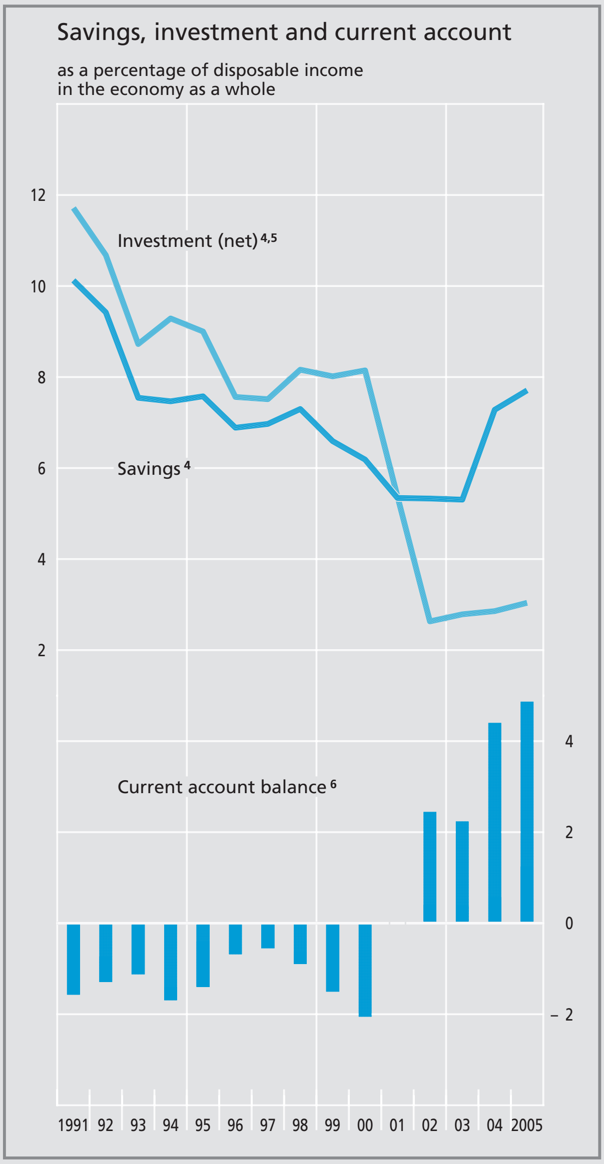
The export successes of German business are only partly reflected in the trade surplus, however, because at the same time the terms of trade deteriorated by 3%, mainly as a result of the prices of energy and raw materials. All in all, the surplus rose by €4½ billion to €160½ billion, which is a record *per se*. At the same time, the deficit on invisible current transactions declined by €11 billion to €48 billion. The current account surplus increased by €10½ billion to €92 billion.[4] It amounted to 4% of nominal gross domestic product and 4¾% of the domestic sectors' disposable income (see the explanatory notes on page 24).

4 In a recent press release entitled "Die deutsche Zahlungsbilanz im Januar 2006" (German balance of payments in January 2006) the Bundesbank modified the monthly presentation of the balance of payments. In doing so, it was following the international recommendations of the IMF, which the ECB also uses as a guide. Trade in goods as defined in the balance of payments now shows only pure repair work under repairs (and not, as hitherto, the value of the goods as well). The value of the goods under repair is therefore no longer relevant to the current account. This adjustment is being backdated to 1993. For other changes in the presentation see footnote 7 on p 31 .

Rising current account surpluses – a difficult performance indicator

The surplus in the German current account amounted to €92¼ billion in 2005, which was around 4% of nominal GDP or 4¾% of the domestic sectors' disposable income.[1] By historical standards, this was a new high. In the previous year, it had been €82 billion.

Since the beginning of the current decade, the picture in the cross-border exchange of goods and services including transfer payments between Germany and the rest of the world has changed significantly. Following a deficit in the current account throughout the 1990s, a balanced result was achieved in 2001 for the first time since reunification.[2] After that, there tended to be marked rises in the surpluses. The sharp rise in the trade surplus, from €59¼ billion in 2000 to €160½ billion in 2005, was a major factor in this marked turnaround. One reason for this was a palpable improvement in the price competitiveness of the German economy and the sharp growth in the export markets. Another reason is the prevailing weakness in the German economy, which put a considerable dampener on the demand for imported goods.



As the adjacent chart shows, the steep rise in the current account from 2002 was associated with a sharp fall in the net investment ratio (gross capital formation minus depreciations as a percentage of disposable income), which was noticeably greater than the reduction in the aggregate saving ratio at the beginning of this decade.[3] Thus, in contrast to what happened in the 1990s, German savings were no longer fully absorbed by aggregate fixed capital formation in Germany. A considerable and rising proportion was made available to non-residents.

At between 2¾% and 3% of disposable income, the net investment ratio was at a historical low between 2002 and 2005. In the first half of the 1990s, it still stood at between 9% and 12%, and in the second half at approximately 8%. The fall in net investment can be put down to two factors. Firstly, despite heavy new public sector borrowing, government gross investment could not even offset the depreciation-related capital consumption. Secondly, households' and enterprises' net investment between 2002 and 2005 was barely half as

1 National disposable income is calculated from nominal GDP after deducting primary income balances and current transfer payments by non-residents as well as depreciations. National disposable income defines the volume of funds that is available to the residents in an economy for consumption and saving and/or for net investment at home and abroad. This concept of income is therefore more appropriate here than GDP. — **2** For more information on the fall in current account balances in the 1990s, see Deutsche Bundesbank, Structural current account balances: longer-term trends and determinants, Monthly Report, January 2001, pp 51-61. — **3** For more information on the relationships between the current account, aggregate savings and aggregate investment, see Deutsche Bundesbank, Monthly Report,

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extensive as in the second half of the 1990s. All the same, it has again been rising since 2003.

Domestic saving, which had already stabilised at the previous year's level in 2002, likewise increased considerably in 2004 and 2005. At just under 8% of disposable income, saving was at as high a level last year as in the mid-1990s. The improved profitability of non-financial corporations, which was also reflected in a greater retention of profits, was one factor which contributed to this increase. Another was the increased volume of private households' saving. Given the growing uncertainty over jobs and the looming demographic strains on the social security system, this reflected the greater significance of caution as a motive and of the individual provisional considerations as well as changes in the distribution of income. By contrast, the state again dissaved to a large extent in both years, ie net public sector assets went further into the red. All in all, the saving ratio was – despite the considerable rise over the past few years – still lower in 2005 than at the beginning of the 1990s, whereas the investment ratio has so far barely been able to pull clear of the very low level at which it stood. This suggests underinvestment rather than excessive saving in Germany.

The German current account balance, which has again been positive since 2001, indicates that a proportion of aggregate savings is made available to non-residents; in 2005, it was actually more than 60%. This is reflected in net capital exports in the balance of payments. This means that Germany's claims on non-residents grew by the extent of the export surplus (minus the net transfers paid). The accompanying improvement in the foreign assets position – after taking valuation adjustments into account – is one possible way of absorbing future strains arising from an ageing society.[7] In this way, the economy receives subsequently increased investment income from abroad. In addition, there is the option of reducing the foreign assets previously accumulated and using it to extend the supply of imported goods in Germany.

At the same time, extensive net capital exports are an indication that capital investments abroad promise a higher rate of return and that investment conditions in other countries are more favourable than in Germany. The rise in net foreign assets is offset by only a weak increase in the domestic capital stock. This picture is consistent with the fact that the capital stock has grown by only 1½% per year in Germany over the past few years, compared with an average accumulation rate of 2½% in the 1990s.

There are two main reasons why Germany has become a less attractive location by international standards. After the collapse of the centrally planned economies and the beginning of the transformation process in central and eastern Europe, these countries, particularly those which joined the EU in 2004, became considerably more attractive for foreign direct investment. In addition, the investment conditions in many emerging market economies outside Europe, especially China, have improved significantly over the past few years.

Against this backdrop, Germany's claim to be the world's top exporter, which it won in 2005 for the third time in a row, must not be overestimated. It refers only to trade in goods. If services are also taken into consideration, the United States still performed best. The sharp growth in exports in recent years is certainly proof that the performance of German exports remains strong. Furthermore, it made an important contribution to the economic recovery which started in 2003. Given the weak growth of productive capital in Germany and its low employment rate, however, Germany's success in foreign markets can be interpreted as a mark of its quality as a location for investment only to a limited extent.

May 1996, p 51. — **4** Based on data from the national accounts. — **5** Calculated from gross investment less write-offs. — **6** Based on data from the balance of payments statistics. — **7** It should be remembered here that German net foreign assets were almost fully depleted during the 1990s owing, not least, to the considerable current account deficits. However, the foreign asset position has improved again considerably over the past few years. Besides valuation adjustments, the turnaround in the current account was a major contributory factor to this. The value of German net foreign assets reached an all-time high in 2005 when it amounted to an estimated 15% of GDP.

Income

The smaller deficit on invisible current transactions – which comprise services, income and current transfers – is due primarily to the larger net cross-border income, which rose by €8 billion to €8½ billion. The marginal increase in the net expenditure on compensation paid to employees abroad was clearly more than offset by the €8½ billion rise in the surplus on investment income to €10½ billion. The reason was an increase (of €18½ billion to € 133½ billion) in the receipts from investment, which was greater than in the case of expenditure (which rose by €10 billion to €123½ billion). The net rise in income from portfolio investment contributed as much to the larger net income from foreign assets as the income from direct investment and from lending to non-residents put together. It was the interest income from portfolio investment abroad and from lending to non-residents that increased the most. This was essentially due to the fact that the interest rate spread between the United States and the euro area widened further last year. Furthermore, income from direct investment grew more robustly than expenditure. This might be linked to the fact that the profitability of the affiliates of German enterprises abroad improved more markedly than that of foreign enterprises in Germany.

Services

The deficit on services decreased by €3½ billion to €28 billion in 2005. The main reason for the smaller deficit was the larger surpluses achieved in transport services, the second-largest service area. These surpluses amounted to €6½ billion in 2005, which meant that they were €2½ billion above the 2004 level. The sharp increase in German exports of goods also played a role here as they are more frequently handled by German transport companies than imports are. Net receipts from merchanting trade likewise increased (by €1 billion).The surplus on cross-border financial services also showed a slight rise to €1½ billion. However, increased surpluses in these segments were accompanied by larger deficits on insurance-related services and foreign travel. The deficit on insurance services rose by €1 billion to €2 billion because receipts from cross-border insurance services fell more sharply than expenditure. On the income side, this was due to the fact that for German reinsurers the relation of receipts from premiums to their payments of claims to non-residents deteriorated. This tendency was not quite so pronounced in the case of foreign reinsurers operating in Germany.

Foreign travel

In the year under review the deficit on foreign travel, the most important segment of the services account, increased slightly by €½ billion to €35½ billion. Although receipts rose slightly faster (5½%) than expenditure (3%), it was much smaller in terms of value. Expenditure on travel to euro-area partner countries as a whole increased at a below-average rate whereas travel to non-euro-area countries again became much more popular. However, a mixed picture emerges when the destination countries are examined individually. The Netherlands, Poland and the Czech Republic were in heavy demand for fairly short trips. Strong growth was also recorded in the case of trips to Portugal and to Turkey, which with a share of 6½% is the fourth-largest recipient of Germany's total travel expenditure. Switzerland was again a popular travel destination, as was Spain, which had become much less attractive during the previous few years. Expenditure on travel to Asian countries also increased appreciably. However, the tsunami disaster in the Indian Ocean at the end of December 2004 had a discernibly detrimental impact on travel to South-East Asia for a time.

Expenditure on travel to the classic holiday destinations of Italy and Greece rose at a below-average rate, with Greece having already sustained large losses during the Olympic year of 2004. By contrast, some European and overseas regions recorded sharply reduced German expenditure on foreign travel. Notably Hungary and the United Kingdom, for example, received fewer visitors than in 2004, and the same applies to France, Austria and Belgium. Egypt likewise lost some of its attractiveness but expenditure on travel to other African countries such as Tunisia expanded substantially. There was also a decrease in expenditure on trips to the United States.

Transfers

In 2005, the deficit on current transfers to non-residents likewise rose only marginally, namely by €½ billion to €29 billion. This is due to the increase of €1 billion in the deficit on public transfers which was accompanied by an increase (of €2 billion) in net payments to the EU budget. The main contributory factors here were the increase in German payments to the EU based on national product as well as a larger EU share in German revenue from value added tax and increasing contributions in connection with the agricultural policy. These more than offset the EU's larger

Major items of the balance of payments

€ billion

Item	2003	2004	2005
I Current account			
1 Foreign trade 1			
Exports (fob)	664.5	731.5	786.2
Imports (cif)	534.5	575.4	625.6
Balance	+ 129.9	+ 156.1	+ 160.6
Supplementary trade items 2	– 11.1	– 15.2	– 20.2
2 Services (balance)	– 34.3	– 31.3	– 27.9
of which Foreign travel (balance)	– 36.8	– 34.8	– 35.3
3 Income (balance)	– 15.9	+ 0.6	+ 8.6
of which Investment income (balance)	– 14.7	+ 1.6	+ 10.3
4 Current transfers (balance)	– 28.3	– 28.3	– 28.9
Balance on current account	+ 40.3	+ 81.9	+ 92.2
II Balance of capital transfers 3	+ 0.3	+ 0.4	– 1.3
III Financial account 4			
1 Direct investment	+ 20.4	– 13.7	– 10.4
2 Portfolio investment	+ 70.9	+ 9.5	– 13.9
3 Financial derivatives	– 1.9	– 5.4	– 4.7
4 Other investment 5	– 137.9	– 106.5	– 73.2
5 Change in the reserve assets at transaction values (increase: –) 6	+ 0.4	+ 1.5	+ 2.2
Balance on financial account 7	– 48.1	– 114.7	– 100.1
IV Errors and omissions	+ 7.5	+ 32.3	+ 9.1

1 Special trade according to the official foreign trade statistics (source: Federal Statistical Office). — **2** Mainly warehouse transactions for the account of residents and the deduction of goods returned as well as goods under repair. — **3** Including the acquisition/disposal of non-produced non-financial assets. — **4** Net capital exports: –. For details see the table "Financial transactions" on page 29. — **5** Includes financial and trade credits, bank deposits and other assets. — **6** Excluding allocation of SDRs and changes due to value adjustments. — **7** Balance on financial account including change in reserve assets.

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payments to Germany in connection with the structural policies. By contrast, the deficit on private transfers declined slightly. The indemnification payments from the "Remembrance, Responsibility and Future" foundation, which are made in equal parts by the private and public sectors, were just over €½ billion down on a year earlier.

Financial transactions

Trends in financial transactions

The striking resilience of global economic growth in the face of the sharply rising oil prices and the changing assessments of risks to stability and growth had a marked influence on events in the international financial markets in the year under review. Against this backdrop, the Federal Reserve continued its programme of gradually tightening monetary policy, and in December the ECB reacted to the risks which the high energy prices and the positive cyclical prospects were posing for price stability by taking an initial step on interest rates. The capital market rates, which in the euro area had reached temporary new lows in the fourth quarter, rose slightly again afterwards but not as steeply as in the United States. The upshot was that the yield spreads between the major currency areas widened in favour of longer-term US assets. The dollar gained substantial ground at the same time. Quotations in the world's share markets likewise moved in various directions during the year under review. In Europe and Japan, in particular, share prices increased rapidly while in the United States they largely moved sideways, albeit at a high level.

The international influences described can also be seen to some degree in the cross-border capital flows into and out of Germany. Thus, investors' fundamentally positive economic sentiment and the perception of slight general price risks were reflected in further growth in financial transactions with non-residents. All in all, Germany saw net capital exports of €100 billion in 2005.

Portfolio investment

A reversal of net flows occurred in portfolio investment, which normally responds quickly to changes in financial market participants' sentiment. For the first time for four years securities transactions resulted in net capital exports (of €14 billion) whereas in the previous few years substantial inflows of funds had been recorded in Germany. At the same time, the favourable market environment was also reflected in the increased turnover, which attained new heights.

German investment in ...

The prolonged trend towards international diversification of portfolio assets was evident in the new record sums that German residents invested abroad in 2005. Their cross-border investment almost doubled to €211 billion in 2005 (2004: €110½ billion). There was particularly heavy demand among German investors for foreign debt securities (€148 billion compared with €103 billion in 2004). The acquired paper was primarily euro-denominated government bonds issued by euro-area partner countries. German investors built up their stocks of such securities by a total of €118 billion, which was a far greater increase than on an annual average since the launch of monetary union (€71 billion). One reason for the heavy demand was no doubt the

... foreign bonds and notes ...

slight yield advantage which these securities still had over Bunds. In the year under review, however, the spread shrank to no more than 9 basis points on an annual average, presumably not least as a result of the keen interest shown by German buyers. However, structural changes in investor behaviour may have played an important role in addition to these earnings criteria. For example, pension funds and insurance companies generally seem to be switching their managed assets increasingly into longer-term interest-bearing paper in order to ensure greater maturity matching between assets and liabilities as prescribed by the new regulatory framework *Solvency II*. They evidently also invested fairly heavily in foreign bonds and notes.

Owing to the greater interest rate advantage of, for example, dollar assets and the appreciation of the US currency, foreign currency bonds also offered good yields to German investors. They acquired net amounts of such issues worth €25½ billion (compared with €10 billion in 2004). It was only in the run-up to monetary union that German residents had previously purchased even greater amounts of foreign currency bonds on the expectation of profit-taking in the course of interest rate convergence – but at that time these acquisitions were denominated mainly in the legacy currencies of the euro. By contrast, German savers reduced their demand for foreign money market instruments (€4½ billion compared with €12½ billion in 2004), ie debt securities with an original maturity of one year or less, which in times of only low general uncertainty probably seemed to offer no favourable risk-return profile.

Financial account

€ billion, net capital exports: –

Item	2003	2004	2005
1 Direct investment	+ 20.4	– 13.7	– 10.4
German investment abroad	– 5.5	– 1.5	– 36.7
Foreign investment in Germany	+ 25.9	– 12.2	+ 26.3
2 Portfolio investment	+ 70.9	+ 9.5	– 13.9
German investment abroad	– 41.7	– 110.6	– 210.9
Equity	+ 4.5	+ 3.5	– 22.9
Mutual fund shares	– 2.8	– 10.9	– 39.9
Bonds and notes [1]	– 53.2	– 90.7	– 143.6
Money market instruments	+ 9.8	– 12.4	– 4.5
Foreign investment in Germany	+ 112.6	+ 120.1	+ 197.0
Equity	+ 23.1	– 12.8	+ 40.0
Mutual fund shares	– 1.8	+ 4.7	+ 0.9
Bonds and notes [1]	+ 69.6	+ 142.7	+ 158.7
Money market instruments	+ 21.7	– 14.5	– 2.7
3 Financial derivatives [2]	– 1.9	– 5.4	– 4.7
4 Other investment [3]	– 137.9	– 106.5	– 73.2
Monetary financial institutions [4]	– 111.6	– 89.5	– 63.3
Long-term	– 38.6	– 4.2	– 79.8
Short-term	– 73.1	– 85.3	+ 16.5
Enterprises and individuals	– 32.9	– 11.2	+ 7.4
Long-term	– 5.2	+ 0.3	– 1.1
Short-term	– 27.7	– 11.6	+ 8.5
General government	+ 4.4	– 0.5	+ 6.9
Long-term	+ 5.0	– 1.4	+ 10.5
Short-term	– 0.6	+ 0.9	– 3.6
Bundesbank	+ 2.2	– 5.3	– 24.2
5 Change in the reserve assets at transaction values (increase: –) [5]	+ 0.4	+ 1.5	+ 2.2
Balance on financial account [6]	– 48.1	– 114.7	– 100.1

1 Original maturity of more than one year. — **2** Securitised and non-securitised options and financial futures contracts. — **3** Includes financial and trade credits, bank deposits and other assets. — **4** Excluding the Bundesbank. — **5** Excluding allocation of SDRs and changes due to value adjustments. — **6** Balance on financial account including change in reserve assets.

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... shares and ...

German residents again invested fairly large amounts (€23 billion) in foreign share markets, too, last year whereas in 2004 they had sold net amounts of foreign equities. These figures were influenced by a fairly large exchange of shares as German residents in the course of an acquisition of a German credit institution by a non-resident enterprise were "paid" in shares issued by the foreign buyer. If this special effect is eliminated, German investors appear to have been largely absent from the international share markets, probably for reasons including the bullish domestic exchanges (CDAX: +16%) and the comparatively moderate price increases, notably in the United States (S&P 500 Composite: +3%) which in the past frequently accounted for a not inconsiderable part of German share purchases abroad.

... mutual fund shares

By contrast, indirect share purchases through foreign investment companies featured prominently last year. German residents invested a record €40 billion in mutual fund shares of foreign funds, far more than in the year before (€11 billion). It was mainly foreign funds of German origin that are open to the general public and often managed from Luxembourg which were popular with German residents.

Foreign investment in ...

Non-residents' investment and diversification strategies in 2005 also led them to increase significantly their investment in the German securities markets. They invested €197 billion in German securities, which was at once a new record and on a par with the record investment of German savers abroad; this means that non-residents actually exceeded the value attained in 1999 when the reshuffling of portfolios at the start of European monetary union saw a rapid acceleration in foreign securities investment in Germany. Their main focus of attention was bonds and notes, which in the period under review they acquired for €156 billion net (compared with €128 billion a year earlier). Most of the investment took place in the first six months of 2005 when the prospect of declining capital market rates in Germany made investment in bonds and notes seem attractive. However, it is possible that the special structural factors already mentioned – in addition to the expected rate movements – influenced purchasing behaviour. More foreign funds flowed into public bonds (€75 billion) than in 2004; even so, private bonds were again slightly more popular with non-resident investors even if total demand declined (€84 billion). This shift in favour of public bonds was probably due in part to the fact that the interest rate advantage of bank debt securities over German government bonds, which are marked by a first-class credit rating and a high degree of liquidity, declined further during the period under review to an average of 15 basis points. Supply factors – net sales of bank debt securities fell discernibly last year – might also have played a role. The generally heavy foreign demand for longer-term debt securities ultimately seems to have been to the detriment of German money market instruments. At all events, non-resident investors sold net amounts of this paper (€2½ billion), notably in the final quarter of 2005.

... German bonds and notes and ...

... shares

The more favourable cyclical prospects that increasingly emerged during the year and the low level of uncertainty that prevailed – measured in terms of the implicit volatilities of options on shares indices – also had a positive effect on the stock exchange climate in Germany. Encouraged by a comparatively favourable price-earnings ratio and an improvement in analysts' forecasts on profitability, fairly extensive amounts of foreign funds flowed into the German share markets. All in all, non-resident investors acquired share certificates of German companies worth €40 billion whereas in the previous year they had been net sellers (€13 billion).[5]

Direct investment

In the course of last year the factors that were having a positive effect on the share markets were also working to the advantage of direct investment. Thus, according to initial estimates from UNCTAD, the global direct investment flows in 2005 were 29% up on the year. Generally speaking, it was events in the area of mergers and acquisitions that showed a particularly marked momentum. Approximately 23,200 M&A agreements with a transaction value of roughly €1¾ trillion were concluded globally last year.[6] However, these figures also include purely national mergers.

Fairly large transactions in connection with acquisitions and the restructuring of multinationals in which German investors had a stake peaked towards the end of last year. The significant improvement in the profitability of many enterprises resulted in a high degree of liquidity and might have fostered growth through acquisitions, especially as any sizeable endogenous growth – not least in view of the rather weak domestic economy – was probably considered difficult in many cases and the conditions for external financing were favourable.

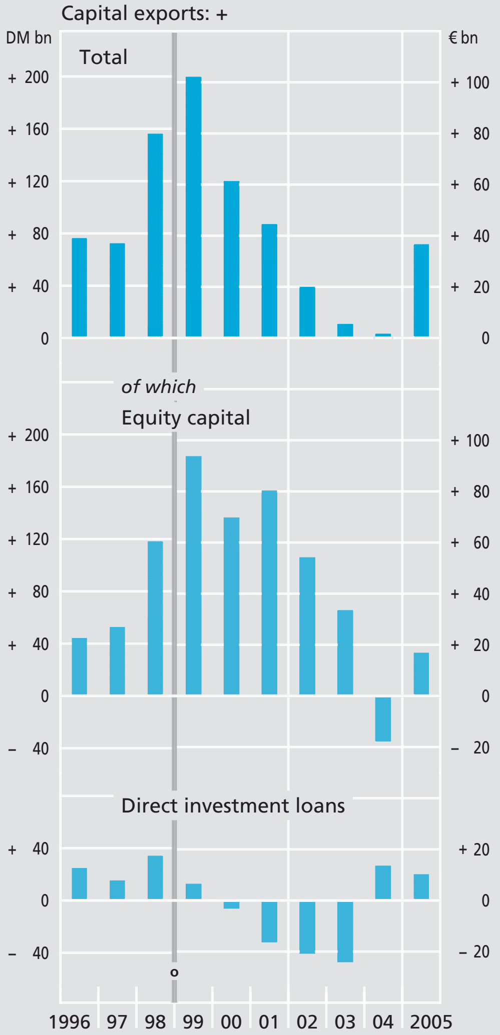
It is against this backdrop that the direct investment flows to and from Germany accelerated markedly last year. However, some of these individual flows of funds cancelled each other, with the result that there were comparatively moderate net capital exports of €10½ billion.

German direct investment abroad

After their previous sharp retreat from investing abroad, German enterprises increased their cross-border investment substantially last year (€36½ billion). This was due largely to the fact that German proprietors provided their affiliates abroad with a significantly increased amount of equity capital.[7, 8] The injection of capital in the form of reinvested

5 Non-residents' acquisitions of German shares was ultimately depressed by the fact that the transfer of the share certificates of the acquired German financial enterprise mentioned at the beginning of this article which were previously held by non-residents were treated in the balance of payments as sales of German shares by non-residents.
6 This compares with €1⅓ trillion or 22,500 transactions in 2004 and just under €1 trillion or 17,000 transactions in 2003. Each of the transaction volumes cited here also contain the net debt of the acquired enterprises. Source: Thomson Financial.
7 Included in these figures are also fairly large disposals of subsidiaries whereas, particularly at the end of the year, the sale of foreign participating interests by a resident enterprise in the pharmaceutical sector together with the transfer of the sales proceeds to the parent company resident in the single currency area was also reflected in the data on foreign direct investment in Germany.
8 The changes in the presentation of the balance of payments mentioned in footnote 4 also affect financial transactions. First, "other capital" arising in the case of direct investment will be included in equity capital in future. The data as hitherto defined will be shown under "equity capital in the narrower sense". Second, various items will be subsumed in "other investment", and the reserve assets, which previously formed a separate category, will be included as a sub-item under financial transactions. The change is being backdated up to and including 1971. Additional information is available on the Bundesbank's website: http://www.bundesbank.de/statistik/statistik_sdds_zahlungsbilanz.en.php.

German direct investment abroad



o Data in euro as of 1999.

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earnings also increased sharply as a result. The bulk of direct investment occurred in the services sector. Communications, banking, insurance and holding companies were particularly involved here. The primary target countries for German foreign investment were the (old) EU member states (€21½ billion) but Switzerland, the Ukraine, China and Canada also recorded sizeable net inflows (€5 billion, €4½ billion, €3 billion and 2½ billion respectively). By contrast, German direct investment in the new EU member states in central and eastern Europe, which often feature prominently in the public debate on the relocation of jobs, remained moderate (€3½ billion). In the case of direct investment in the United States liquidations outweighed new investments, with German proprietors withdrawing €5½ billion net.[9]

Foreign direct investment in Germany

Foreign direct investment in Germany resulted in capital imports of 26½ billion in 2005 whereas a year earlier foreign proprietors had been withdrawing funds from the German affiliates (€12 billion). The transaction of a pharmaceutical company, the counter-entry of which resulted in a liquidation of foreign direct investment assets in Germany, had a dampening effect on the net inflows of direct investment capital. On the other hand, the acquisition in November of a German credit institution by a bank domiciled in the euro area triggered inflows of a similar amount.[10] Although foreign proprietors injected less equity capital into their German affiliates in net terms last year (€11½ billion compared with €27½ billion in 2004), funds were again provided (€7½ billion) through the granting of intra-group credit.

9 The main reason for this was the transaction in the pharmaceutical sector mentioned in footnote 8.
10 The acquisition, which was financed by an exchange of shares, also led to counterflows of capital of a similar dimension through cross-border portfolio investment (see p 28 f). The upshot was, on the one hand, the acquisition of shares of the buyer by German residents as a result of the exchange of shares, leading to a large net procurement of foreign shares by residents, and the surrender of the acquired enterprise's shares in the hands of diverse shareholders abroad, on the other.

Longer-term developments in trade credit relationships between German enterprises and non-residents

Trade credit relationships between German enterprises and non-residents have been subject to some changes over the past ten years. In addition to the introduction of the euro, one of the main reasons for this is likely to have been the efforts of enterprises to improve their balance sheet structures.

The Bundesbank's Statistics Department records terms of payments granted and used in merchandise and service transactions with non-residents as trade credits as well as advance payments made and received in connection with the import and export of large plant and equipment. Most of the trade credit relationships which German enterprises enter into are in the form of terms of payment agreements or "supplier credit", which led to claims of €119 billion and liabilities of around €65 billion on an average of 2005. [1]

There is naturally a close relationship between the build-up of trade credit relationships and foreign trade developments. However, borrowing, on the one hand, and lending, on the other, have not followed the underlying commodity flow at the same pace during the past few years. Whereas German enterprises have made full use of terms of payments to finance their imports, they have become increasingly selective in their own granting of terms of payments. The extent to which German enterprises have used supplier credit has therefore been virtually proportional to import developments – in line with the long-term trend – whereas the rate of their own granting of credit has not kept pace with export developments.

The increasing reluctance to pre-finance exports by granting supplier credit has been most clearly reflected in business relationships with emerging market economies and developing countries. For example, claims arising from accounts receivable from this group of countries have been rising by less than 1 % per annum on an average of the past five years, even though exports have simultaneously risen sharply at an average rate of 9½ %. However, a more restrictive practice in the granting of supplier credit can also be observed in the case of other trading partners, particularly in the EU. It appears that the reduction in the granting of payment terms primarily affected those foreign business partners with whom there are no capital links; by contrast, it is less striking in the case of affiliated enterprises.

It is unclear what effect the introduction of the euro has had on developments in trade credits. The significance of the domestic currency for the invoicing of German imports and exports has always been considerable, something which has not changed radically following the transition to the single European currency. The former D-Mark and now euro share, which stood at just under two-thirds for both accounts receivable and accounts payable on an average of 1995, now amounts to around 70 %, 5 percentage points higher than before. However, it should be noted that the weak growth in accounts receivable from non-affiliated enterprises almost exclusively affects contracts invoiced in foreign currency and is in stark contrast to the development of contracts in euro. Given the sharp exchange rate fluctuations of the euro, for example, against the US dollar in the past few years, exchange rate risks could have contributed to the caution in awarding foreign currency loans.

It may also be that the changes indicated above are an expression of efforts to improve the refinancing structure and asset management. In any case, this is consistent with the fact that the acceptance of payment terms (thus avoiding bank loans) enjoys ongoing popularity, while the granting of payments (binding one's financial resources) is on the wane. Significantly, supplier's credit has been particularly limited in those areas that tend to be fraught with higher risk and require costly hedging measures.

1 The average annual claims arising from trade credits in 2005 amounted to a total of €126 billion, while liabilities came to €98 billion. The discrepancies in the aforementioned figures are explained by the advance payments made and received, which stood at €7 billion and €33 billion, respectively, on an average of 2005.

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Accounts receivable and accounts payable in foreign trade

Year or period	Exports 1	Accounts receivable 2			Imports 1	Accounts payable 2		
		Total	from affiliated enterprises	from other enterprises		Total	to affiliated enterprises	to other enterprises
	Values, € billion							
1995	383.2	77.7	30.0	47.7	339.6	36.5	22.6	13.9
2000	597.4	111.1	50.8	60.4	538.3	56.5	34.2	22.3
2005	786.2	118.9	57.4	61.5	625.6	64.6	39.2	25.4
	Percentage average annual change							
1995 to 2000	9.3	7.4	11.1	4.8	9.6	9.2	8.7	9.9
2000 to 2005	5.6	1.4	2.5	0.4	3.1	2.7	2.8	2.6

1 Special trade; annual totals. — **2** Annual averages.

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The reduction in (mainly long-term) financial credits which was triggered by the change in the thin capitalisation rules and which was observed in each of the two previous years seems to have petered out in the year under review.[11] Evidently, foreign direct investors had rediscovered credit as a form of financing and again optimised their intra-group allocation of funds. At all events, this is indicated by the extensive funds flowing via Germany to and from group enterprises domiciled in various countries. It is advisable to be cautious when interpreting these direct investment funds, which flow backwards and forwards, sometimes in rapid succession, and which often have little to do with real economic investment.

Other investment ...

In the new presentation of the balance of payments other investment comprises not only unsecuritised credit transactions but also other transactions, which had previously been shown separately. These include, for example, the Federal Government's contributions to international organisation although it is not its holdings that are captured but only – as is customary in the balance of payments – the transactions made in the period under review.[12] The item "Other transactions" was comparatively small last year with net capital exports of €4 billion. As in previous years,

11 See also Deutsche Bundesbank, German balance of payments in 2003, Monthly Report, March 2004, p 49.
12 The item also includes inter alia purchases of movable property remaining abroad as well as equity interests not deemed to be direct investment and not recorded under portfolio investment either (where, for example, shares are not involved).

unsecuritised credit transaction were much more significant in terms of value.

... of non-banks ...

The transactions of enterprises and individuals with counterparties abroad that are statistically recorded in other investment resulted in net capital imports of €7½ billion in 2005, all of which arose – on balance – through the raising of financial credits. Evidently German enterprises used favourable financing facilities outside Germany for these. Conversely, they built up their bank deposits abroad and granted net amounts of trade credits to foreign counterparties.

General government also made intensive use of the international capital markets in the course of their financial operations. Their cross-border transactions resulted in net capital imports of €7 billion. In the process they borrowed long-term abroad while retrieving financial credits previously granted to foreign borrowers and parking short-term funds in foreign accounts.

... and MFIs

In the unsecuritised external operations of the banking system (including the Bundesbank), by contrast, there were net outflows of €87½ billion – the counterpart, as it were, of all other balance of payments transactions. German credit institutions accounted for €63½ billion of this sum. As in previous years, the growth in receivables dominated the corresponding deposits and borrowing operations. For example, new lending to foreign borrowers was almost four times greater than the corresponding funds borrowed. Marked differences also emerge with regard to maturities. A build-up of long-term net claims amounting to just under €80 billion was accompanied by net capital imports of €16½ billion at the short end of the market.

A further €24 billion (net) was exported through the accounts of the Bundesbank. These funds primarily reflect the build-up of claims in connection with the large-value payment system TARGET (€22 billion).

Bundesbank's reserve assets

The reserve assets of the Bundesbank, transaction-related changes in which are likewise included in the financial account now and no longer shown in a separate sub-category, declined last year by just over €2 billion at transaction values. When valued at end-of-year market prices, the reserve assets grew strongly in value. This was due primarily to the rise in the price of gold and the year-on-year appreciation of the US dollar. Holding gains contributed about €12½ billion in the case of gold and just over €4 billion in the case of the foreign currency reserves. At the end of 2005, therefore, the reserve assets stood at €86 billion, ie €15 billion more than at the end of 2004.