German balance of payments in 2006

Last year German exporters again benefited from the generally strong growth in export markets. The heavy global demand for capital goods, which account for a substantial part of Germany's range of exports, also played a role. Overall, the value of Germany's exports of goods grew by 13¾% in 2006. Imports actually grew somewhat more vigorously at 16½%. This was due largely to the surge in the prices of energy and industrial raw materials. Even so, the surpluses in the trade balance and in the current account reached record highs. The current account balance rose to 5% of GDP.

The counterpart within the balance of payments is to be found in Germany's extensive net capital exports. German banks, in particular, saw a sharp increase in their net external assets last year, a development which can certainly be regarded in part as a reflection of the current account surplus. Germany also experienced fairly substantial outflows of capital as a result of direct investment. By contrast, portfolio investment, which usually reflects changing conditions in the financial markets particularly quickly, closed almost in balance in 2006.

Current account

External setting

The underlying international conditions were again favourable for German exporters in 2006. The global economy expanded at just over 5% and therefore more sharply than in 2005. The volume of world trade grew by 9% compared with 7½% a year earlier. The shifts in international exchange rate patterns had little effect on German enterprises. The effective overall appreciation of the euro was marginal (at ½%). It has to be remembered that 42% of German exports are destined for the euro area. Here, nominal exchange rate movements vis-à-vis the currencies of non-euro-area countries are important only to the extent that they affect the competitiveness of competing suppliers from these third countries. The appreciation of the euro was offset by a further improvement in the cost situation of German enterprises over that of their main foreign competitors, with the result that the overall price competitiveness of German exporters in 2006 rose by a further ¾% on average.[1] Germany's relative price advantage amounted to 6½% on a long-term average.

Exports

German export markets expanded even faster in 2006 than in 2005. German enterprises also benefited from the fact that capital goods constitute a relatively high proportion of their total range of products. The value of their exports of goods increased by 13¾% in 2006 and therefore more sharply than at any time since the boom year of 2000. In real terms, exports grew by 11¼%. Although, at 2½%, prices rose twice as fast as in 2005, export prices actually increased fairly moderately given the marked rise in prices overall and especially of industrial raw materials (+34% in euro terms) and crude oil (+18½% in the case of Brent crude).

Regional breakdown of exports

The strongest stimuli on German exports in 2006 came from countries outside the euro area as the overall economic output of these countries grew more dynamically than that of the euro area. German exports to non-euro-area countries expanded by 16¼% in nominal terms and 14¼% in real terms. The upshot was that Germany increased its market position outside the euro area in 2006.

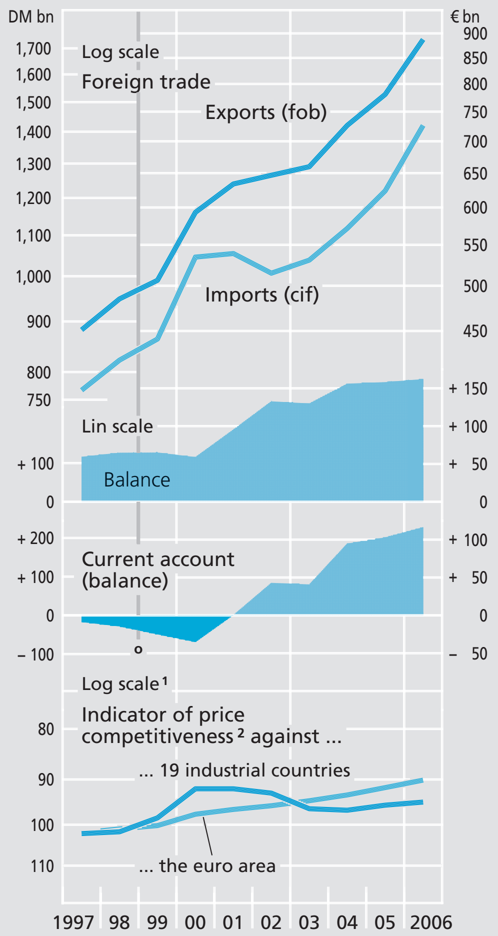
Greatest export growth in the major regional markets was achieved in the Russian Federation (35¼%), whose demand for German goods was fuelled by the further increase in revenue from oil and gas sales. There was likewise a significant upturn in the amount of goods exported to the OPEC countries (9¾%) even though the rate of growth was somewhat below the levels of the previous two years. Exports to China grew dynamically again (+29½%) after almost stagnating in 2005. Evidently the economic policy measures taken there in 2006 to check the investment boom have still not exerted any discernible negative effects on German exports. Exports to the emerging markets in South-East Asia, which had also risen only slightly in 2005, likewise grew in double figures again (14¾%) in 2006. By contrast, exports to Japan, at 4%, were somewhat weaker than in 2005. That was probably due in part to the appreciation of the euro against the yen.

1 Based on the price index of total sales.

Goods exports to the United States were up by 12½% following an increase of 6¾% the year before. At first glance, this is surprising in that the US economy had been expanding virtually at the same rate in both years and the euro appreciated slightly against the US dollar in 2006. The main reason for the successful sales development in the US market was the increased demand for German chemical products and machinery and equipment as well as for motor vehicles. Exports to the new EU member states, with which trading links have become increasingly closer over the years, also grew extremely vigorously (+21½%). The salient feature in this development was the 29% increase in exports to Poland, Germany's most important customer among the new member states.

German exports of goods to other euro-area countries again grew sharply, at 11%, albeit not quite so dynamically as sales to non-euro-area countries. In real terms, the increase amounted to 8%. The further 1¾% improvement in Germany's price competitiveness over that of its euro-area partners was a contributory factor here. The outcome was that German enterprises increased their market shares in the euro area during the period under review. Export growth rates diverged widely from one country to another, but this was partly a reflection of the differences in economic growth in the various member states. It was also due in part to the fact that exports to those euro-area countries whose price competitiveness was deteriorating fastest in relation to that of Germany received a correspondingly bigger boost. For example, prices and costs in Luxembourg, Ireland, Spain and Greece increased quite sharply compared with those in Germany whereas the corresponding rates in Austria, France and Finland were only marginally above those in Germany. Differing developments in wage costs were the primary reason for this. By contrast, the further increase in energy prices in 2006 hardly changed bilateral competitive positions as it affected all euro-area countries to a similar extent.

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 1999 Q1 = 100; based on the price index of total sales.

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Structure of and trends in regional foreign trade in 2006

Country/group of countries	Percentage share	Percentage change from previous year
Exports		
All countries	100.0	13.7
of which		
Euro-area countries	42.0	10.9
Other EU countries	20.3	14.5
of which		
Ten new member states	9.3	21.6
United States	8.7	12.6
Russian Federation	2.6	35.3
Japan	1.5	3.9
Emerging markets in South-East Asia	3.5	14.7
China	3.1	29.6
OPEC countries	2.4	9.7
Developing countries excluding OPEC	8.7	17.2
Imports		
All countries	100.0	16.5
of which		
Euro-area countries	38.8	15.4
Other EU countries	18.8	14.1
of which		
Ten new member states	9.8	19.2
United States	6.6	16.1
Russian Federation	4.1	35.4
Japan	3.2	8.9
Emerging markets in South-East Asia	4.6	7.7
China	6.7	19.4
OPEC countries	1.8	17.5
Developing countries excluding OPEC	9.6	16.0

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Breakdown of exported goods

All major German export sectors participated in the dynamic growth in the world economy in 2006.[2] The manufacturers of capital goods, who account for 44% and therefore constitute the largest group of German exporters, benefited from the brisk pace of global investment. The manufacturers of machinery and equipment, for example, achieved a 10½% increase in export earnings. The car industry increased exports by 7½%. Exports of goods in the information and communications technology (ICT) sector expanded by 4¼%. Growth was probably much faster in real terms as the prices of these goods again fell significantly.

The value of exports of intermediate goods, which account for almost one-third of German exports, was actually 12¼% higher in 2006 than a year earlier. German producers passed on a sizeable part of the considerable cost increases arising from industrial raw materials and crude oil, which are required in large measure for the manufacture of intermediate goods, to their customers at home and abroad. For example, the export earnings from basic metals and fabricated metal products rose by 21¾%, but almost 60% of this increase was price-related. Exports of chemical products likewise expanded exceptionally fast in nominal terms. In this case it was primarily the higher energy costs that induced manufacturers to increase their export prices

2 The picture of the breakdown of exported and imported goods is distorted by the large percentage of goods which are still not classifiable by sector. Consequently, the rates of change for the individual categories of goods and main groupings cannot be aggregated to form an overall rate.

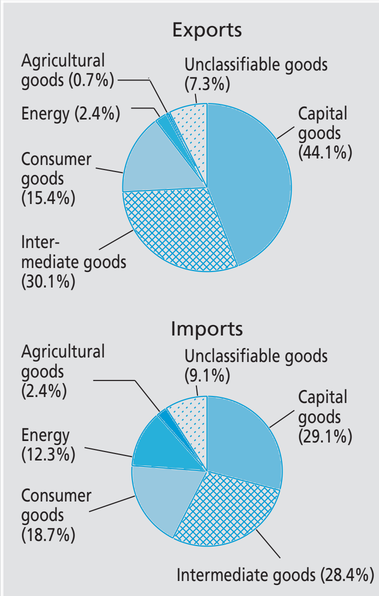
markedly. Exports of consumer goods also increased sharply (+8¼%).

Imports

Nominal imports of goods grew by 16½% in 2006 and – as in 2005 – therefore faster than exports. In real terms, foreign trade flows expanded at the same rate (+11¼%) in both directions as the price of imports increased more than twice as much as exports (5¼%). This rise was due principally to the substantially higher prices of imported energy and intermediate goods, which generally absorb a large percentage of raw materials. Furthermore, the increased price of raw materials in world markets was offset to only a marginal extent by the appreciation of the euro against the US currency, in which approximately one-third of the imports from non-euro-area countries were invoiced in 2006. By contrast, the import prices of consumer goods rose only moderately, and imported capital goods were actually cheaper.[3] All in all, the value of the increased imports of the various categories of goods diverged more in 2006 than the corresponding volumes.

Germany's terms of trade deteriorated further (by 2¾%) in the period under review. As this was due primarily to the increased prices of imported energy and raw materials, German customers were virtually unable to substitute German products for foreign goods which had tended to become more expensive. Overall, real imports increased more sharply than they had done for the past eight years. This was due, first, to the substantial expansion in exports, whose import content had risen to almost 42% by the year 2005 and probably increased further in 2006, and, second, to a

Foreign trade by selected categories of goods in 2006



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strong recovery in domestic demand. The latter development was to some extent the result of anticipatory effects of the increase in value added tax which came into force on 1 January 2007. These anticipatory effects reached their peak in the second half of the year.

Breakdown of imported goods

In terms of value, imports of energy expanded most rapidly (24¾%) in 2006. However, just over 90% of this rise was due to price increases. The overall decline in purchasing power associated with this amounted to ½% of GDP. At the beginning of the 1970s and 1980s, when oil prices had likewise risen rapidly and energy input in production was still relatively high, the decline in purchasing

3 This is linked to the marked improvements in quality, which are taken into account when assessing prices.

power in relation to GDP had almost touched 1½% at times.

The value of imports of intermediate goods likewise increased perceptibly (+13½%) in 2006. Almost half the increase was related to prices. In the case of imports of basic metals and fabricated metal products, which recorded a nominal 26½% year-on-year increase in value, as much as two-thirds of the increase was due to higher prices. The value of chemical products exported to Germany by foreign manufacturers rose by 10¼%. However, two-fifths of this increase resulted from higher prices.

Imports of machinery and equipment received an exceptionally strong boost last year owing to the fact that the propensity to invest had again risen sharply. Foreign manufacturers of machinery saw a 9¼% increase in the value of their sales in Germany. However, price rises here were modest. Imports of motor vehicles, trailers and semi-trailers increased by a nominal 6½% and at constant prices by almost as much. The aforementioned anticipatory effects of the increase in value added tax were a contributory factor in this. That is particularly true of the imported consumer electronics, which also benefited from the increased demand in the run-up to the FIFA World Cup. Total imports of ICT goods rose by 7½%. As the downward trend in the import prices of these products had continued, the rise in real terms was much greater than that.

Nominal imports from the euro area increased by a total of 15½% in the year under review.

Regional breakdown of imports

The cyclical upturn in Germany benefited all euro-area countries. However, it was those countries whose price competitiveness had faired relatively well against that of Germany which gained most from the stronger domestic demand. Although in terms of value imports of goods from the euro area increased somewhat less sharply than imports from non-euro-area countries (17¼%), they rose just as steeply in real terms. This was in turn the result of the above-average increase in the prices of energy and raw materials, the bulk of which are imported from non-euro-area countries.

Accordingly, imports from the major oil and gas-producing countries, such as the Russian Federation and the OPEC countries, recorded particularly high growth rates (35½% and 17½% respectively). Imports of goods from China also rose strongly again (+19½%). By contrast, supplies from the emerging markets of South-East Asia grew much more sluggishly (+7¾%). German imports from the ten countries which acceded to the EU in 2004 increased even more sharply than in the previous two years (+19¼%). Furthermore, the increase in US exports to Germany reached double figures for the first time since the boom year of 2000 (16%). The appreciation of the euro against the yen was a contributory factor in the sharp rise in imports from Japan (9%) as this made Japanese goods substantially cheaper.

Trade and current account balances

Even though the value of imports in 2006 increased slightly faster than that of exports, there was still a rise in the trade surplus because the volume of exports was again much greater than that of imports. The surplus rose by €4 billion to a record €162¼ billion. The surplus would have been even larger if the terms of trade had not deteriorated further as a result of the increased prices of energy and raw materials. At the same time, the deficit on current invisible transactions with non-residents declined by €9¾ billion to €27 billion. This meant that the current account ran a surplus of €116½ billion, which was €13½ billion up on the year.[4] The current account surplus amounted to 5% of nominal GDP and 6% of the domestic sectors' disposable income.

Services

The smaller deficit on current invisible transactions with non-residents, which comprise services, income and current transfers, was due to improvements in all three sub-accounts. The services account, whose deficit declined by €5¾ billion to €23 billion, made a significant contribution to this outturn. This was partly the result of the turnaround in the balance on cross-border insurance services from -€1¾ billion to +€1 billion. This was due to the fact that for German reinsurers the relation of receipts from premiums to their payments of claims to non-residents improved whereas in the case of foreign reinsurers their business operations in Germany deteriorated. Another factor was the net increase of €2¼ billion in receipts from merchanting trade. The surplus on cross-border financial services showed only a slight increase (of €½ billion). By contrast, the surpluses achieved in transport services, the second-largest service area, declined by €1½ billion. The sharp growth in German imports of goods, which are handled more frequently by foreign carriers than exports are, might have been a contributory factor here.

Foreign travel

The deficit on foreign travel, which is the most important component of cross-border services, declined by €2¾ billion in 2006. The reason was that receipts rose by 11¼% while expenditure fell marginally. On the revenue side, a major role was played by additional receipts from the FIFA World Cup in Germany in the second and third quarters of the year. Spending on overnight stays and other consumption by foreign visitors to the World Cup in Germany, including purchases of tickets for the individual football matches and expenditure on journeys within Germany, had a positive impact here.[5] The overall effect of the World Cup on Germany's revenue from cross-border services, which was spread essentially between May and July, totalled just under €1½ billion, two-thirds of which came from EU countries. Overall, more than half of the rise in travel receipts in the year under review was due to the World Cup.

German travel expenditure abroad, by contrast, was ¼% below its 2005 level. However, expenditure associated with trips to other euro-area countries, which account for more than half of total German travel expenditure, remained unchanged whereas for the first time since 2002 less was spent on journeys to non-euro-area countries.

4 The trade balance (including the supplementary trade items of -€18½ billion in 2006) and the current invisible transactions combine to form the current account balance.
5 See also Deutsche Bundesbank, The World Cup effect on travel receipts in Germany, Monthly Report, November 2006, p 43.

Major items of the balance of payments

€ billion

Item	2004	2005	2006
I Current account			
1 Foreign trade 1			
Exports (fob)	731.5	786.3	893.6
Imports (cif)	575.4	628.1	731.5
Balance	+ 156.1	+ 158.2	+ 162.2
Supplementary trade items 2	– 17.0	– 18.5	– 18.6
2 Services (balance)	– 29.4	– 28.9	– 23.1
of which Foreign travel (balance)	– 35.3	– 36.3	– 33.5
3 Income (balance)	+ 13.1	+ 20.8	+ 23.0
of which Investment income (balance)	+ 14.0	+ 22.3	+ 24.3
4 Current transfers (balance)	– 27.9	– 28.5	– 26.8
Balance on current account	+ 94.9	+ 103.1	+ 116.6
II Balance of capital transfers 3	+ 0.4	– 1.3	– 0.2
III Financial account 4			
1 Direct investment	– 19.3	– 15.8	– 29.1
2 Portfolio investment	+ 14.4	– 23.9	+ 1.2
3 Financial derivatives	– 7.2	– 7.2	– 6.3
4 Other investment 5	– 107.4	– 74.6	– 115.1
5 Change in the reserve assets at transaction values (increase: –) 6	+ 1.5	+ 2.2	+ 2.9
Balance on financial account 7	– 118.0	– 119.4	– 146.3
IV Errors and omissions	+ 22.6	+ 17.6	+ 30.0

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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Income

In the year under review net receipts from cross-border income increased by €2¼ billion to €23 billion. This was due primarily to the rise of €2 billion in the surplus on investment income to €24¼ billion. Here receipts from investment grew by €32½ billion (to €182½ billion) and expenditure by only €30½ billion (to €158¼ billion). Furthermore, there was a slight decline in the net earnings from employment paid to non-residents.

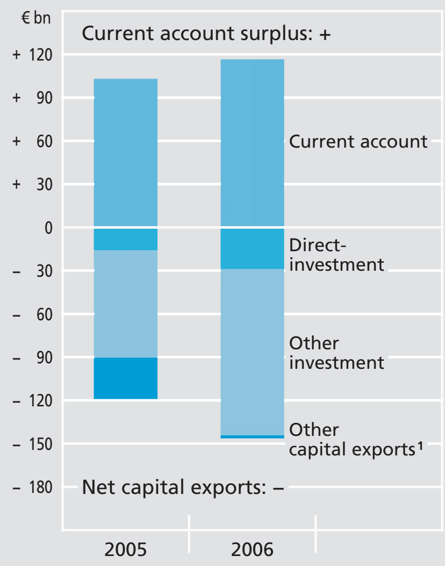
The net rise in income from foreign assets was due to the net rise in income from loans to non-residents, which more than compensated for the decline in net income from direct investment and the increase in net expenditure on debt services in connection with portfolio investment. In the process, both income and expenditure rose sharply in the area of cross-border credit interest payments, which are essentially due to bank lending. This development is primarily the result of the increase in short-term interest rates at home and abroad. The volume of bank loans also increased substantially. In addition, the cross-border credit interest payments of German enterprises and households to non-residents in 2006 grew more than twice as fast as similar payments in the opposite direction. This might be associated with the fact that German enterprises are increasingly financing the acquisition of foreign firms through borrowing abroad and therefore the cost of cross-border foreign debt servicing is likewise greater. This is consistent with the fact that in 2006 worldwide merger and acquisition (M&A) operations showed a sharp rise (see pages 32 and 33).

The increase in net expenditure on portfolio investment was due to the substantial rise in dividend payments to foreign investors. This was a reflection of the discernible improvement in German enterprises' profitability. Overall expenditure on direct investment grew faster than the corresponding income, a development which was likewise due to larger interest charges and dividend payments.

Transfers

The deficit on current transfers to non-residents decreased by €1¾ billion to €26¾ billion in 2006. This was the result of the €3 billion decline in the deficit on public transfers, one contributory factor here being larger tax revenue from non-residents. Another factor was the decline in the net contributions to the EU budget due principally to rising receipts under the Common Agricultural Policy. On the expenditure side, the greater contribution payable to the EU from Germany's revenue from value added tax and the lower German payments to the EU based on national product more or less cancelled each other out. By contrast, the deficit on private transfers increased by €1¼ billion. The indemnification payments from the "Remembrance, Responsibility and Future" foundation, which are made in equal parts by the private and public sectors, amounted – five years after their inauguration – to barely €¼ billion compared with €½ billion in 2005. This means that the funds provided have now been almost fully paid out.

Major items of the balance of payments



1 Including the balance of portfolio investment (including financial derivatives) and the change in the reserve assets (at transaction values).

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Financial transactions

Trends in financial transactions

The transactions recorded in Germany's financial account with non-residents last year are to be seen, first, in connection with the large Germany current account surplus. Second, they were largely determined by factors emanating from the international financial markets. In the light of the sustained buoyancy of the world economy and the better earnings outlook for many enterprises, stock prices rose sharply worldwide during the year under review and ended the year almost everywhere at close to their multi-year highs.[6] At the

6 Stock prices initially prolonged their upward movement at the beginning of 2007 before recording sharp declines at the end of February and the beginning of March. When this report went to press, however, stock prices in the major markets were still close to their end-of-year levels.

Financial transactions

€ billion, net capital exports: –

Item	2004	2005	2006
1 Direct investment	– 19.3	– 15.8	– 29.1
German investment abroad	– 11.9	– 44.6	– 63.3
Foreign investment in Germany	– 7.4	+ 28.8	+ 34.2
2 Portfolio investment	+ 14.4	– 23.9	+ 1.2
German investment abroad	– 102.3	– 202.8	– 159.4
Equities	+ 9.0	– 17.1	+ 6.3
Mutual fund shares	– 12.1	– 43.5	– 24.4
Bonds and notes 1	– 87.2	– 137.2	– 134.5
Money market instruments	– 11.9	– 5.0	– 6.8
Foreign investment in Germany	+ 116.8	+ 178.9	+ 160.6
Equities	– 13.7	+ 21.3	+ 27.5
Mutual fund shares	+ 4.6	+ 1.1	+ 9.3
Bonds and notes 1	+ 140.3	+ 159.5	+ 125.1
Money market instruments	– 14.4	– 3.0	– 1.3
3 Financial derivatives 2	– 7.2	– 7.2	– 6.3
4 Other investment 3	– 107.4	– 74.6	– 115.1
Monetary financial institutions 4	– 89.5	– 63.3	– 147.1
Long-term	– 4.2	– 79.8	– 83.5
Short-term	– 85.3	+ 16.5	– 63.6
Enterprises and households	– 11.5	+ 6.2	+ 8.0
Long-term	– 0.5	+ 1.8	– 6.3
Short-term	– 10.9	+ 4.4	+ 14.3
General government	– 1.1	+ 6.7	+ 0.8
Long-term	– 2.0	+ 10.3	+ 8.3
Short-term	+ 0.9	– 3.6	– 7.5
Bundesbank	– 5.3	– 24.2	+ 23.2
5 Change in the reserve assets at transaction values (increase: –) 5	+ 1.5	+ 2.2	+ 2.9
Balance on financial account 6	– 118.0	– 119.4	– 146.3

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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same time, bond yields in the course of the year rose slightly, albeit with some sharp fluctuations. Interest rates in the euro area saw the sharpest upturn, with the result that interest rate differentials moved in favour of euro-denominated financial instruments. While the Fed had been holding the Federal Funds target rate unchanged at 5.25% since June 2006 and the Bank of Japan made merely an initial increase in the overnight rate last year in July, raising it to 0.25%, the Governing Council of the ECB continued its policy of gradual monetary policy tightening throughout the year. As a result of shifts in the relative cyclical and interest rate patterns, the euro appreciated by approximately 5% on a weighted average last year; its external value improved even more against the US dollar (11½%) and the yen (13%).

Given such a setting, internationally oriented players extended their cross-border investments further. This can also be seen in the amounts of capital that flowed in and out of Germany. The outcome was that in 2006 Germany recorded substantial net outflows of funds, which, in the aggregate, exceeded the surplus on current account. The "Errors and omissions" item in the balance of payments recorded a positive residual of €30 billion.

Portfolio investment

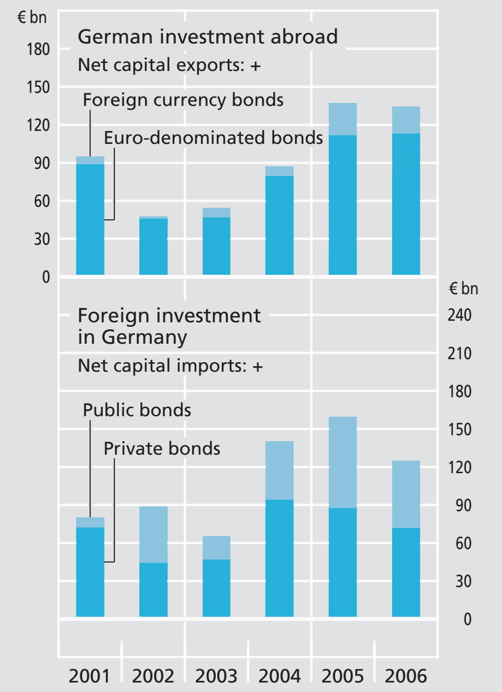
Germany's portfolio transactions with non-residents, which, as a rule, are quick to reflect investors' changing assessments, were almost in balance in 2006. All in all, they ended the year with modest net capital imports of €1 billion compared with net outflows of €24 billion in 2005. The reversal was due to the fact that, owing to the favourable financial market conditions in Germany, German investors' securities acquisitions abroad did not match the previous year's record whereas non-residents again invested quite substantially in the German securities markets.

Non-residents invest in ...

Although foreign asset holders likewise purchased fewer German securities in 2006 than in 2005 (€160½ billion compared with €179 billion), the amount invested was still far above the average investment sum in the German market since the start of monetary union (€133 billion) and – as mentioned above – was also slightly in excess of German residents' purchases of securities abroad. Non-resident investors focused most of their attention on German debt securities and added a significant amount of these to their portfolios (€124 billion compared with €156½ billion in 2005). The first increase for six years in long-term German bond market interest rates and the associated price losses possibly curbed non-residents' acquisitions – despite the eventuality of valuation gains ex post owing to the appreciation of the euro. In any case it was obvious that in the second quarter of 2006, a period of rising interest rates, foreign investors were reluctant to buy German debt securities. As in earlier years, they focused on private-sector bonds (€72 billion), notably bank debt securities. These have an interest rate spread over Federal bonds (Bunds), which enjoy a first-class credit rating and a high degree of liquidity. This interest rate spread of bank debt securities doubled for a time to more than 30 basis points despite heavy demand and did not ease again somewhat until almost the end of the year. It is also possible that the *de facto* preference of non-residents for bank debt securities arose in connection with supply factors in the case of government issues, the reason being that, owing to the favourable cash balances of central and state government, net sales of public bonds amounted to no more than €52½ billion and thereby reached a five-year low. Foreign investors acquired longer-term (German) government paper worth a total of €53½ billion. German money market instruments, which are generally suitable for hedging against price risks at times of rising interest rates, were purchased by non-residents only during the first few months of last year, consistent with the changes in interest rates. Over the year as a whole, there was a small net sale of money market instruments (€1½ billion).

... German debt securities and ...

Portfolio investment



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... shares

The momentum of the global economy and the vigorous cyclical upswing in Germany also strengthened the German share market during the period under review. For the fifth year in succession the share market recorded a rise in value and also developed more favourably than the stock exchanges of other industrial countries. The rally was borne by more optimistic estimates from analysts on corporate earnings, vigorous M&A activity worldwide and – as measured by the implied volatility of the CDAX – the comparatively low degree of uncertainty about future share price movements. This uncertainty jumped only briefly between mid-May and June when anxiety about future economic developments in the United States sharpened market participants' risk awareness. Foreign investors benefited from the increasing value of German shares last year and contributed decisively to this increase through their purchases. They purchased continuously throughout the year, buying German equities worth a total of €27½ billion (compared with €21½ billion in 2005). A substantial percentage of German shares is now held by foreigners. In the case of DAX-listed enterprises, on which international investors frequently focus their attention, this percentage is estimated to be more than 50%.[7]

Foreign investors also acquired mutual fund shares of domestic investment companies worth €9½ billion; this was only slightly less than in the record year of 2000 when €11 billion in foreign resources accrued to German funds. Part of this capital presumably likewise accrued to the German share market indirectly.

German residents invest in ...

The fact that the underlying sentiment in German financial markets was much more optimistic than in many other financial centres around the world can also be seen in the investment behaviour of German residents in 2006. Although their investment in foreign securities markets likewise increased in the course of their investment and diversification plans, their net expenditure on investment outside Germany was discernibly less than in the previous year. For example, German residents spent €159½ billion on acquiring securitised paper abroad compared with €203 billion in the record year of 2005. The main contributory factor to this decline was a shift in their investment preferences vis-à-vis equities. In 2005 German residents had invested €17 billion in the shares of foreign enterprises but in the year under review they became net sellers (€6½ billion). The withdrawal was confined to the second quarter of 2006 and possibly took place in connection with the emerging uncertainty about the US economy in that period when market expectations suddenly turned and investors reassessed the risks in the share markets, especially vis-à-vis the United States. This line of reasoning is confirmed at least by the fact that German investors sold shares in listed US corporations worth €4 billion during this period. Another possible motive is that the German share market expanded by 21½% and therefore more sharply than other major markets as witnessed by, for example, the Japanese Nik-

... foreign shares ...

7 See Factbook of the Deutsches Aktieninstitut 2006, which contains data on the foreign ownership of approximately half of the DAX-listed enterprises, which, in the aggregate, account for about two-thirds of the stock market capitalisation of the index. The shares held as direct investment are included.

kei index (7%) and the US Standard & Poor's (13½%). The appreciation of the euro during the year will also have been a factor in Germans' more cautious investment behaviour outside the monetary union.[8]

... mutual fund shares ...

By contrast, investment companies domiciled abroad recorded further inflows of funds even if in this case, too, German residents invested somewhat less in 2006 than in 2005. As a result of transactions, the volume of mutual fund assets under their management increased by €24½ billion (compared with €43½ billion in 2005). A substantial percentage of the resources flowing abroad accrued to the foreign subsidiaries of German investment companies.[9]

... debt securities

German savers, however, continued to show great interest in the longer-term interest-bearing instruments of foreign issuers. The outflows in this segment of the financial account amounted in 2006 to €134½ billion; this means that they were almost equally as voluminous as in the previous year (€137 billion). Interest-bearing securities from public sector borrowers in other euro-area countries, which are regularly added to portfolios owing to their slight yield spread (averaging 11 basis points over the year) over the benchmark Bund, were in particularly heavy demand (€113½ billion), notably from the financial managers of domestic banks. The efforts of institutional investors to ensure greater maturity matching between assets and liabilities in their balance sheets in connection with the new regulatory framework Solvency II probably also contributed to the structural shift in demand in favour of longer-term interest-bearing instruments.

Euro-denominated debt securities were not the only ones to find favour with German residents. Foreign currency bonds were in demand, too, despite the strength of the euro and the continuing global current account imbalances. German investors bought such paper for a net €21 billion. That was the second-largest amount that Germans have paid for such instruments since the introduction of the euro. Greatest demand was for US-dollar-denominated bonds, with German investors adding a record €18½ billion worth of these securities to their portfolios (compared with €11½ billion a year earlier). In addition, foreign money market instruments with an original maturity of one year or less and worth €7 billion were also acquired. Some investors thought that this paper had a favourable risk-return profile in view of the possible increase in interest rates.

Direct investment

The same factors which had a positive impact on the share markets, namely the favourable economic situation, the encouraging earnings outlook and the advantageous conditions for corporate financing, also fostered direct investment worldwide in 2006. A 35% increase to US$1 trillion in 2006 meant that the rise in global direct investment flows, according to initial estimates by UNCTAD, was even greater than in 2005 (29%). Even so, the total

8 Even so, the German share market did not benefit from the investible funds that had become available as residents also sold net amounts of German shares. See Deutsche Bundesbank, Annual Report 2006, p 63.
9 See Deutsche Bundesbank, Outflows from domestic mutual funds in 2006, Monthly Report, February 2007, p 37.

value was still below the record US$1½ trillion reached in 2000. However, the growth in direct investment has to be seen against the background of the sharp increase in M&A activity. The global M&A volume expanded to more than €2 trillion, with cross-border deals accounting for about one-third of this sum.[10]

The cross-border transactions of multinationals in which German investors have a stake also rose rapidly in 2006 even if the increase, at just under 12%, was smaller than its global counterpart. This increase was reflected in greater inward and outward foreign direct investment, which comprises not only corporate mergers but also all other cross-border financial transactions of affiliated enterprises (see the box on pages 32 and 33). All in all, the result was net capital exports of €29 billion compared with €16 billion a year earlier.

German direct investment abroad

German enterprises, in particular, extended their presence abroad considerably in 2006. They provided their foreign affiliates with more funds (€63½ billion) than they had done for the previous six years (2005: €44½ billion). The large volume of reinvested earnings – in addition to the acquisition of participating interests already mentioned – contributed to this situation, which suggests that their foreign branches and subsidiaries had been generating excellent profits. The amount invested abroad would actually have been even greater if it had not been for considerable reverse flows, that is to say, loans granted by these affiliates to their parent companies domiciled in Germany. As had happened frequently in the past, intra-group transactions with financing institutions in the Netherlands were the predominant factor in this. The main host countries for German direct investment last year were the United States (€15½ billion), Malta (€9 billion)[11] and the United Kingdom (€6 billion). A further €9 billion flowed into the EU countries in central and eastern Europe and into Russia. The fact that most of the capital was transferred to other industrial countries suggests that the purpose of acquiring participating interests was to open up new markets. Tax and cost considerations were no doubt also major investment incentives. These assumptions are supported by looking at a breakdown by investing sector. Among the most active here were credit institutions (€20½ billion) and the manufacturers of machinery and equipment (€8 billion). However, the manufacturers of textiles and textile products (€4½ billion) and the chemicals industry (€4 billion) also built up their presence abroad considerably.

Foreign direct investment in Germany

Foreign enterprises invested €34 billion in Germany last year compared with €29 billion in 2005. A few sizeable corporate mergers were important here and also affected the breakdown by region and sector. For example, the bulk of inward investment came from other industrial countries, the greatest amounts stemming from France (€5½ billion), Denmark (€5 billion) and the United States (€5 billion). Investors' interest centred on the banking and insurance sector (€11½ billion) and on holding companies (€8 billion). However, substantial funds (€7 billion) also flowed into the chemicals industry, which was princi-

10 The transaction volume given here refers to mergers and acquisitions actually completed.
11 Most of the funds went to holding companies.

pally the result of two acquisitions. A significant portion of the investment made its way to Germany via international financial centres (including Switzerland, Ireland and Bermuda), with the result that it was not always possible to determine the regional provenance of the actual investors reliably.

Other investment ...

As in the case of direct investment, other investment, which comprises loans and trade credits as well as bank deposits and other assets, recorded net capital exports in 2006 (€115 billion) compared with outflows of €74½ billion a year earlier. The non-

... of non-banks and ...

securitised credit transactions of non-banks, however, resulted in net inflows of funds (€9 billion). This was due primarily to the operations of enterprises and households (€8 billion). They increased their – particularly long-term – cross-border liabilities from financial loans more sharply (€27 billion) than their (short-term) bank balances abroad (€15 billion). The transactions by general government resulted in modest inflows of capital (€1 billion net). However, there were shifts within general government's external assets. First, it reduced its long-term external assets (€8 billion), a notable factor here being Russia's repayment of a debt incurred through the Paris Club; second, it increased its short-term bank balances abroad (€6½ billion). Evidently foreign financial centres are still offering favourable conditions for the investment of liquid funds, and these terms are being exploited both by enterprises and general government.

... MFIs

Consequently, it was primarily the unsecuritised credit transactions of the banking system (including the Bundesbank) with net capital exports of €124 billion that, along with the aforementioned capital outflows through direct investment, formed the counterpart to the large current account surplus. For example, Germany's credit institutions last year heavily expanded their lending to foreign customers. It was primarily interbank transactions that were involved here. The repatriation of business hitherto undertaken by German banks' disbanded foreign affiliates also played a major role. All in all, German banks' net external assets rose by €147 billion last year. In the case of the Bundesbank, by contrast, there were inflows of funds (€23 billion net). This is attributable mainly to a reduction in claims within the large-value payment system TARGET.

Reserve assets of the Bundesbank

The reserve assets of the Bundesbank, transaction-related changes in which are included in the financial account, declined by €3 billion in 2006. In the process, there were reductions in both the holdings of foreign exchange reserves and the reserve position in the IMF (including SDRs). In the case of the foreign exchange reserves it was the claims on foreign credit institutions that fell in particular. The decline in the IMF position was due to repayments by European countries – notably Turkey – of credits previously taken up at the IMF. By contrast, the reserve assets increased in value – albeit less sharply, at €1½ billion, than in 2005 – owing to the usual revaluation at market prices. The rise in the price of gold meant a €5 billion upward revaluation of the gold holdings whereas the foreign exchange reserves, primarily as a result of the weakness of the US dollar, lost €3½ billion in value. In balance-sheet terms, the reserve assets there-

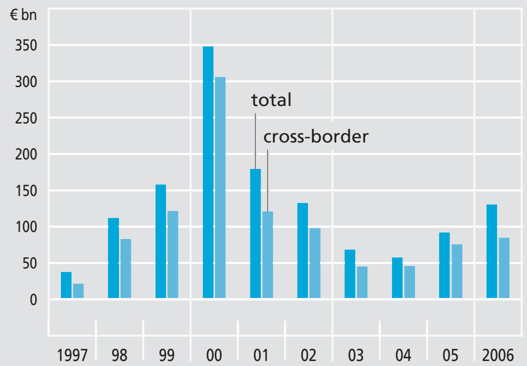
Mergers & acquisitions as an element of direct investment: development, sectors and financing

The Bundesbank collects data on cross-border direct investment on the basis of the Foreign Trade and Payments Act and internationally approved definitions.[1] In this context, new investments and liquidations of equity capital, reinvested earnings and credit transactions between affiliated enterprises are recorded and shown separately. New investment comprises long-term investment amounting to at least 10% of the capital or the voting rights. Thus, it includes not only cross-border mergers and acquisitions (M&As) between or of existing enterprises but also – which are currently indistinguishable – startups (greenfield investments).[2]

A separate analysis of cross-border M&As therefore still requires recourse to data from private providers. Since these providers pursue different goals when compiling the data and thus use different criteria and sources as a basis, some of their figures differ significantly from the official figures.[3,4] Nevertheless, these statistics can also offer important additional information about enterprises' equity acquisitions and any risks resulting from their financing.

Last year, the effective mergers and acquisitions – calculated on the basis of figures from Thomson Financial SDC Platinum – increased worldwide by almost 30% to some €2.2 trillion. The German M&A market also recorded a further upturn in 2006. Thus, the value of completed transactions with German involvement rose by over 40% to €130 billion (see adjacent chart). In this case, almost three-quarters of the volume was accounted for by cross-border acquisitions.

Volume of effective M&As with German involvement



Source: Thomson Financial SDC Platinum (includes euro conversion prior to 1999).

Direct investment flows often develop analogously to trade flows.[5] This is consistent with earlier observations that the substantial expansion of German foreign trade last year also gave the German economy a more prominent role in international M&A activity. Another factor may have been that domestic enterprises have internationally transferable competitive advantages – such as an attractive product range, a good market position or technical expertise – with which economies of scale could be realised by acquiring enterprises abroad.[6] For example, German investors expanded their cross-border M&A involvement in 2006 by 14½% to €39 billion. Just over one-quarter each of German enterprises' total investment volume was directed at the materials sector abroad and the pharmaceuticals sector abroad. Both cases involved the two largest individual transactions.

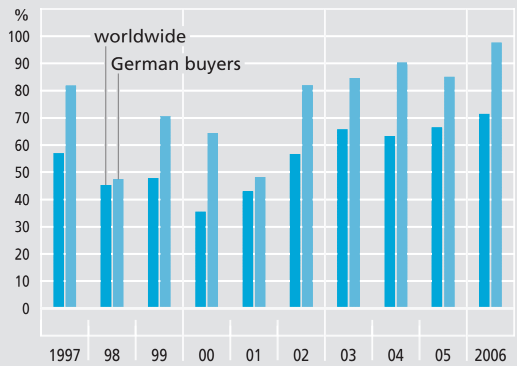
Conversely, Germany was also an important target country for corporate acquisitions by foreign enterprises, even though the transaction volume in 2006 – following sharp rises in the previous two years – did not increase any further. Non-residents acquired participating interests in domestic enterprises worth €47½ billion. For the second year in a row, they showed a special interest in the German

1 See Deutsche Bundesbank, Statistical Supplement to the Monthly Report 3, Balance of payments statistics, pp 37 ff and Special Statistical Publication 10, International capital links, April 2006, pp 18 ff. — **2** In the case of first-time reports for 2005, the German stock statistics on direct investment differentiate between greenfield investment, purchases, mergers or acquisitions, and overshooting the reporting threshold. It is planned to publish the data at the end of April 2007. For the balance of payments statistics, too, there are plans to achieve a more detailed breakdown on the basis of an internationally harmonised set of rules. — **3** For example, Thomson Financial SDC Platinum evaluates publicly available information about M&As and also processes reports from the advising investment banks. This is based on an acquisition of a capital share of at least 5% or less in certain circumstances. Moreover, capital increases are recorded, too. Problems also occur with regard to periodisation and the recorded transaction values. In the case of new investment, the balance of payments statistics focus on the actual transfer of ownership and include only that part of the transaction value which is actually exchanged between residents and non-residents. — **4** If only M&As that result in a capital share of at least 10% are considered – as in the balance of payments – domestic enterprises acquired foreign enterprises worth €39 billion in 2006, while non-resident proprietors accumulated participating interests in Germany worth €40½ billion, according to Thomson Financial SDC Platinum. The values published as new investment in the balance of payments were €91 billion and €25 billion, respectively. — **5** See K Ekholm, R Forslid and J Markusen, Export-Platform Foreign Direct Investment, NBER real estate sector, which accounted for almost €19 billion in 2006.

The financing structure of M&As has changed significantly over the past few years. Generally, there are two financing options for M&As: the exchange of shares or a cash offer. In the case of share swaps, the proprietors of the acquired enterprise are paid in shares of the investing enterprise, while in the case of a cash offer, they receive a cash payment. In the latter case, the acquiring enterprise can draw on available liquid funds or, as is often the case, it resorts – at least in part – to debt-financing by means of loans or the issuance of bonds. While during the "new economy" boom (in the years 1998 to 2001) the exchange of shares was the predominant financing method worldwide, accounting for 57%, most recently 72% of the financing volume was accounted for by cash offers. One reason for this change may be that, following the slump in share prices, shares have become less attractive as a "means of payment" for the shareholders of acquired enterprises. Moreover, the rising profitability of enterprises in recent years is likely to have facilitated the accumulation of liquid funds. In addition, the debt financing of acquisitions has become especially attractive of late owing to the low interest rates in the capital markets. It is noteworthy that, over the past ten years, the average share of cash transactions in acquisitions by German enterprises was 20 percentage points higher than the worldwide average.[7]

In macroeconomic terms, M&As can help to improve the allocation of capital. Welfare gains can be expected from the realisation of cost advantages, more efficient management or the exploitation of economies of scale. However, debt-financed acquisitions, in particular leveraged buy-outs (LBOs), ie acquisitions of established enterprises or parts of them in which a significant part of the acquisition cost is paid for using borrowed funds, can also pose problems to financial stability, especially as there has been a sharp rise in the financing volume in this area in particular.[8] The fact that the average rating of LBO enterprises has tended to deteriorate – with possible negative implications for the previous creditors – should be viewed critically. Although the sharp rise in the ratio of debt to operating profit observed in the recent past can be seen as an attempt by investors to increase their return on equity in times of low interest rates, it must not be forgotten that this could make enterprises increasingly vulnerable in the event of rising interest rates, for example. Even if banks pass on the loans relating to an LBO to other creditors, they may still incur risks because, as underwriters, they may be exposed to a market shift during the holding period. They may also be vulnerable to an indirect risk if the exposure arising from LBOs is assumed by hedge funds which themselves are indebted to the banks.[9]

Share of cash financing in the effective transaction volume



Source: Thomson Financial SDC Platinum and Bundesbank calculations.

Working Paper, No 9517, 2003 as well as S Herrmann and A Jochem, Trade balances of central and east European EU member states and the role of foreign direct investment, Deutsche Bundesbank Discussion Paper, Series 1, No 41/2005. — **6** J H Dunning (1988), The Eclectic Paradigm of International Production: A Restatement and Some Possible Extensions. Journal of International Business Studies 19(1), pp 1-31. Technological aspects seem to be especially important for cross-border activities. See R Frey and K Hussinger, The role of technology in M&As: a firm-level comparison of cross-border and domestic deals, Deutsche Bundesbank Discussion Paper, Series 1, No 45/2006. — **7** The large share of cash transactions of German enterprises may also reflect legal constraints on share swapping, eg the problem of the exclusion of existing shareholders from participating in capital increases and a possible complaint from existing shareholders about the dilution of the share value. Moreover, German enterprises are allowed to hold only 10% of their own shares. See Börsen-Zeitung, Deutsche Konzerne bei M&A im Nachteil, 19 January 2007, p 10. — **8** The total amount of worldwide M&As completed in 2006 exceeded €2.2 trillion, €315 billion (14½%) of which are classified as leveraged buy-out transactions according to figures provided by Thomson Financial SDC Platinum. For acquisitions with German involvement, the share was somewhat lower at 9½%. — **9** See also Deutsche Bundesbank, Risks arising from the financing of leveraged buy-out transactions (LBOs), Financial Stability Review, November 2006, pp 44-45.

fore declined by €1½ billion in the period under review and ended the year 2006 at a level of €85 billion.

Errors and omissions

All in all, the statistically recorded net capital exports exceeded the current account surplus considerably. A balancing item therefore arose last year, which, at €30 billion, was unusually high. A fairly large part of this can presumably be explained by cross-border cash transactions that were not captured in the statistics. For example, cash expenditure by German residents on travel, where this is transacted in euro, and capital outflows through the transfer of euro banknotes by German credit institutions or the Bundesbank are each captured only once – with no corresponding counterbooking.[12]

12 See also Deutsche Bundesbank, Recording cross-border cash transactions in the balance of payments, Monthly Report, March 2005, p 37.