German balance of payments in 2007

German exporters benefited again in 2007 from the fairly sharp growth in world trade. There was a further sharp increase, of 8½%, in export sales of German goods, even though the appreciation of the euro had led to a deterioration in German enterprises' price competitiveness in sales markets outside the euro area. This was also the case for exports to the South-East Asian emerging markets and to China. The increase in the value of imports was perceptibly slower at 5%. This was due mainly to lower energy imports owing, above all, to the mild weather at the beginning of 2007, VAT-related anticipatory effects, and losses of purchasing power which curbed demand. Overall, the current account surplus rose by 1½ percentage points to 7½% of gross domestic product (GDP).

In line with this, there were large net capital exports in transactions with non-residents – principally owing to the banks' external transactions as well as direct investment. However, in portfolio investment, which usually responds very rapidly to changes in financial market conditions, there were net inflows of funds as a result of the existing uncertainties since mid-2007. Once again, domestic securities proved to be a "safe haven" for investible capital.

Current account

External setting

Starting from a strong position, German exporters were continuing to operate in a favourable international setting in 2007. There was further sharp growth, at 5%, in the world economy, although momentum was lost towards the end of the year. According to estimates by the OECD, global trade expanded by 6½%, which means that it was less dynamic than in 2006, but still at a high level taking a long-term view. Nevertheless, the appreciation of the euro meant that, following a slight improvement in 2006, the price competitiveness of German enterprises deteriorated by 1½% against major trading partners.[1] Despite this, German entreprises' competitive position was still quite strong in 2007. This was one of the reasons for the continuing positive underlying trends in both the German trade balance and current account.

Exports

Being well positioned with their range of goods in the relevant markets, German exporters greatly benefited from ongoing vigorous growth in the world economy, especially from buoyant global investment. The volume of German enterprises' export orders in 2007 was 11¾% up on the year, compared with +11% in 2006. Such notable success in attracting orders was due, in part, to a large number of exceptionally big export contracts which, experience suggests, are processed over an extended period of time. Sentiment among German exporters therefore remained fairly optimistic towards the end of 2007, even though it failed to match the high levels recorded in the first half of the year. In 2007, German industry increased the value of its exports by 8½% on the year following growth rates of between 7½% and 13½% in the three preceding years.[2] Given a 1¾% rise in export prices, this produces a real increase of 6½%. The increase in export prices was dampened, not least, by the fact that the prices of imported intermediate goods and raw materials were tending to be subdued by the appreciation of the euro. Furthermore, the export prices of a number of products, expressed in the currency of the country of sale, are likely to have been kept stable or not increased by the full amount of the euro's appreciation. This means that they fell in euro terms or showed only a small increase. Such a pricing-to-market strategy helps German exporters to contain the loss of market shares, although it does involve losses of profitability (see the article on pages 33-46).

Regional structure: exports to other euro-area countries...

In 2007, German exports again received strong stimuli from partner countries in the euro area. At 10¼%, the rise in the value of exports to other euro-area countries was more or less as sharp as in 2006. At the same time, this growth clearly exceeded that in export sales to non-euro-area countries (7¼%). This is a reflection, first, of the positive economic development in the euro area, which became more broadly based last year. Second, the low overall rate of inflation in Germany led to the price competitiveness of

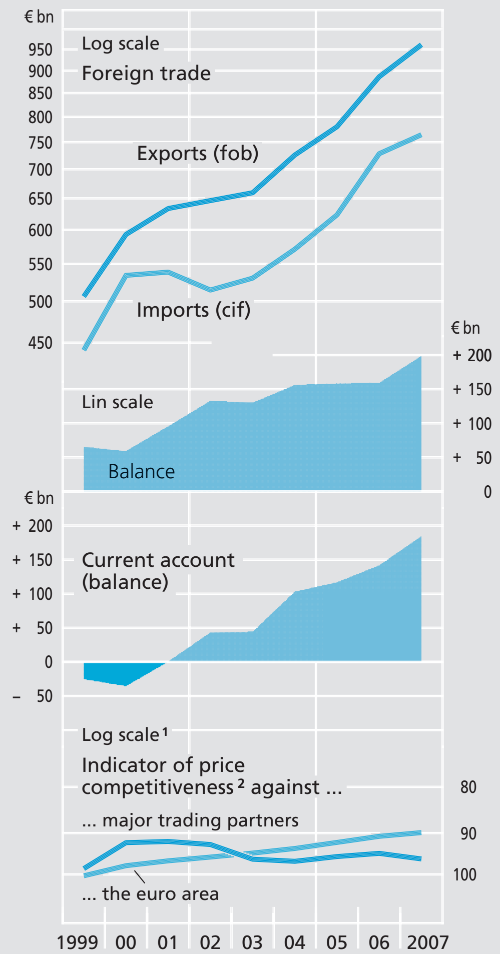
1 Based on deflators of total sales.
2 The growth rate of exports, which is calculated from the external trade statistics, and – to a lesser extent – the growth rate of imports of goods, was pushed downwards for 2007 because movements of goods in connection with repair and maintenance work, in accordance with European and international concepts, have not been recorded since January 2007.

German exporters showing a further slight (1%) improvement on that of suppliers in the rest of the euro area. German enterprises' export sales increased in all the euro-area partner countries, with especially sharp growth in exports to Spain (15¼%) and Finland (11½%) as well as to France (10½%) and the Netherlands (10¼%). Exports to France were favoured by anticipatory effects at the end of the year owing to the entry into force of a special tax on vehicles with high CO_2 emissions on 1 January 2008. The new tax affects mainly up-market vehicles, a segment of the market in which German manufacturers are very heavily represented.[3] All in all, German enterprises were able to further expand their market position within the euro area in 2007.

... and to non-euro area countries

Despite the marked decline in price competitiveness against competitors outside the euro area (-4½%), German exporters were able to maintain their position in non-euro-area markets overall in 2007, although developments differed very widely from region to region. Nominal exports to the United States fell by 6%, for example. First, the euro's appreciation against the US dollar, averaging more than 9% in 2007, is likely to have impaired their value. Second, growth in US demand for imported goods weakened owing to the slackening pace of economic growth. The fall in the value of German exports to Japan (-5¾%) and Canada (-1¾%) was also due mainly to exchange rate movements. By contrast, the value of exports to the emerging markets of South-East Asia went up by 2¼% and to China by 9%. The appreciation of the euro against the renminbi in 2007, at 4%, was smaller than that against the US dollar.

Selected indicators on external sector



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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This reflects the fact that the dollar orientation of the renminbi has loosened somewhat since the changeover to a crawling peg in 2005. Once again, there was an exceptionally sharp increase in exports to the rapidly expanding economies of the new EU member

3 The year-on-year increase in the value of exports of motor vehicles to France in the final quarter of 2007, at 13¼%, was much sharper than that of exports by the German automotive industry as a whole (6½%).

Structure of and trends in regional foreign trade in 2007

Country/group of countries	Percentage share	Percentage change from previous year
Exports		
All countries	100.0	8.5
of which		
Euro-area countries (13)	42.8	10.2
Other EU countries (14)	21.9	12.9
of which		
Eleven new member states	10.8	15.6
United States	7.6	– 5.9
Russian Federation	2.9	20.6
Japan	1.3	– 5.8
Emerging markets in South-East Asia	3.3	2.1
China	3.1	8.9
OPEC countries	2.4	6.8
Developing countries excluding OPEC	8.4	4.9
Imports		
All countries	100.0	5.2
of which		
Euro-area countries (13)	39.5	7.2
Other EU countries (14)	20.0	11.3
of which		
Eleven new member states	11.1	15.4
United States	5.9	– 7.3
Russian Federation	3.7	– 4.2
Japan	3.1	0.3
Emerging markets in South-East Asia	4.3	– 8.0
China	7.1	9.4
OPEC countries	1.6	– 7.3
Developing countries excluding OPEC	9.4	– 0.7

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states in central and eastern Europe (15¾%). The sharp growth in exports to Poland, at 24½%, played a major part in this. Exports to Russia were similarly buoyant (+20¾%). The value of exports to the OPEC countries went up 6¾%.

Breakdown of exported goods

In 2007, all goods-exporting sectors of industry in Germany benefited from the mostly buoyant demand in the export markets.[4] German capital goods manufacturers, which account for almost 44% of the German export sector, increased their exports by 5%. Manufacturers of machinery and equipment sold 6¾% more of their products abroad. The rise in automotive industry exports was, in fact, somewhat higher (8¾%), partly on account of the above-mentioned anticipatory effects in France at the end of last year. Export earnings from information and communication technology (ICT) products were 1½% down in nominal terms on 2006, but exports are likely to have shown a perceptible further rise in real terms since the prices of such goods, given sustained marked quality improvements, have fallen again considerably.

Producers of consumer goods – accounting for some 16% of all goods exported – also recorded quite a high rate of increase (6¾%). Given the weak growth in private consumption in Germany primarily as a result of the increase in VAT, there was evidently a strong incentive to be especially active in promoting

4 The picture of the breakdown of exports and imports of goods in 2007 is distorted by the large percentage of goods which are still not statistically classifiable by category. Consequently, the rates of change for the individual categories of goods cannot be aggregated to form an overall rate.

export business. The increase in exports of intermediate goods, which account for just over 30% of German exports, was almost as sharp (6%). First, there was a marked rise in exports of chemical products (7%), which also reflects price increases owing to higher energy costs and the use of petrochemical inputs. Second, there was a considerable increase in nominal export sales of metals and metal products (10¼%). This growth was almost entirely price-related, however, since the worldwide boom, especially in the steel market, allowed enterprises to pass on the markedly higher costs for wages, ores and energy in their sales prices.

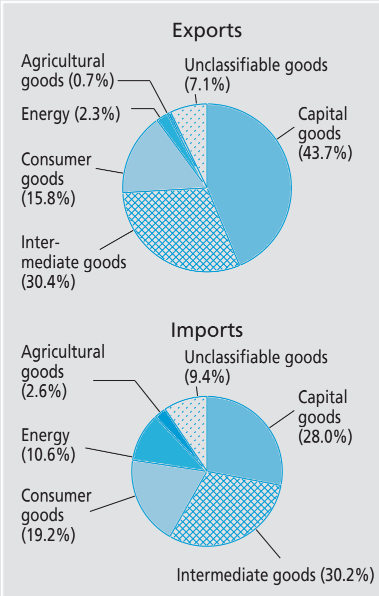
Imports

Imports of goods rose by 5% in value in 2007, which was nowhere near as sharply as exports of goods. In real terms, the differential in growth compared with exports was smaller, however, since the rise in the cost of imports was relatively moderate overall, at 1¼%, primarily as a result of the appreciation of the euro. Higher import prices for raw materials and semi-finished goods (+4%) as well as for intermediate goods (+4¾%) contrasted with the 1½% fall in the prices of finished goods. Overall, the terms of trade increased by ½% after deteriorating by a total of 6% in the three preceding years.

Breakdown of imports

Import growth was given a marked boost in 2007 by German enterprises' demand for imported intermediate inputs, which increased by 6¾%. At the end of the period under review, this category of goods accounted for 30% of total imports. There were exceptionally sharp increases in imports of chemical products (8%) and of metals and metal products (13%). Imports of consumer goods, which had grown by as much as 10% in 2006, increased by no more than 3¼% in 2007. One factor in this context was the shift in demand into 2006 owing to the VAT increase. Another factor was the loss of purchasing power in 2007 due not only to the tax increase but also to higher food prices among other things.

Foreign trade by selected categories of goods in 2007



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Nominal imports of capital goods fell by as much as 5% in 2007. This was attributable mainly to the fact that imports of "Other transport equipment", which includes air and water transport equipment and rail vehicles, were almost one-third lower than in 2006. This item is very volatile from year to year; if it is excluded, imports of capital goods were virtually unchanged. Furthermore, the continuing sharp fall in prices for goods of the category "Office machinery and equipment", amounting to 25% in 2007, pushed down import values. It should also be borne in mind that imports of motor vehicles, which are assigned to capital goods for statistical purposes, grew considerably more slowly than in 2006 owing to the anticipatory effect generated by the VAT increase. If transport equipment is excluded, imports of machinery and equipment are likely to have increased perceptibly in price-adjusted terms; this is also consistent with the buoyant investment in Germany.

Furthermore, 2007 was marked by weak energy imports, which declined by 8¼% in value and 10¼% in quantity on an annual average. The main reason for this is likely to have been the mild winter in 2007. As the annual average increase in the cost of imported energy sources was relatively moderate in euro terms (2¼%), the overall decline in purchasing power associated with energy prices, at €1½ billion, or 0.1% of nominal GDP, was quite small compared with 0.7% and 0.5% of GDP in 2005 and 2006 respectively.

Regional breakdown of imports

At 7¼%, the increase in the value of imports from the euro-area partner countries was notably sharper than that of imports from non-euro-area countries (4%). The growth differential was significantly smaller in real terms since the value of goods imported from non-euro-area countries went up less sharply (½%) than imported goods from other euro-area countries (2½%) because of the appreciation of the euro. Within the euro area, there was an increase in imports from all of Germany's partner countries, albeit to a varying extent. Outside the euro area, there was a very large increase in imports from the EU member states in central and eastern Europe (15½%). Imports of goods from Slovakia and the Czech Republic rose by 22½% and 20% respectively. The increase for imports from Hungary was 15¼% and from Poland 13½%. This shows once again that Germany's economic links with these countries are proceeding apace.

In addition, the value of goods imported from China once again showed vigorous growth (9½%), which means that China's share of total German imports has now increased to 7%, overtaking the United States for the first time. A 7¼% decline in imports from the USA led to its share going down to 6%. This negative development in imports from the USA was probably due, above all, to lower sales figures in euro owing to appreciation. There are, however, no indications of a significant reduction in the quantity of imports. In contrast to imports from China, imports from the emerging markets in South-East Asia also declined in value (-8%). As much was imported from Japan in nominal terms as in 2006. Owing to the weather-related weak demand for energy in Germany, imports from Russia and the OPEC countries, consisting mainly of mineral oil and natural gas, were down 4¼% and 7¼% on 2006 respectively. The fact that euro import prices for oil and gas combined went up by an average of no more than ½% in 2007 should also be taken into consideration.

Income

Invisible current transactions, which comprise cross-border factor services, trade in services and current transfers, showed hardly any change overall, although there were counterbalancing movements in the sub-accounts. There was a marked overall increase in the deficits on services and current transfers, for example, but this was almost offset by the larger surplus in factor income, with a €4 billion increase in the surplus in cross-border investment income. This was due, in particular, to higher net interest income from loans. Growth in interest income from cross-border loans already granted was markedly higher than the corresponding expenses for loans taken up abroad. This was attributable, not least, to the rising net external asset position. Furthermore, the debt service burden was eased by the appreciation of the euro, which was accompanied by a reduction in the payments of interest on non-euro-denominated foreign loans. Moreover, there was a marked decline in interest rates in the USA in the second half of the year. In 2007, combined dividend and interest income from portfolio investment abroad increased at virtually the same pace as the corresponding income of non-residents in Germany. By contrast, direct investment income grew somewhat more slowly than expenditure. In the case of income from employment, net expenditure halved to €½ billion, which was due mainly to the higher income of German cross-border workers.

Transfers

Germany's net current transfers to non-residents increased by €4 billion to €30½ billion. The deficit on public transfers increased by €1½ billion. This was caused mainly by significantly smaller payments received by Germany in connection with EU agricultural policy, as a result of which net payments to international organisations increased by €3½ billion. This contrasted with extra tax receipts (+€2 billion net), especially from investment income tax on the assets of non-residents in Germany. The deficit on private transfers increased by €2 billion, which was somewhat sharper than the deficit on public transfers.[5] The indemnification payments from the "Remembrance, Responsibility and Future" foundation, which are made by the private and public sectors, have now been largely disbursed.

Services

The deficit on services increased by €½ billion to €16½ billion in 2007. The higher receipts from transport, insurance and financial services were unable to offset entirely the deterioration in the other sub-accounts (especially in foreign travel). The biggest improvement on the balance, namely of €1½ billion to €6½ billion, was achieved in cross-border transport. The surplus on insurance-related services was increased by €1 billion, which was essentially due to higher receipts. German reinsurers' payments of claims to non-residents showed a sharp increase last year, but premium income rose even more sharply. Net income from financial services (especially bank commissions) likewise rose, namely by €1 billion.

The deficit on travel rose by €1½ billion to €34 billion in 2007, but was still lower than in

5 This is due, among other things, to higher lump-sum severance payments, higher contributions to international organisations, and cross-border tax payments by resident enterprises.

Major items of the balance of payments

€ billion

Item	2005	2006	2007
I Current account			
1 Foreign trade 1			
Exports (fob)	786.3	893.0	969.0
Imports (cif)	628.1	734.0	770.4
Balance	+ 158.2	+ 159.0	+ 198.6
Supplementary trade items 2	– 13.8	– 12.7	– 9.4
2 Services (balance)	– 24.9	– 15.6	– 16.3
of which			
Foreign travel (balance)	– 36.3	– 32.8	– 34.2
3 Income (balance)	+ 25.7	+ 37.6	+ 42.0
of which			
Investment income (balance)	+ 27.1	+ 38.6	+ 42.6
4 Current transfers (balance)	– 28.6	– 26.9	– 30.7
Balance on current account	+ 116.6	+ 141.5	+ 184.2
II Balance of capital transfers 3	– 1.2	– 0.2	+ 0.2
III Financial account 4			
1 Direct investment	– 21.6	– 31.5	– 85.1
2 Portfolio investment	– 30.9	– 10.3	+ 134.6
3 Financial derivatives	– 9.0	– 6.5	– 71.2
4 Other investment 5	– 71.3	– 105.7	– 198.1
5 Change in the reserve assets at transaction values (increase: –) 6	+ 2.2	+ 2.9	– 1.0
Balance on financial account 7	– 130.7	– 151.1	– 220.9
IV Errors and omissions	+ 15.4	+ 9.8	+ 36.4

1 Special trade according to the official foreign trade statistics (source: Federal Statistical Office). From January 2007, excluding supplies of goods for or after repair/maintenance, which up to December 2006 were deducted via supplementary trade items. — **2** Including warehouse transactions for the account of residents and the deduction of goods returned. — **3** Including the acquisition/disposal of non-produced non-financial assets. — **4** Net capital exports: –. For details see the table “Financial transactions” on page 25. — **5** Includes financial and trade credits, bank deposits and other assets. — **6** Excluding allocation of SDRs and excluding changes due to value adjustments. — **7** Balance on financial account including change in the reserve assets.

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the years prior to 2006, which might, not least, have something to do with Germany’s increased attractiveness as a travel destination since the FIFA World Cup. Income, which was boosted by €2½ billion in 2006,[6] held up well in 2007 (€26½ billion). Lower receipts from travellers from non-European countries who visited Germany in larger numbers in the FIFA World Cup year 2006, were accompanied by higher income from tourists and business travellers from Europe. Expenditure on German foreign travel increased by a total of €1½ billion last year to a record level of €60½ billion. While spending by German residents on tourism in the euro-area partner countries was virtually unchanged overall, more money was spent on long-haul journeys. Not least on account of the appreciation of the euro, travel destinations in Africa, Asia and America were more popular than before.

Trade and current account balances

In 2007, there was a trade surplus of €198½ billion, which was €39½ billion up on the year.[7] The deficit on invisible current transactions remained unchanged at €5 billion. The current account surplus, which is produced from the sub-accounts and the supplementary trade items, increased by €42½ billion to €184 billion, which was 7½% of nominal

6 Of this, €1½ billion alone was due to additional receipts from persons from other countries visiting the FIFA World Cup (see Deutsche Bundesbank, Monthly Report, November 2006, p 43).
7 The year-on-year comparison is distorted by the fact that the values in the external trade statistics for 2006 still contain movements of goods in connection with repair and maintenance work, while the figures for 2007 no longer do so.

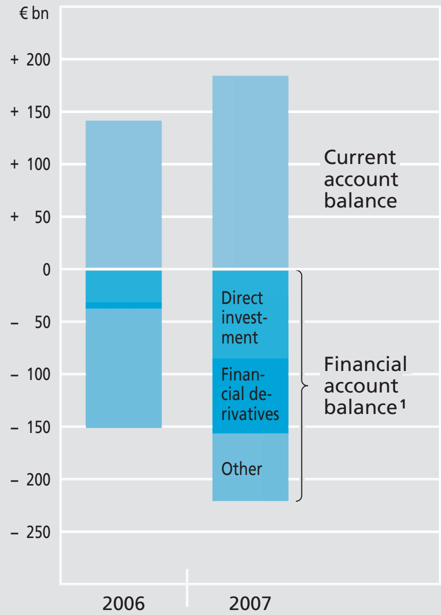
GDP.[8] In 2007, however, this German asset item was accompanied by deficits in the majority of euro-area partner countries, which means that the euro area as a whole was in a virtually balanced external position last year.

Financial transactions

Trends in financial transactions

In the balance of payments, the current account surplus was associated with large net capital exports by Germany. Financial transactions in 2007 were strongly affected by the turbulence in the international financial markets, however. Strong global economic growth, positive figures for the economy in Germany and Europe as a whole as well as evidently robust economic activity in the USA ensured favourable sentiment in the stock markets, which was reflected in low rates of volatility and very benign equity markets. From the middle of last year onwards, however, the escalating crisis in the US mortgage market – which hit banks and trading in structured credit products, in particular – prompted a fundamental reassessment of risks. The spreads on risky bonds widened considerably, for example, and the interest rate spread between longer-dated US Treasuries and euro-area government bonds reversed in favour of the euro area. A particular factor in this context was that the Fed began to ease interest rates from mid-September last year, while the Governing Council of the ECB, in view of the uncertainties in the second half of 2007, left lending rates on hold. Against this backdrop, the euro appreciated significantly against major currencies, especially the US dollar. The outlined international effects had an impact on the activities of financial market players in Germany and abroad. As the year went on, they acted with increasing caution with regard to cross-border exposures and preferred secure and liquid forms of investment.

Major items of the balance of payments



1 Net capital exports: –.

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This was seen very clearly in portfolio investment, in which Germany recorded large net capital imports in 2007. By contrast, there were outflows in other segments of the financial account. This was especially true of the unsecuritised lending of banks, which greatly increased their net external assets, but also applied to direct investment. Overall,

8 Owing to smaller deductions from the supplementary trade items, the current account surplus in the reporting year is nominally €3½ billion higher, an outcome which, in large part, is due to the fact that it is no longer necessary to eliminate repair and maintenance work.

there were net capital exports to the record amount of €221 billion. They were thus higher than the current account surplus, which – as a result – was reflected in a (positive) errors and omissions item in the balance of payments (see page 31).

Portfolio investment

There were net capital imports of €134¼ billion through portfolio investment alone in 2007. This was the highest ever figure and contrasted with outflows totalling €10½ billion in 2006. There were two key factors behind this sharp reversal. First, given robust domestic economic activity and the financial market turbulence that set in later in the year, German investors purchased fewer foreign instruments in 2007 than in the previous year (€133½ billion compared with €161½ billion). Second, in a period of heightened tensions, domestic securities again proved to be a "safe haven" for international investors. Additionally, new statistical definitions in portfolio investment played a part, since certain warrants hitherto assigned entirely to the category of financial derivatives have been recorded as debt securities since February 2007. This change means that, now, only the hedging of such instruments is assigned to financial derivatives (see the explanatory notes on pages 26-27). As a result, markedly higher capital imports were recorded under money market paper and bonds.

Foreign investment in domestic …

In total, non-residents purchased €268 billion worth of German securities. Even after taking due account of the statistical break, the interest shown by foreign investors in German securities is extremely notable. This record amount of investment was due very largely to

… bonds …

the buying of domestic debt securities (bonds and money market paper), a total volume of €258 billion of which was placed with foreign investors. It was mainly foreign demand for private issues that showed a sharp year-on-year rise (€71½ billion to €144 billion). In some cases, this involved cross-border transactions within affiliated enterprises and financial institutions. In these cases, financial products launched in Germany (principally certificates and warrants) were also sold *en bloc* to affiliated enterprises domiciled abroad. Such instruments were primarily targeted at German private investors outside the financial sector. In the end, however, these investors acquired only a fairly small part of the original volume from the interposed intermediaries. The remaining amount is being held by the foreign institutions up to the paper's final maturity and – where reports are available – will ultimately be recorded again as a redemption and, hence, a counterbalancing transaction. The current sharp growth in business in innovative financial products should therefore be borne in mind when analysing the funds flowing to Germany as a result of the sale of debt securities. An increase in counterbalancing financial flows may be expected given further market maturity and increasing redemptions.

Alongside private issues, public bonds – which were not affected by the developments mentioned above – remained highly favoured by foreign investors (€64 billion, compared with €52½ billion). Secure and liquid German government bonds are preferred by the market players especially in periods when they have a heightend perception of risk. How much such instruments were in demand last year was revealed not only by the large amounts invested. There was a marked widening of the spreads on debt instruments of other public and private issuers. The interest advantage of the benchmark Bund over other European government bonds hit a peak of 24 basis points in November, having averaged no more than 8½ basis points in the first quarter of 2007. This increase was probably due, not least, to the high liquidity of Federal bonds.

... money market paper ...

Money market paper was also in heavy demand, however, especially in the second half of the year when concerns about the soundness of some financial investments were continually emerging and it was proving difficult for some market players to assess their own liquidity needs. Added to this was the above-mentioned statistical effect of the recording of warrants, which have a maturity of less than one year in some cases and therefore count as money market paper. All in all, foreign investors purchased short-term German paper for €50 billion.

... stocks ...

In the German stock market, non-resident investors were again prominent as buyers in the context of their globally oriented portfolio decisions in 2007, albeit to a lesser extent than in 2006 (€6 billion, compared with €20½ billion). Foreign funds flowed into Germany particularly in the first half of the year, when the general setting was being shaped by comparatively low levels of uncertainty – measured by the implicit volatilities of options on stock price indices – and optimistic estimates of profits. That large German companies are

Financial transactions

€ billion, net capital exports: –

Item	2005	2006	2007
1 Direct investment	– 21.6	– 31.5	– 85.1
German investment abroad	– 55.4	– 75.5	– 122.3
Foreign investment in Germany	+ 33.7	+ 44.0	+ 37.2
2 Portfolio investment	– 30.9	– 10.3	+ 134.6
German investment abroad	– 204.9	– 161.3	– 133.3
Equities	– 19.9	+ 7.0	+ 22.7
Mutual fund shares	– 43.5	– 23.4	– 41.7
Bonds and notes 1	– 136.4	– 137.2	– 95.8
Money market instruments	– 5.1	– 7.6	– 18.6
Foreign investment in Germany	+ 174.0	+ 151.0	+ 267.9
Equities	+ 11.8	+ 20.7	+ 6.2
Mutual fund shares	+ 6.0	+ 8.4	+ 3.7
Bonds and notes 1	+ 159.3	+ 124.7	+ 207.8
Money market instruments	– 3.1	– 2.8	+ 50.2
3 Financial derivatives 2	– 9.0	– 6.5	– 71.2
4 Other investment 3	– 71.3	– 105.7	– 198.1
Monetary financial institutions 4	– 63.3	– 147.1	– 151.6
Long-term	– 79.8	– 83.5	– 111.0
Short-term	+ 16.5	– 63.6	– 40.6
Enterprises and households	+ 9.5	+ 17.3	– 3.5
Long-term	+ 5.9	+ 3.1	– 29.6
Short-term	+ 3.6	+ 14.2	+ 26.1
General government	+ 6.7	+ 0.9	+ 11.4
Long-term	+ 10.4	+ 8.4	– 1.3
Short-term	– 3.6	– 7.5	+ 12.7
Bundesbank	– 24.2	+ 23.2	– 54.4
5 Change in the reserve assets at transaction values (increase: –) 5	+ 2.2	+ 2.9	– 1.0
Balance on financial account 6	– 130.7	– 151.1	– 220.9

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 Bundesbank. — **5** Excluding allocation of SDRs and excluding changes due to value adjustments. — **6** Balance on financial account including change in the reserve assets.

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Certificates and warrants in the balance of payments

The German market for structured securities[1] has experienced dynamic growth over the past few years. Thus, according to data provided by the German Derivatives Association (*Deutscher Derivate Verband*),[2] the number of exchange-traded products issued in Germany rose in the course of last year alone from just under 138,000 to almost 300,000.[3] The association estimated the market volume of these securities at the end of 2007 at €135 billion.[4] German banks, in particular, but also, increasingly, subsidiaries of non-resident institutions which do not have their own banking licence and statistically are assigned to the sector German non-banks, act as issuers.

In 2007 German market participants' cross-border activities with these products, which are recorded in the balance of payments, also increased significantly, due mainly to the rise in intra-group transactions by German special purpose vehicles with non-resident parent and affiliated companies. This concerns, first and foremost, trade in structured products, the vast majority of which, as explained below, are classified as debt securities. However, the hedging transactions of German issuers with non-resident counterparties, which protect against the risks resulting from the sale of these securities, also accounted for a considerable amount. As these are generally performed with non-securitised financial futures contracts, they are recorded as derivatives in the balance of payments.

Recording securities transactions in the balance of payments is more complicated, as the conventional statistical classifications are often not able to provide a suitable representation of the great variety of structured products, especially in the light of the rapid innovation. Since the performance of structured securities depends on the performance of an underlying asset,[5] these products, from an economic perspective, are derivatives. From a legal perspective, by contrast, they are generally debt securities within the meaning of section 793 of the German Civil Code (*Bürgerliches Gesetzbuch*) because they are bearer securities that certify a payment promise.

The classification in the balance of payments focuses on the legal features of these securities. Cross-border transactions in structured products that fulfil the criteria specified in section 793 of the German Civil Code are therefore classified as debt securities.[6] Accordingly, structured securities that do not fulfil the criteria specified in section 793 of the German Civil Code are classified as financial derivatives.

At the beginning of 2007, the strict application of this classification scheme led to a change in the recording of warrants (ie securitised option rights which, as already mentioned, also belong to the group of structured products) in the balance of payments statistics. Up to and including January 2007, warrants had gen-

1 Structured products are created by combining features of various financial instruments (shares, bonds, foreign exchange assets etc) in one single security. The large number of combination possibilities and the use of derivatives can therefore produce investment or speculative instruments that have the widest range of risk-return profiles. In the financial market, structured securities for private investors are often also referred to as certificates. Another important group of structured products are warrants, ie securitised option rights. — **2** The German Derivatives Association was created at the end of 2007 through the merger of the two industry associations Derivatives Forum (Derivate Forum e.V.) and German Derivatives Institute (Deutsches Derivate Institut e.V.). — **3** Levels at the end of 2006 and the end of 2007 (Source: www.deutscher-derivate-verband.de). — **4** The market volume is estimated using the open interest (open positions) of the issuers participating in regular surveys. The open interest of an individual security is calculated as the product of the outstanding number of securities

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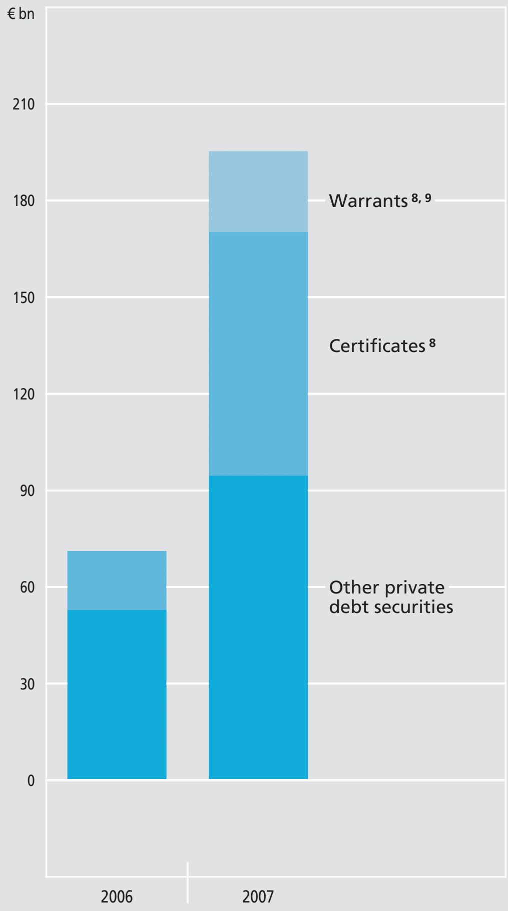
erally been classified in their own subcategory within financial derivatives. However, the Banking Statistics Circular 13/2007 of 27 March 2007[7] made it clear that warrants also certify a payment promise within the meaning of section 793 of the German Civil Code, if, in accordance with the terms of issue, in the case of a positive value on the maturity date or on the last day of the exercise period, the option right is deemed to be exercised without further action by the holder. As the vast majority of warrants exhibit this feature, virtually all transactions in these securities have been classified as debt securities rather than financial derivatives since February 2007.

In 2007, the above-mentioned activities of market participants had a noticeable impact on the respective balance of payment items, not least on account of the reclassification of warrants. Thus a major part of the increase in non-residents' purchases of German private debt securities from €71 billion in 2006 to €195½ billion in 2007 is due to both the growth in purchases of certificates by non-residents (+€57½ billion) and the change in the classification of warrants (+€25 billion). As a mirror image of this, German issuers have significantly stepped up their net purchases of foreign financial futures contracts. This has been reflected in the increase in net outflows in the balance of financial derivatives from €6½ billion in 2006 to €71 billion in 2007.

Non-residents' purchases of German private debt securities by type of security



and the market price on the reporting date. The individual values are then aggregated to give the open interest of the market as a whole. — **5** The underlying asset can in turn consist of one or more financial market instruments (shares, bonds, foreign exchange assets, indices etc). — **6** Depending on the original maturity, either as money market instruments (less than one year) or bonds and notes (more than one year). — **7** http://www.bundesbank.de/download/presse/rundschreiben/2007/20070327_rs_13.pdf (available in German only). — **8** Securities that were classified as warrants or certificates in the securities database "Wertpapiermitteilungen" and are legally debt securities pursuant to section 793 of the German Civil Code. — **9** Since February 2007 warrants have been classified as debt securities pursuant to section 793 of the German Civil Code if they have the feature of automatic exercise. They had previously been classified as financial derivatives.

now also very closely interlinked in terms of ownership is shown, not least, by the fact that roughly half of the stocks of DAX enterprises are in the hands of non-residents.

... and mutual fund shares

There were also fewer sales of domestic investment companies' mutual fund shares to foreign investors. In the reporting year, only €3½ billion was raised, which was significantly less than in 2006 (€8½ billion). This decline may be due to business policy decisions by investment companies domiciled in Germany, reflected in an increased sale of mutual fund products through locations abroad. This is suggested by the fact that domestic investors purchased foreign mutual fund shares on a large scale (as described below in more detail).

German investment in foreign ...

The reversal of sentiment in the financial markets during the year is shown very clearly by the behaviour of German investors. Resident investors bought €133½ billion worth of securities abroad. At €122 billion, the lion's share was purchased in the first half of the year, however. Moreover, the total amount invested was down on the figure for 2006 (€161½ billion).

... bonds ...

This reorientation particularly affected euro-denominated foreign bonds. These are predominantly bonds issued by public debtors in other euro-area countries, but some are asset-backed securities. In the wake of the financial market turbulence, German investors switched, on the whole, from buying to selling euro-denominated bonds in the middle of last year. Residents had been purchasing such longer-dated interest-earning instruments up to the end of June 2007 (€79 billion) but – for the first time in 15 years – were selling them in the six-month period up to the end of the year (€12½ billion). As mentioned above, this regrouping of investment was accompanied by marked price discounts on foreign bonds compared with Federal bonds.

As in earlier years, German residents also added quite a large amount of foreign currency bonds to their portfolios (€29½ billion, compared with €22 billion in 2006). In addition to classical forms of investment, such as foreign government bonds, residents also acquired new products, such as securitisations of traditional bank loans (€13 billion). Towards the end of last year, however, domestic demand for such paper issued abroad dried up almost entirely. Overall, it was mainly bonds denominated in US dollars that attracted the interest of German investors – despite adverse factors, such as the weakness of the US dollar and the reversal of the interest rate spread in favour of the euro.

... money market paper ...

German investors also invested fairly large amounts in foreign money market paper last year (€18½ billion). One factor in the acquisition of these products was that, in unsettled times, short-term paper has a favourable risk-return profile. Besides such portfolio considerations, purchasing money market paper was also motivated by the efforts of some financial institutions to give prompt support to their securitisation special purpose vehicles domiciled abroad, which had come under pressure in the wake of the financial market turbulence.

... stocks ...

German investors, however, continued to withdraw on balance from the global stock markets, especially from the stock exchange centres of Germany's EU partner countries. German investors sold foreign equities for €22½ billion, having already sold €7 billion worth of such instruments in 2006. It was probably not so much a case of a prevalent general mistrust of foreign shares. Rather, the return prospects on the German stock market were especially promising. For example, at 17½%, the broad CDAX showed an obviously sharper increase in value than many stock price indices in other countries.

... and mutual fund shares

Indirect holding of shares through foreign investment funds is becoming increasingly important, however. At €41½ billion, investment by German residents in non-resident funds was well up on the figure for the previous year (€23½ billion). Foreign money market funds were also part of this development (€16 billion). As in previous years, these resources flowed mainly into foreign mutual funds open to the general public; these are of German origin but often manage their assets from Luxembourg.[9]

Financial derivatives

Cross-border transactions in financial derivatives, which form an item of their own within financial investment, closed with large net capital exports (€71 billion) in the reporting year. These were largely hedges in connection with the above-mentioned issues of structured products. The balance was also expanded to a small extent by a reclassification of certain warrants. These developments are explained in more detail on pages 26-27.

Direct investment

Robust global economic activity, the ample liquidity of many enterprises owing to their strong profitability and the initially ongoing positive financing conditions led to a further rise in global direct investment flows last year. With an increase of one-sixth to more than US$1.5 trillion (€1.1 trillion), growth – according to initial UNCTAD estimates – was no longer quite as strong as in 2006, however, and was driven mainly by the buoyant trend in mergers and acquisitions.[10]

There was also a sharp increase in cross-border M&A activities with German involvement. At 45%, the increase was, in fact, significantly larger than the figure worldwide (19½%). This rise was ultimately reflected in German firms' higher direct investment abroad, which also comprises all the other cross-border financial transactions among affiliated enterprises. All in all, there were net capital exports of €85 billion in direct investment in 2007, compared with €31½ billion a year earlier.

German direct investment abroad

German enterprises, in particular, expanded their presence abroad considerably in 2007. They provided their foreign affiliates with more funds (€122½ billion) than ever before

9 By contrast, the inflows of funds to domestic mutual funds declined in 2007. They amounted to €13½ billion. As much as €8 billion was withdrawn from domestic funds open to the general public, in fact.
10 According to data from Zephyr, Bureau van Dijk, the volume of completed mergers and acquisitions increased worldwide to around €1.7 trillion in terms of value, which was spread over more than 20,000 transactions. Cross-border transactions accounted for considerably more than half of this. The credit crisis is likely to have made it more difficult to borrow for leveraged projects from the middle of the year onwards. Unlike in the case of the announced mergers and acquisitions, this did not lead to a sharp decline in the transactions that were actually conducted in 2007, however. The volume and number of worldwide M&As remained almost constant during the year. This was probably due in part to the fact that many of the acquisitions were financed with available cash resources or conducted by an exchange of shares and, therefore, without recourse to borrowing.

(2006: €75½ billion). This growth was due mainly to the increase in credit transactions with affiliated enterprises abroad. This involved outflows of funds amounting to €45 billion, compared with inflows of €5½ billion in 2006. Just under half of this was the repayment of loans which had been granted to German parent companies by their subsidiaries abroad. As was frequently the case in the past, large German enterprises' intra-group transactions with their financing institutions in the Netherlands were a key factor in this. In addition, however, foreign subsidiaries were also provided with a large amount of financial resources in the form of loans. Equity investment (€46½ billion net) and reinvested profits (€30 billion) also contributed to the aggregate result for German direct investment. Their substantial level of the reinvested profits points to the continuing strong profitability of the branches and subsidiaries domiciled abroad.

Host countries and ...

The main host countries for German direct investment last year were the Netherlands (€25½ billion), the USA (€16 billion), the United Kingdom (€14 billion) and Switzerland (€13 billion). The above-mentioned credit transactions were reflected in the figures for the Netherlands, while a fairly large transaction in the pharmaceuticals sector was a key factor in the case of Switzerland. At a total of €101½ billion, the resources flowed predominantly into industrial countries. Once again, foreign investment is therefore likely to have primarily served the purpose of opening up markets.[11] Furthermore, investment location decisions invariably also have other motives, including taxation and cost considerations.

... investing sectors

A sectoral analysis shows that holding companies (€35½ billion), the insurance sector (€14½ billion) and manufacturers of transport equipment (€5 billion) expanded their cross-border investment last year. Manufacturing provided its foreign affiliates with a total of €25½ billion.[12]

Foreign direct investment in Germany

Foreign enterprises invested €37 billion in Germany last year, which was somewhat less than in 2006 (€44 billion). At €34 billion, most of the invested funds came from industrial countries. These inflows came mainly from the EU partner countries, including the Netherlands (€18 billion), France (€14½ billion) and the United Kingdom (€8½ billion).[13] Foreign investors' interest was focused on the services sector. A major part of the financial resources flowed into holding companies (€7½ billion) and into credit institutions and insurance companies (€7 billion). Manufacturing received funds totalling €6 billion.[12]

Other investment ...

Like direct investment, other investment, which comprises financial and trade credits as well as bank deposits and other assets, re-

11 Besides developing markets by establishing production plants in the host countries, the marketing subsidiaries of German multinationals play a major role. This is indicated by the fact that a large part of German exporters' cross-border receivables resulting from exports were created in the form of trade credits to affiliated enterprises abroad.
12 The sectoral breakdown of direct investment can be analysed only to a limited extent on the basis of the available data. First, in the case of the holding companies, which accounted for almost one-third of German direct investment in the reporting period, the final direct investment objective is not expressed directly. Second, the figures on reinvested profits (roughly one-quarter of the total figure) are based on estimates that are not broken down by sector.
13 The inflowing funds from the Netherlands were almost entirely attributable to foreign direct investors' credit transactions and were due principally to the transfer of assets from another EU country.

corded net capital exports in 2007. These amounted to €198 billion, compared with outflows of €105½ billion one year earlier.

... of non-banks ...

Counter to the overall trend, however, there were net inflows of €8 billion in the non-banks' unsecuritised financial transactions. This was due mainly to the activities of general government (€11½ billion), which liquidated foreign bank deposits and repatriated the funds. There were small outflows of funds (€3½ billion) in the case of enterprises and households, which sharply increased their foreign bank balances (€41½ billion)[14] but simultaneously took up loans abroad on a somewhat smaller scale (€35½ billion).

... and banking system

Consequently, it was primarily the unsecuritised financial transactions of the banking system (including the Bundesbank), with net capital exports of €206 billion, that formed the counterpart to the current account surplus. The domestic credit institutions considerably expanded their net lending to non-resident customers. All in all, German banks' net external assets grew by €151½ billion last year. The external position of the Bundesbank increased by €54½ billion, doing so solely by building up claims in the context of the TARGET large-value payment system.[15]

Reserve assets

There was a slight transaction-related increase in the Bundesbank's reserve assets of just under €1 billion in 2007. This was due in part to an increase of €1½ billion in the foreign exchange reserves, which consisted mainly of reinvested interest income. The reserve position in the IMF (including SDRs) declined somewhat (€½ billion), however.

Owing to their regular revaluation at market prices, although this is of no relevance to the balance of payments, the reserve assets increased by roughly €7 billion in value. In particular, the increase in the price of gold was reflected in a €9 billion upward revaluation of the gold holdings. By contrast, the currency reserves fell €2½ billion in value – mainly as a result of the weakness in the US dollar. In balance sheet terms, the reserve assets therefore increased by €8 billion in the reporting period and amounted to €92½ billion at the end of the year.

Errors and omissions

All in all, the statistically recorded net capital exports exceeded the current account surplus quite considerably in 2007. This means that there were corresponding errors and omissions in the balance of payments last year, too (€36½ billion). Much of this is probably attributable to non-recorded cross-border cash transactions. For example, expenditure on travel by German residents, 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, ie without a matching counterbooking.[16] Such transactions inevitably result in errors and omissions, as do reporting mistakes, gaps in recording, and problems regarding allocation to time periods.

14 Much of this amount is associated with the warrants mentioned earlier.
15 From 19 November 2007, TARGET2-Bundesbank.
16 See also Deutsche Bundesbank, Recording cross-border cash transactions in the balance of payments, Monthly Report, March 2005, p 37.