The German balance of payments in 2010

Thanks to the significant impetus contributed by foreign trade, the German current account surplus increased slightly in 2010, but still remained considerably below the record high seen in 2007. German enterprises' exports recovered very robustly in the wake of the global economic upswing, although the nominal increase in goods imports was a little higher in percentage terms and also broadly based across regions. The German economy's comparatively strong presence in the Asian emerging market economies is helping to channel the cyclical impulses from what is the current centre of global economic growth to Europe. Germany's rising demand for imported intermediate goods and its increasing imports of capital goods and consumer goods are tending to reduce its external surplus position vis-à-vis the rest of the euro area.

2010 also saw sharp growth in cross-border business-related and financial services on the back of the economic recovery. By contrast, German residents' propensity to travel is still far below its pre-crisis level. This applies especially to private trips abroad, which were curtailed noticeably in the face of the recession and have not yet recovered. Revenue from income-related transactions fell further during the reporting period but the corresponding expenditure stabilised after contracting sharply in the two previous years.

The current account surplus in 2010 was accompanied by net capital exports totalling €131½ billion, which was attributable primarily to high outflows in direct investment and portfolio investment. The worldwide economic recovery revived enterprises' cross-border operations globally, and the German economy likewise invested more abroad. The net capital exports in portfolio business were due less, however, to the securities transactions of private market participants than to the transfer of balance sheet positions of German banks and their foreign group companies to resolution agencies. The transactions associated with this also had a distorting effect on cross-border unsecuritised credit transactions. An even bigger quantitative impact ensued from the substantial increase in the Bundesbank's claims from the TARGET2 payment system (€147½ billion), which is recorded in the balance of payments as a capital export. These settlement balances resulted from transfers of central bank money within the Eurosystem and represent a claim on the European Central Bank. The growth of the Bundesbank's claims under TARGET2 implies no direct change in its level of risk exposure.

Current account

Underlying trends

Rise in current account surplus due to higher foreign trade result

Germany's current account surplus increased moderately in 2010 by just under €8 billion vis-à-vis its 2009 level thanks to the overall very rapid economic recovery both in Germany and abroad as well as the associated sharp rise in international trade flows. It totalled €141½ billion and amounted to 5¾% of gross domestic product (GDP), which was barely more than the ratio registered in the crisis year 2009 and fell well short of the peak figure of 7½% of GDP recorded in 2007. The current account increase was primarily attributable to the rise in the foreign trade surplus. The growth of the current account surplus was dampened by the fact that the positive balance from income transactions decreased and net current transfers to the rest of the world increased in 2010. The overall deficit from services was reduced slightly.

Marked cyclical influence on trade in goods and business-related services

The impact of cyclical developments can be seen more clearly in cross-border revenue and expenditure flows than in the change in the balance. Not only trade in goods but also in most services staged an, in some cases, marked recovery during the reporting period after contracting considerably during the recession year 2009. One exception to this was transfers of investment income, where the incoming total decreased in the wake of further falling interest rates and declining portfolio investment receipts, albeit not as sharply as in 2009. The outgoing total stabilised at a low level.

But travel still below pre-crisis level

While only goods imports have exceeded their pre-crisis level to date, both imports and exports of business-related services[1], which likewise fluctuate heavily over the course of the business cycle, surpassed this mark. Although the combined assets side of these two cyclically sensitive current account components suffered a sharper decline during the recession, the corresponding import expenditures rose more strongly than export receipts during the reporting period. The fact that the surplus rose nonetheless is due to the difference in levels in favour of the assets side. The dampening effect of the crisis on travel appears to be lingering longer, however, as resident business travellers and tourists spent significantly less abroad in 2010 than before the crisis. The same is true of foreign travellers' spending in Germany.

Goods flows and balance of trade

Sharp recovery in foreign trade ...

Global economic influences had a profound impact on German foreign trade over the past two years. Following the collapse of trade flows on the heels of the global recession in the latter part of 2008 and early part of 2009, the world economy has had an uplifting effect thereafter. The dynamic development of many sales markets caused exports of good to swell by 18½% in 2010 after they had shrunk by a similar margin in the recession year 2009. Imports of goods grew at the even faster pace of 20% during the period under review. While the surplus on traded goods increased further in 2010 on

1 Business-related services here comprise all services excluding travel, finance and insurance services, the film industry and governmental transactions.

the back of the strong recovery to reach €154½ billion, this is still almost one-tenth less than the average level between 2004 and 2008. This chiefly reflects the slightly stronger domestic impulse in the current upturn compared with the previous upswing.

... weakened somewhat in the second half of 2010

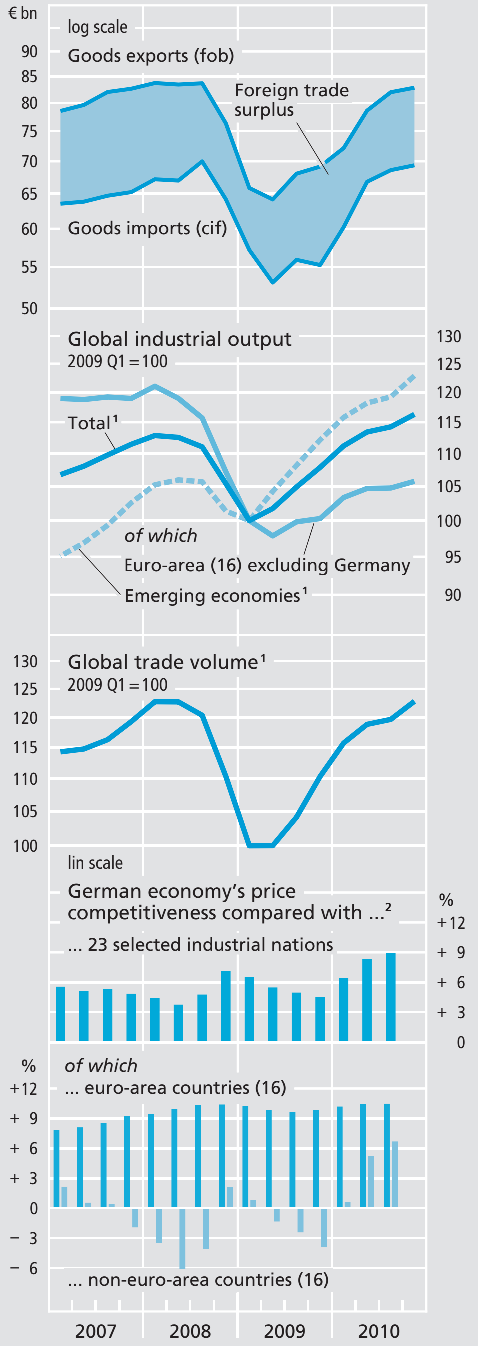
The strong revival in cross-border goods trade was concentrated on the first half of 2010, when the seasonally adjusted value of exported products increased by around one-sixth and the nominal value of imports of goods surged by one-quarter. The second half of the year saw a more moderate expansion in the underlying trend for export revenues while expenditure on imported goods generally held steady. Given the massive import price rises towards the end of 2010, the volume of imports may actually have declined at the end of the period under review. The significant slowdown in export business can be partly attributed to the weakening of the upturn in the high-growth regions of the global economy last summer. This suggests that the substantial improvement in the price competitiveness of German products on markets outside the euro area in the first half of 2010 owing to the depreciation of the euro was of lesser significance. The fall-off in foreign demand was also a key factor behind the partial loss of momentum of the domestic economic recovery, which in turn had repercussions on import demand.

Stimulus from high-growth regions mainly benefited intermediate and capital goods manufacturers

The current growth lead of the German economy compared with a number of other industrial nations can be partly explained by the fact that the upsurge in the global economy is being driven even more than during the

German foreign trade within the international economic and price setting

Quarterly, seasonally adjusted



1 Source: CPB Netherlands Bureau for Economic Policy Analysis. — 2 Based on the deflators of total sales. Deviation from long-term average (positive = better).

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Foreign trade by region

%

Country/ group of countries	Percentage share 2010	Annual percentage change 2008	2009	2010
Exports				
Euro area (16)	41.2	– 0.5	– 18.3	14.3
Other EU countries	19.6	0.4	– 22.3	18.0
of which United Kingdom	6.2	– 8.0	– 17.0	11.7
Central and east European EU countries (8) 1	9.8	7.5	– 25.8	21.9
Switzerland	4.4	7.3	– 9.0	17.5
USA	6.9	– 2.6	– 23.9	20.6
Japan	1.4	– 2.2	– 14.6	20.6
BRIC	10.5	15.2	– 12.0	36.0
of which China	5.6	13.9	9.4	43.9
Russia	2.8	14.7	– 36.2	27.8
South and East Asian countries 2	4.0	0.9	– 12.2	33.0
OPEC	2.7	19.9	– 12.6	13.9
All countries	100.0	2.0	– 18.4	18.5
Imports				
Euro area (16)	38.5	2.6	– 18.0	18.9
Other EU countries	18.6	2.3	– 16.4	21.9
of which United Kingdom	4.8	– 0.8	– 22.1	18.9
Central and east European EU countries (8) 1	10.7	4.0	– 12.6	24.7
Switzerland	4.1	5.0	– 10.2	15.6
USA	5.7	1.0	– 15.5	14.7
Japan	2.8	– 5.1	– 18.1	16.5
BRIC	15.5	14.4	– 16.4	31.6
of which China	9.6	7.8	– 6.8	35.0
Russia	4.0	28.4	– 32.1	26.2
South and East Asian countries 2	4.9	– 6.2	– 14.5	37.7
OPEC	1.2	42.0	– 42.0	19.2
All countries	100.0	4.7	– 17.5	20.0

1 Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania. — **2** Brunei Darussalam, Hong Kong, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand.

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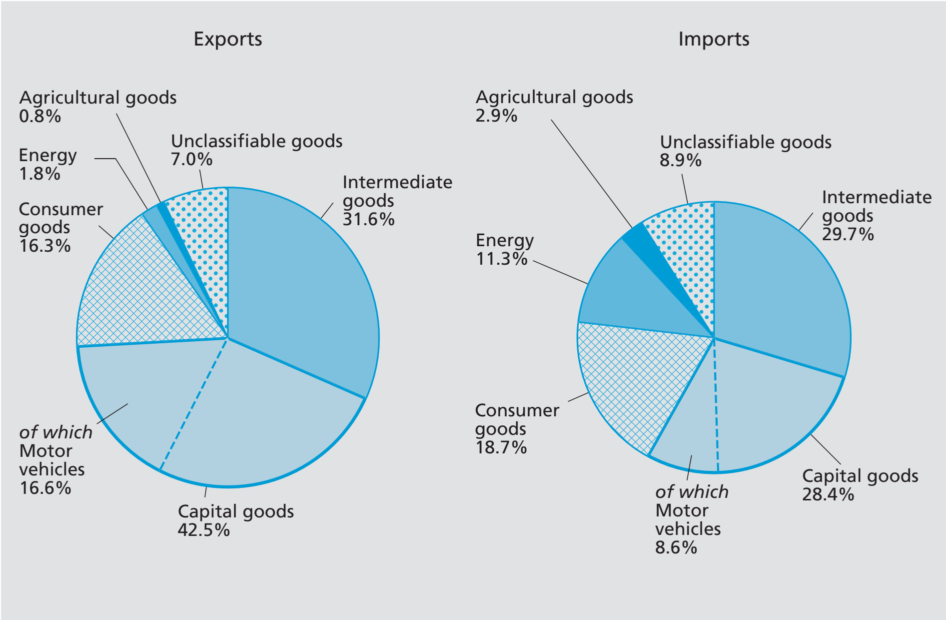
last upswing by the catching-up processes underway in the emerging market economies. The demand pull stemming from them is based for the most part on products upon which German enterprises are often particularly well positioned on the international stage. The favourable market position in intermediate and capital goods is also attested by the growth in exports for these two ranges in 2010, which at 21% and 18½% respectively was exceptionally high in comparison to 2009. Motor vehicle exports enjoyed a particularly strong period of growth, expanding by just under 30% thanks in part to a boom in demand for high-quality new cars from certain parts of the world. Global investment needs in 2010 were not quite as dynamic due to widespread global capacity underutilisation, resulting in a below-average increase in exports of machinery and equipment (+11½%). At the lower end were consumer goods producers, whose exports grew by 7½%.

European export markets lagging

The increasing presence in Asian growth markets, in particular, made up for the fact that the goods delivered to other euro-area countries – which is by far the most important sales region for German products – underperformed compared with other regions despite expanding by a very robust 14½% in 2010. Exports to China once again recorded the biggest leap (+44%), while one-third more was exported to the South and East Asian countries excluding China. German exports to the USA, Japan, and central and eastern Europe grew by just over one-fifth in each case. The growth in exports to several large EU countries, by contrast, was much smaller.

Foreign trade by selected categories of goods in 2010



Deviations from 100% due to rounding.

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While the 11½% increase in deliveries to France came close to reversing the losses accrued in 2009, similar rises in goods exports to the UK and Spain in 2010 fell well short of their respective pre-crisis levels.

Goods imports broadly based across regions

In the case of imports, the growth gap between the euro area and non-euro-area countries was not as large as on the export front, with Germany importing 19% more goods from euro-area partner countries than in 2009. Taken together with the somewhat more robust rise in imports from the other EU countries (+22%), Europe equalled the average rate of increase recorded across all countries. This underlines the fact that the German economy is channelling the global economic impulses into Europe by performing comparatively well in non-European sales markets and then distributing the resulting import demand fairly evenly amongst its trading partners (see box on pages 22 and 23 "The transmission and regional distribution of the German economy's cyclical impulses within Europe"). Given the current global economic setting in which the Asian emerging market economies are acting as the world's growth engine, this mechanism is helping Germany *per se* to reduce its trade surplus vis-à-vis the rest of the euro area. In actual fact, Germany's surplus vis-à-vis the rest of the euro area has not rebounded in the recovery following the sharp downward slide endured during the financial and economic crisis: at just under €85 billion in 2010, it was around one-quarter below the record value seen in 2007.

The transmission and regional distribution of the German economy's cyclical impulses within Europe

Germany plays an important role in European economic development owing to its size as a production location and sales market and its high trade intensity. The German economy's strong rebound is thus spilling over to its neighbouring countries, although the strength of the stimulus on individual regions varies. Together with Germany's specific growth profile, this mirrors the diverse specialisation patterns of the countries concerned with regard to the provision of goods and services.

During this upturn, in contrast to the past two cycles, the German economy is largely performing the function of a growth locomotive for Europe as the present economic upswing in Germany is more dynamic than that in most of its neighbouring countries. Thus Germany has accumulated an annualised lead of around 2½ percentage points since mid-2009 compared with mean GDP growth of all EU countries excluding Germany.[1] Germany's growth lead over the rest of the euro area is as much as 2¾ percentage points. The German upswing is being fuelled chiefly by stimuli from the growth markets outside Europe. Its European trading partners are also participating in this. The transmitted impulse mostly takes the form of an additional demand effect. In addition, there is the impetus arising from the expansion of domestic business activity in Germany.

However, the individual demand components show notable differences with regard to their growth momentum. The demand for intermediate goods, which the German economy (chiefly the manufacturing sector) normally covers through imports, rose sharply with the onset of the economic upturn. The German economy then stepped up its procurements of machinery and equipment with a certain time lag. There has only been a tentative pick-up so far in private consumption of German residents, which could generate demand effects abroad through both the purchase of foreign consumer goods and in the form of travel expenditure, after it proved a stabilising element during the crisis.

Germany's direct demand effect on its trading partners is measured as the proportion of goods and services exported to Germany in these countries' GDP. This ratio is largely determined by the degree of openness of the countries concerned and Germany's weight as a destination for their exports. Based on these criteria, the European countries can be divided into several different groups. On the one hand, there are the (relatively) large economies, which tend to have a fairly low degree of openness compared with other European nations and which, with the exception of France, also transact a below-average share of their foreign business with German firms. On the other hand, there are a large number of smaller economies which exhibit a large structural dependence on exports. It is noticeable in this context that the trade relationships of the central and east European neighbouring countries are concentrated more strongly on Germany than those of the adjacent western and northern countries, which have been embedded in the international division of labour for decades. Austria's and Switzerland's exchange of goods with Germany is traditionally likewise particularly close.

In view of the German economy's growth profile, the vast majority of its European trading partners benefit from the fact that they rely relatively strongly on the export of intermediate goods including energy.[2] Only with the Mediterranean countries is the interlinkage of the supply chains not very advanced so far. In the case of capital goods the regional structure is more concentrated. Switzerland and the Czech Republic specialise in supplying machinery and other equipment to German customers.[3] The Slovak Republic has a higher weighting in motor vehicles and motor vehicle parts, followed some way behind by other central and east European countries and Spain.

The spillover effects of German business activity tend to be weaker in countries which mainly deliver consumer goods to Germany and/or which are holiday destinations. This holds particularly for the Mediterranean countries (excluding France but including Portugal).[4] In the case of Italy – and Turkey – the export of consumer goods to Germany is more important than supplying tourist services for German holidaymakers. Poland, too, is relatively

1 The economic output of the EU countries overall and of the euro area did not increase until the third quarter of 2009, whereas German real GDP has been rising since spring 2009. — **2** Only the Netherlands and the United Kingdom show significant shares for energy exports. — **3** France's large weight in this category is predominantly due to the manufacture of aircraft and spacecraft. — **4** Ireland's large

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strongly reliant on exporting consumer goods. Greek and Cypriot ship owners provide transport services for German enterprises on a scale that almost matches German tourists' travel expenditure in these countries. Other services are dominated by finance and insurance business, explaining the relatively high revenue shares of the United Kingdom, Ireland and Switzerland.

The German economy is currently exerting its strongest knock-on impulses on its eastern neighbours plus Austria and Switzerland. The production sites there are closely linked with German enterprises via supply chains. The "old" EU partners profit from the established trade relationships, with the Benelux countries tending to benefit more from the openness of their economies than the larger economies. The spillover effect of Germany's strong economic recovery on the Mediterranean countries has remained subdued as their exports to Germany account for only a very small share of their aggregate economic output; they are focused on consumption-related goods and services, which have not featured prominently in Germany's import growth hitherto.

The demand for goods and services of German enterprises and households in other European countries

Average of the years 2008-2010

Country or group of countries	German economy's demand for goods and services: € billion	% of total exports of country of origin	% of GDP of country of origin	Percentage share of selected groups of goods and services: Intermediate goods and energy	Capital goods (excluding motor vehicles and motor vehicle parts)	Motor vehicles and motor vehicle parts	Consumer goods	Travel	Transport services	Other services
EU	544.5	14.7	5.6	32	14	10	15	7	4	9
Euro area (16)	368.9	14.7	5.5	32	13	9	15	8	4	8
France	72.5	15.3	3.8	26	26	10	12	5	3	10
Italy	52.3	13.1	3.4	29	14	10	19	11	3	6
Spain	30.4	11.5	2.9	19	7	19	12	22	4	7
Netherlands, Belgium, Luxembourg	118.1	15.4	12.2	47	7	5	14	4	4	8
Austria	43.9	29.1	15.7	28	12	13	10	14	4	10
Greece, Portugal, Cyprus, Malta	12.3	10.9	2.9	17	7	5	18	21	18	9
Ireland	18.6	12.5	11.3	12	12	0	51	2	1	19
Slovakia, Slovenia	13.0	18.3	13.0	29	14	25	18	2	3	4
Finland	7.7	10.4	4.3	54	16	4	3	3	3	11
United Kingdom	54.5	11.1	3.2	32	15	9	8	3	5	23
Sweden, Denmark	29.3	10.4	5.3	35	13	5	16	7	5	7
Central and east European EU countries (8)	91.9	22.2	11.4	27	16	18	15	6	6	4
Poland	31.4	23.3	9.2	27	11	13	21	7	8	4
Czech Republic	30.9	29.6	21.5	31	18	18	10	6	3	3
Switzerland	41.9	21.2	11.7	29	18	1	18	6	3	18
Turkey	14.0	12.2	2.8	12	8	7	34	24	5	4

share of consumer goods is largely accounted for by pharmaceuticals, which are statistically assigned to this category of goods; they are predominantly not manufactured there, however, but are merely forwarded to its European trading partners.

High demand for imported intermediate goods

Domestic production was the main factor driving goods imports in 2010. This is demonstrated by the fact that import growth in intermediate goods (29%) was more than twice that of capital goods (14%). After taking account of the respective pre-crisis level (which was exceeded by both groups of goods at the end of the year under review), there is, however, no substantial difference as the crisis-induced decline was not as distinct for capital goods. While consumer goods imports are less sensitive to cyclical fluctuations, their comparatively small growth of 6% during the reporting period means that the losses from 2009 were no way near being offset.

Breakdown of invisibles

Smaller services deficit

German enterprises' service exports rose by 8% in 2010 after declining by 4½% in 2009. German firms and households spent just over 6% more on services from foreign providers in 2010 than one year previously compared with 5% less in 2009. The negative balance on the services account stood at €8 billion, representing an improvement of €2½ billion on 2009.

Business-related services up sharply

The global economic recovery triggered a sharp rise in cross-border business-related services. Given the pronounced fluctuations in foreign trade and close international production ties, it is not surprising that the growth in transport services, which account for just under one-third of both receipts from and expenditure on foreign business-related services, grew especially sharply in 2010 following the crisis-induced declines in 2009. German freight carriers and hauliers earned 17½% more from their business with foreign clients on the year, while the amount of such services provided by non-residents in Germany increased by more than one-fifth. This far outstripped even the expansion of cross-border financial and insurance services, income from which increased during the reporting period by 7% and expenditure by 9%.

Private travel still far below pre-crisis level

German residents' wanderlust remains far below the level seen prior to the financial and economic crisis. Their travel spending abroad rose by a mere ¾% in 2010 after contracting by 6% in 2009. In statistical terms, the growth resulted solely from the strong recovery in business travel – up by one-tenth – whereas expenditure on private travel decreased again following the sharp drop in 2009 (-5%). That said, the decline of -¾% was actually very small. Looking at the main holiday destinations, it can be seen that the shift in the expenditure trend over the past two years towards cheaper countries prompted by the financial and economic crisis has persisted to date. The balance of payments shows, for example,[2] that travel expenditure to euro-area Mediterranean countries (excluding France but including Portugal) was almost one-eighth below its 2008 level, while spending on vacations in Turkey increased significantly. German holidaymakers again spent far less money during trips to the Al-

2 The accommodation statistics indicate that a greater number of Germans have tended to spend their holidays in Germany over the past two years. The number of permanent residents who stayed overnight in Germany rose slightly (+¼%) in 2009 despite the crisis (and the associated decline in business travel). In 2010 it increased by a further 2%.

pine countries in 2010 than in 2008. Although long-haul journeys to the USA and Asia registered a noticeable increase during the year under review, this did not compensate for the decline in the crisis year 2009.

Higher travel receipts

Non-residents' use of domestic hotels and restaurants grew by 5½% during the reporting period after having contracted by 8½% in 2009. Travel income generally reacts more strongly to cyclical effects than travel expenditure in this segment due to the larger share of business travellers.

Fall in factor income flows smaller than in 2009

The receipts from cross-border factor income, which are predominantly made up of earnings from invested assets, declined further in 2010, primarily because the return on investments abroad decreased again by 3% during the reporting period, although this was far less than the year-on-year fall in 2009 (-9½%). By contrast, the corresponding payments to foreign investors equalled the 2009 result, which was heavily down on the preceding boom years. The incoming and outgoing factor income flows were both depressed by the further sharp falls in domestic and foreign interest receipts and the renewed fall in portfolio earnings. Earnings from direct investment, however, rose noticeably on both sides of the balance sheet for the second consecutive year. Compared to the low recorded in 2008, foreign investment expenditure increased by €22½ billion and related receipts by as much as €37 billion. Overall, Germany's clearly positive net external position resulted in a substantial inward surplus of around €45 billion in 2010, which is €5½ billion less than in 2009. The minimal in-

Major items of the balance of payments

€ billion

Item	2008 r	2009 r	2010 r
I Current account			
1 Foreign trade [1]			
Exports (fob)	984.1	803.3	951.9
Imports (cif)	805.8	664.6	797.4
Balance	+ 178.3	+ 138.7	+ 154.5
Supplementary trade items [2]	– 14.1	– 11.6	– 11.4
2 Services (balance)	– 11.6	– 10.4	– 8.0
of which Travel (balance)	– 34.7	– 33.3	– 32.4
3 Income (balance)	+ 35.6	+ 50.1	+ 44.5
of which Investment income (balance)	+ 35.1	+ 50.2	+ 44.8
4 Current transfers (balance)	– 33.4	– 33.0	– 38.1
Balance on current account	+ 154.8	+ 133.7	+ 141.4
II Balance of capital transfers [3]	– 0.2	+ 0.1	– 0.6
III Financial account [4]			
1 Direct investment	– 49.8	– 29.2	– 44.3
2 Portfolio investment	+ 51.4	– 82.7	– 124.9
3 Financial derivatives	– 30.2	+ 12.4	– 17.6
4 Other investment [5]	– 129.6	– 49.1	+ 57.1
5 Change in the reserve assets at transaction values (increase: –) [6]	– 2.0	+ 3.2	– 1.6
Balance on financial account	– 160.2	– 145.4	– 131.4
IV Errors and omissions	+ 5.6	+ 11.6	– 9.4

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 27. — **5** Includes financial and trade credits, bank deposits and other assets. — **6** Excluding allocation of SDRs and excluding changes due to value adjustments.

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crease in the outward surplus from cross-border labour was of no quantitative consequence to the overall factor income result.

Bigger deficit from current transfers

Current transfers to the rest of the world grew noticeably in 2010 (+10%), whereas residents received transfers from foreign sources in virtually the same volume as they did in 2009. This divergent development meant that the corresponding deficit increased by €5 billion to €38 billion in 2010 after having decreased slightly in 2009. Roughly half of this deficit was made up of net transfers to the EU budget.

Financial transactions

Determinants of financial transactions

On the one hand, the transactions recorded in Germany's financial account with the rest of the world reflect the German current account surplus; on the other hand, they were heavily influenced in 2010 in addition by resolution agencies assuming risk positions from domestic credit institutions (and their group enterprises) on a large scale, which led to corresponding capital flows within the balance of payments both in the portfolio account and in other investment (see box on pages 28 and 29). The activities of private financial players, who were caught between the two stools of a critical financial market situation and a gradually brightening economic outlook, played a lesser role. Market participants found themselves on uncertain ground when making their portfolio decisions as the equities and bond markets in the individual economies developed very heterogeneously. Thus the yield spreads of euro-area government bonds over German Bunds, which prior to the crisis were negligible, widened sharply as the crisis of confidence that spilled over from Greece escalated considerably in spring 2010. At the same time, positive economic signals increased globally during the course of the year which, supported by favourable corporate earnings and improved profit outlooks, led to significant share price gains on most international stock exchanges. The euro lost just over 8% of its weighted average value against 21 trading partners during 2010 amid considerable fluctuations, and by the end of the year was trading at roughly its launch value from 1999. The aforementioned influences are also partly reflected in Germany's financial transactions with the rest of the world. Taking portfolio and direct investment together, more funds flowed out of Germany in 2010 (€169½ billion) than in 2009 (€112 billion). This outweighed the net incoming payments on the current account.

Portfolio investment

Net capital exports in portfolio investment

The net result from portfolio transactions was determined not so much by shifts in the overall risk and return setting and market participants' associated trading positions as by the aforementioned transfers of securities to resolution agencies, the upshot of which was a net capital export from securities transactions totalling €125 billion.

Domestic investment in foreign debt securities, ...

All in all, German investors purchased €171½ billion of foreign securities, the bulk of which were once again debt securities issued by foreign borrowers. In total, German residents purchased longer-dated bonds and notes for €156 billion. Two-thirds of the entire securities volume was euro-denominated, which on balance was acquired solely by the public sector (including resolution agencies). Private agents seem to have shied away from buying interest-bearing securities as the crisis escalated; this may be due not least to the widening of bid/offer spreads as the crisis unfurled, which indicated a reduction in the securities' liquidity and – when marked to market – might have diminished the holders' earnings.

... foreign currency bonds, ...

Foreign currency bonds were bought from non-residents in the amount of €53 billion net. The bonds were issued in the United States (€18½ billion), the United Kingdom (€11 billion) and Japan (€7½ billion). The vast majority were bonds whose value had proved to be non-sustainable during the crisis and were now transferred to resolution agencies. A sizeable amount of the bonds were asset-backed securities (ABS), an investment and financing instrument that had been widely used prior to the crisis. Hence the wish to diversify is likely to have played a fairly minor role in the purchase of foreign currency bonds.

... foreign money market instruments, ...

Foreign money market instruments failed to attract resident investors' interest in 2010. This may well have been due to the low short-term interest rates, which made such paper unattractive to domestic investors. The final quarter of 2010 was so clearly dominated by repayments and sales that this securities segment recorded further outflows of funds (€6½ billion net) on the year.

Financial transactions

€ billion, net capital exports: –

Item	2008 r	2009 r	2010 r
Direct investment	– 49.8	– 29.2	– 44.3
German investment abroad	– 52.7	– 56.3	– 79.2
Foreign investment in Germany	+ 2.9	+ 27.1	+ 34.8
Portfolio investment	+ 51.4	– 82.7	– 124.9
German investment abroad	+ 25.1	– 69.1	– 171.3
Equities	+ 39.1	– 2.8	+ 0.2
Mutual fund shares	– 7.6	+ 1.8	– 21.8
Bonds and notes [1]	– 24.2	– 81.2	– 156.1
Money market instruments	+ 17.7	+ 13.1	+ 6.4
Foreign investment in Germany	+ 26.3	– 13.6	+ 46.4
Equities	– 34.7	+ 2.3	– 4.1
Mutual fund shares	– 8.7	+ 5.4	+ 2.4
Bonds and notes [1]	+ 29.8	– 71.7	+ 48.3
Money market instruments	+ 39.9	+ 50.4	– 0.2
Financial derivatives [2]	– 30.2	+ 12.4	– 17.6
Other investment [3]	– 129.6	– 49.1	+ 57.1
Monetary financial institutions [4]	– 129.2	+ 61.7	+ 214.7
Long-term	– 129.5	+ 1.9	+ 71.8
Short-term	+ 0.3	+ 59.8	+ 142.9
Enterprises and households	+ 20.7	– 24.5	– 47.8
Long-term	+ 3.4	– 20.5	– 45.0
Short-term	+ 17.3	– 4.0	– 2.8
General government	+ 9.1	– 3.2	+ 32.3
Long-term	– 1.4	– 2.6	– 53.0
Short-term	+ 10.5	– 0.6	+ 85.3
Bundesbank	– 30.2	– 83.0	– 142.1
Change in the reserve assets at transaction values (increase: –) [5]	– 2.0	+ 3.2	– 1.6
Balance on financial account	– 160.2	– 145.4	– 131.4

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.

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The influence of the newly established resolution agencies on Germany's balance of payments for 2010

The transactions undertaken by resident resolution agencies had a large impact on cross-border portfolio and other investment in 2010. Two severely distressed German financial institutions, WestLB and the HRE group, set up resolution agencies based on the Financial Market Stabilisation Development Act *(Gesetz zur Fortentwicklung der Finanzmarktstabilisierung)*, to which they transferred primarily cross-border risk positions and non-strategic business units on a considerable scale.

The resolution agencies are commercially independent public-law entities with partial legal capacity operating under the umbrella of the Financial Market Stabilisation Agency (FMSA),[1] which, following a decision by the Statistical Office of the European Communities (Eurostat),[2] are assignable to the general government sector. The government sector, via the resolution agencies, therefore features for the first time as a large buyer of foreign securities and lender to non-residents in the balance of payments.

In December 2009, WestLB transferred a first portfolio, consisting of structured securities, with a nominal value of roughly €6 billion to its resolution agency Erste Abwicklungsanstalt (EAA); a second, much larger portfolio with a nominal value of approximately €71 billion followed in April 2010.

The HRE group's winding-up institution, FMS Wertmanagement (FMS-WM), became operational in October 2010. The portfolio (excluding derivatives) that was transferred to it had a nominal value of around €173 billion at the time and included positions of HRE Holding AG and its direct and indirect domestic and foreign subsidiaries.

Large transactions affecting the balance of payments mainly took the form of the transfer of securities, risk positions and the non-strategic business units of foreign group units. However, even after the transfer itself, a considerable volume of transactions were recorded between the resolution agencies and non-resident units.[3]

In portfolio investment, a transfer of securitised assets affects the balance of payments if the portfolio is transferred by non-resident group units of the banks in question to resident resolution agencies. Depending on whether the securities in question were issued by residents or non-residents, German investment abroad (foreign securities) increases or foreign investment in Germany (domestic securities) declines. Both cases are reflected in net capital exports in the financial account.

Last year, the principal cross-border item transferred to the resolution agencies were foreign debt securities. The book value of such securities represented more than half of foreign securities purchases, which totalled €171½ billion.

Unsecuritised financial flows in the general government and banking sectors are – where relevant to the balance of payments – derived from changes in stocks and entered as other investment by maturity. They include

- Transfers of the balance sheet positions of resident group units of the banks in question to resident resolution agencies, provided these items represent external assets or liabilities. For statistical purposes, the banks' original credit relationships are dissolved and new financial relationships established in the general government sector. Overall, this does not affect the balance of the financial account.
- Direct transfers of the claims and liabilities of foreign affiliates to resolution agencies, provided they relate to non-residents. This gives rise to capital exports or imports.

1 Resolution agencies are subject to legal supervision by the FMSA. To a limited extent they are also supervised by the Federal Financial Supervisory Authority (BaFin). — **2** See http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/471529_let%20WR-BMF_EAA.pdf. The concrete decision only relates to EAA. FMS-WM was classified accordingly. — **3** The funding

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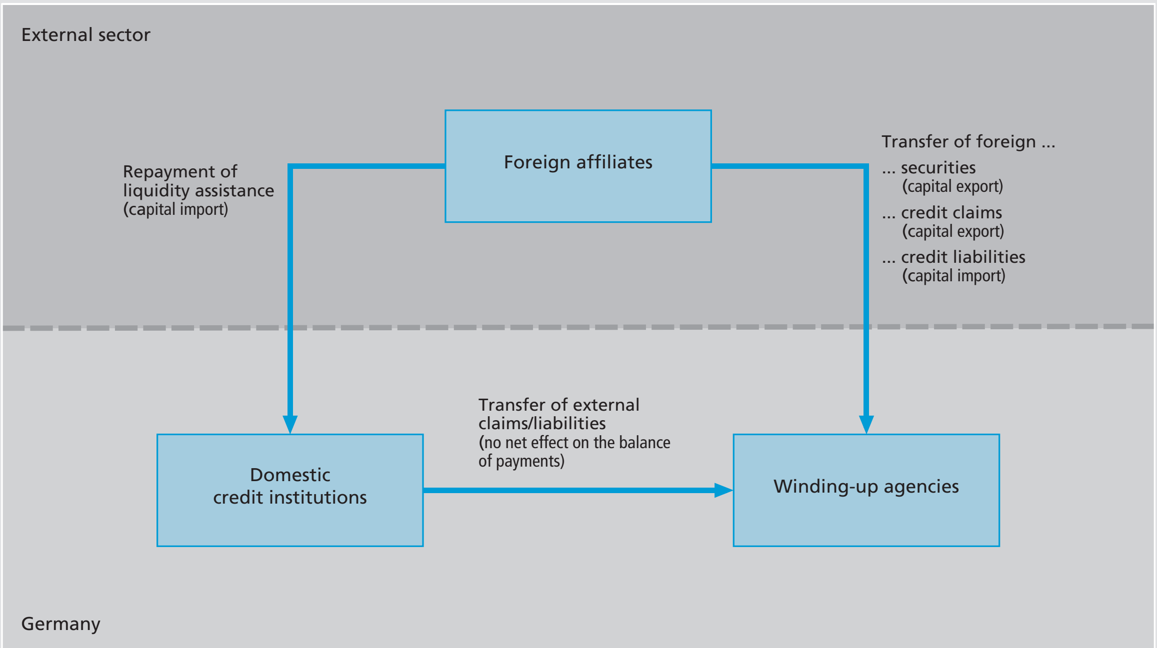
In terms of other investment, this had the following concrete impact in 2010.

– In the item long-term credit transactions by general government, the transfer of credit portfolios to resolution agencies caused net capital exports in a double-digit billion euro figure in statistical terms.

– General government's short-term credit transactions, by contrast, saw even greater inflows of funds from the external sector. This can largely be explained by the fact that liabilities to non-residents were also transferred to the resolution agencies. In addition, the agencies borrowed further funds from non-resident counterparties after they were set up.

– The above-mentioned banks have – as stated – also transferred their own claims on non-resident clients to the resolution agencies. This has significantly reduced their net external position. In statistical terms, all other things being equal, this equates to a net capital import which is mainly reflected in banks' short-term credit transactions. Moreover, as outlined on page 36, the banking system experienced further net capital imports as a result of deleveraging and increased net inflows from abroad.

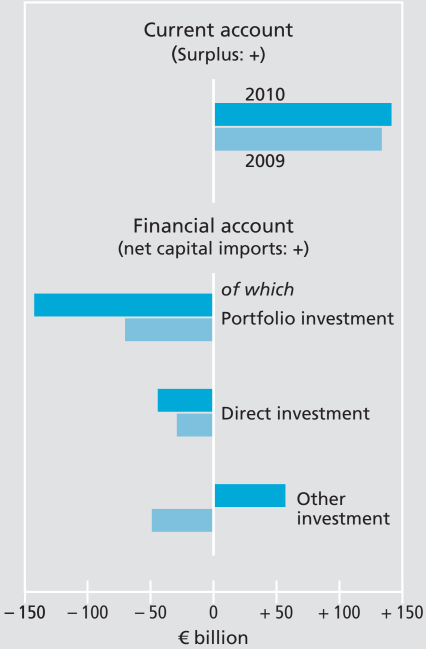
Important transactions undertaken by the winding-up agencies and their reflection in the balance of payments



of the resolution agencies in particular, which is, in some cases, short term and involves non-resident counterparties, continually gives rise to cross-border transactions. Looking ahead, the realisation or liquidation of assets will trigger further capital flows that are relevant to the balance of payments.

Major items of the German balance of payments

Balances



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... foreign equities ...

Domestic investors barely changed their level of holdings of foreign equities despite the favourable global economic outlook. One reason for their restraint in this segment may be that the domestic market, which gained 15% as measured by the broad CDAX index, recorded the strongest growth of the major currency areas in the wake of the very robust cyclical recovery in Germany.

... and foreign mutual fund shares

By contrast, domestic investors acquired €22 billion of mutual fund shares in investment funds based abroad. This segment, which succeeded in raising its inflows overall, was therefore able to resume the trend that had prevailed prior to the start of the crisis. The mutual funds in question were often foreign subsidiaries of domestic financial institutions, with financial locations in Luxembourg (€8 billion) and Ireland (€5 billion) being the primary beneficiaries of the new investment.

Foreign investment in ...

... German bonds and notes, ...

Foreign asset holders became net buyers again in 2010 after having sold German securities the year before on balance. Even so, their expenditure of €46½ billion was much lower than the average annual amount they had invested in the German securities markets since the launch of European monetary union (€117 billion). Non-resident investors were most interested in longer-term debt securities in 2010, purchasing €48½ billion worth. They discriminated clearly between asset classes, however, with public bonds being particularly sought after because of their reputation as a safe haven in times of great financial uncertainty thanks to their top credit rating and high liquidity. In total, non-residents bought a record amount of German public debt instruments (€71 billion). Foreign demand actually exceeded total net sales by €20 billion. The high demand was also reflected in the falling yield on ten-year Bunds, which for a time dipped to an all-time low of just over 2%. By contrast, private bonds with an initial maturity of over one year once again recorded net repayments and sales (€22½ billion). Measured against the extraordinarily high outflows totalling almost €99 billion in 2009, however, this can be seen as a slight easing of the situation for bank bonds, as the outstanding volume of public Pfandbriefe has been contracting for years for structural reasons – shrinking by €63 billion last year alone. In addition, the bulk of domestic corporate bonds and notes are not issued in Germany but rather via financing subsidiaries abroad, so that purchases of these securities by international investors are not reflected in the German balance of payments.

... German money market instruments, ...

Domestic money market instruments played a minor role in non-resident investors' operations, with no funds being transferred to Germany via this instrument on balance in 2010. In the second half of the year, however, purchasing activity picked up strongly (€25½ billion), although it should be noted that this owed much to transactions of resolution agencies with business partners abroad.

... German equities and mutual fund shares

The price rally on the German stock market did not entice foreign investors to increase their investments in Germany. On balance, they actually sold German equities worth €4 billion. One reason for this may be the persisting very subdued level of issuance on the German stock market. Indirect purchases of domestic equities by non-residents via investment funds increased somewhat, however, with a total of €2½ billion flowing into the German mutual fund industry from abroad. This means that it has recovered further from the slump it suffered in 2008.

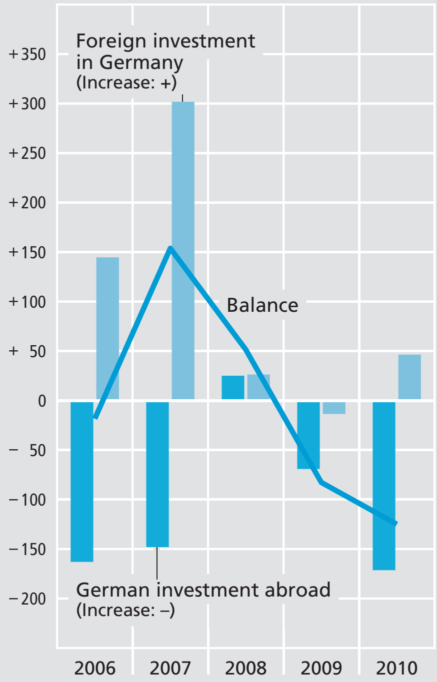
Direct investment

Direct investment worldwide...

After the rapid declines of 2008 and 2009 owing to the financial and economic crisis, global direct investment rose again slightly in 2010 by 1% to US$1.12 trillion according to initial UNCTAD estimates.[3] Direct investment flowed especially strongly to the rapidly growing emerging market economies in Asia and Latin America. This meant that for the

Portfolio investment

in € billion



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first time, more than half of the world's direct investment flows were channelled into emerging and transition countries. With the recovery of the global economy and the improvement in profitability, it was primarily the rise in reinvested earnings that was the driving force behind enterprises' increased cross-border investment.

... and in Germany

The global recovery was also reflected in Germany's outward and inward direct investment. All in all, this component of the financial accounts saw net capital exports of €44½ billion in 2010, representing a year-on-year increase of more than a half.

3 See UNCTAD, Global Investment Trends Monitor, No 5, 17 January 2011.

German direct investment abroad

The main reason for this increase was the sharp rise in foreign investment by domestic enterprises (€79 billion, compared with €56½ in 2009). Contributory factors behind this were the strengthening global economy, sharp growth in exports and the improvement in domestic enterprises' profits. German owners notably provided their subsidiaries abroad with additional equity capital (€42 billion, after €51½ billion in 2009). The decline compared with 2009 reflects the fact that mergers and acquisitions by German enterprises, which have an impact on this position, fell by just under 25% according to Thomson Reuters data.[4] Furthermore, German direct investment abroad was buoyed by somewhat higher reinvested earnings thanks to their improved profitability. (€23½ billion, after €22½ billion in 2009).[5] A further €13½ billion was loaned by domestic owners to their foreign subsidiaries, whereas the year before parent companies had borrowed funds from them in the form of intergroup loans (€18 billion).

Regional and sectoral breakdown

The manufacturing sector was a principal investor in 2010 (€20½ billion), prominent among which were vehicle manufacturers (€13 billion) – mainly via intergroup credit transactions. The chemical industry was also a large cross-border investor (€6½ billion). Both are high-export sectors with extensive international production chains. As in previous years, the domestic banking and insurance industry was an especially active investor (€17½ billion). Part of this, however, resulted from German banks' need to offset losses incurred by their foreign subsidiaries. At €40 billion, over half of German direct investment flowed into other euro-area states. The most important recipient countries included the Netherlands (€10 billion), France (€8½ billion) and Belgium (€7 billion). Aside from Europe, the USA also seemed a very attractive investment location (€11 billion), while emerging markets and developing countries absorbed €11½ billion of German direct investment.

Foreign direct investment in Germany

Foreign direct investment in Germany also recorded a rise in 2010, although the increased amount of €7½ billion to €35 billion was less than German direct investment abroad. This included foreign owners supplying their Germany-based subsidiaries with €23 billion in the form of (mainly long-term) intergroup loans and €8 billion in additional equity capital. Even though foreign direct investment both into and out of Germany has yet to reach pre-crisis levels, there is no mistaking the renewed interest in Germany as an investment location. Unlike before the crisis, however, large-scale mergers and acquisitions are not currently making a major contribution to this. Reinvested earnings (€5½ billion, up from €1½ billion in 2009) also generated a rise in funding inflows to subsidiaries of foreign enterprises based in Germany. This reflects *inter alia* the improved profitability of foreign-owned German enterprises.

4 Source: Thomson ONE Banker, Thomson Reuters. Completed M&A deals in which the purchaser owns 10% or more of the shares in the target enterprise after the transaction.
5 The cyclically induced increase in earnings by German enterprises' foreign subsidiaries was stronger than the reinvested earnings figures show, meaning domestic owners also received considerable dividend payments. The total profits of direct investment firms are recorded as investment income in the current account.

Regional and sectoral breakdown

The inflow of capital from foreign owners particularly benefited their domestic subsidiaries in manufacturing (€13½ billion), and here primarily the chemical industry (€5½ billion). In addition, foreign investors strongly increased their holdings in the banking and insurance industry (€10 billion) and in holding companies (€9½ billion). This notably included inflows of capital into Germany from Belgium (€9 billion), the USA (€5½ billion) and Central America (€5½ billion), where offshore centres play a significant role.

Other investment

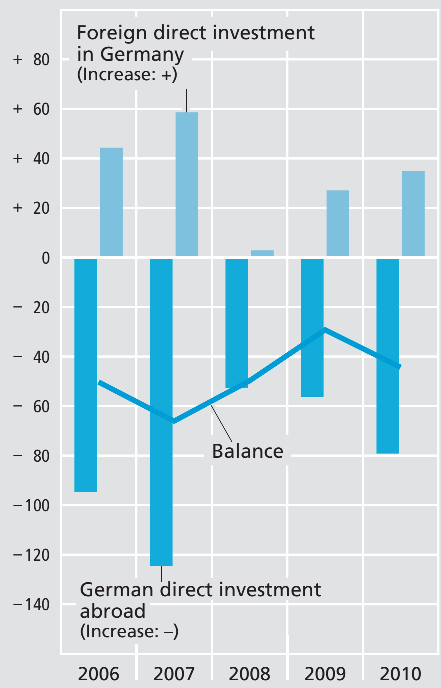
Net capital imports from other investment

While portfolio investment and direct investment both recorded net capital exports, other investment, which includes financial and trade credits (where not allocated to direct investment) as well as bank deposits and other assets, registered net capital imports in 2010. The inflow of capital amounted to €57 billion, which was a stark difference to the outflow of €49 billion net in 2009.

Non-banks

In contrast to the overall trend, non-banks recorded net capital exports of €15½ billion. The main reason for this was high outflows of funds through unsecuritised lending by enterprises and individuals (€48 billion net), who mainly increased their short-term bank deposits abroad. Conversely, the cross-border financial operations of general government led statistically to capital imports (€32½ billion net). The dominant factor in this were transactions associated with the aforementioned establishment of resolution agencies, which for statistical purposes are reported under general government. These agencies

Direct investment



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not only assumed credit claims on entities abroad – the credit institutions (and their affiliates) concerned also offloaded credit liabilities to non-resident counterparties on a particularly large scale. In addition, the resolution agencies partly resorted to foreign lenders for their ongoing financing.

Banking system

The outsourcing of financial positions was partly reflected in two-way cross-border credit flows from the banking sector which, however, were outweighed by the credit institutions' other unsecuritised foreign operations. For example, credit institutions further deleveraged their foreign loan portfolios; also affected was liquidity aid that had previously been granted to group enterprises abroad. At the same time, domestic credit institutions took up financial loans abroad on balance for

The dynamics of the Bundesbank's TARGET2 balance

In 2010, the Bundesbank's cross-border claims, which for statistical purposes include claims on the ECB, rose by €163 billion net as a result of transactions. A substantial part of this – €147½ billion – was attributable to an expansion of the TARGET2 balance. At the end of 2010, the Bundesbank's claims under TARGET2 stood at €325½ billion, all of which are claims on the ECB.

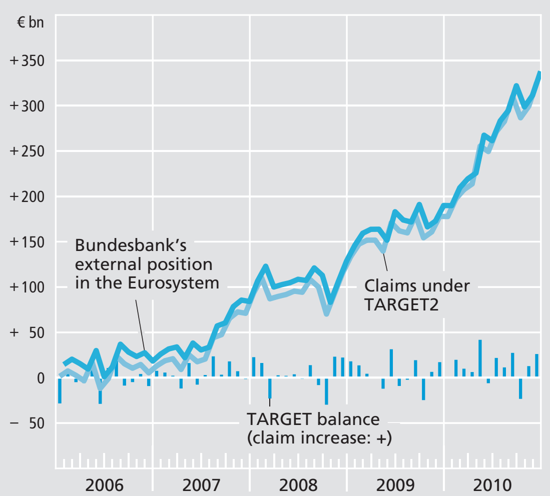
A systematic and exceptionally sharp rise in the Bundesbank's TARGET2 claims first emerged in 2007. During the previous years, Germany's TARGET2 positions had exhibited alternating signs and remained mainly within fairly narrow bounds.

The analysis below explains which transactions are predominantly reflected in the TARGET2 balance and how the observed increase came about. Finally, the associated risks are addressed.

The TARGET2 system for individual payments

Cross-border payments that arise, say, from foreign trade transactions or from securities or lending transactions with non-residents are normally carried out via the banking system. These transactions are reflected in the corresponding (changes to the) interbank claims or liabilities vis-à-vis the rest of the world. These types of payments can be settled using TARGET2 by EEA commercial banks and Eurosystem central banks. In addition to payments between credit institutions and from other systems (eg securities settlement systems), payments undertaken as part of the Eurosystem's open market operations are settled via TARGET2.[1]

Bundesbank claims on the Eurosystem



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Origin of TARGET2 balances

If, for example, foreign funds are transferred to a bank that participates in TARGET2 via the Bundesbank, this results in a liability of the Bundesbank to this bank (such as in the form of a credit to this amount on the bank's current account). In return, the transaction generates a Bundesbank claim for the same sum on the sending central bank. This central bank then in turn debits the account of the originating commercial bank. This requires the originating commercial bank to have a sufficient credit balance in central bank money. Central bank credit balances are primarily provided by the Eurosystem's monetary policy refinancing operations.

The resulting claims and liabilities generated at the national central banks by the multiple transactions over the course of a day normally do not fully balance out. Under the terms of a Eurosystem agreement, the outstanding claims and liabilities of all the national central banks participating in TARGET2 are transferred to the ECB at the end of the business day, where they are netted out. The resulting TARGET2 (net) balances hence arise from the cross-border distribution of central bank money within the Eurosystem's decentralised structure.

Statistical implications

The TARGET2 balance in the Bundesbank's balance sheet is therefore mainly attributable to cross-border transactions which involve banks that participate in TARGET2 via the Bundesbank.[2] On the one hand, it is affected by credit institutions' operations on the money and capital markets and, on the other, by transactions carried out by the non-banking sector, which generates payments via the banking system. As the TARGET2 balance represents a settlement balance vis-à-vis the ECB, it is classified as "cross-border" and is therefore assigned to the net external position; the (transaction-related) change is recorded in the balance of payments within other investment under the Bundesbank's short-term external credit balance. For the purposes of the balance of payments, an increase in TARGET2 claims is considered to be a net capital export. Around half of Germany's net capital exports since the start of 2007 are attributable to TARGET2.

From a euro-area perspective, TARGET2 balances largely disappear, just like the national current account balances

1 For a detailed account see Deutsche Bundesbank, TARGET2 – the new payment system for Europe, Monthly Report, October 2007, p 69 – 82, and Deutsche Bundesbank, Annual Report 2010, p 129. — **2** Several banks from other EU countries participate in TARGET2 via the Bundesbank in cases where their own national central banks do not participate in TARGET2.

within the euro area. The claims of the Bundesbank (and other national central banks) on the ECB are offset by the liabilities of other national central banks (see chart below). The ECB's remaining liability-side position was mainly generated through the Securities Markets and Covered Bonds Programme, and to a lesser extent through ECB seigniorage liabilities to the Eurosystem national central banks.

Reason for the increase

The sharp rise in the Bundesbank's TARGET2 balance since 2007 is essentially due to the tension on the money market and problems in the banking sector within the euro area. In the years prior to the financial crisis, Germany's cross-border payments were virtually balanced. Credit institutions' (short-term) net external position in particular acted as a kind of "offsetting item" in the balance of payments. As the current account surplus and frequent net capital imports in portfolio transactions meant that incoming payments regularly outweighed outgoing payments, most years saw outflows of funds (net capital exports) in banks' short-term credit business. Hence temporary TARGET2 positions were quickly reduced by private capital flows.

This all changed with the financial crisis. While funds tended to continue to flow into German banks from abroad due to non-bank payments and their own operations, after the onset of the crisis they were less willing, and in some cases unable, to lend these funds to foreign institutions on the interbank market. Instead, they gradually curtailed their refinancing operations with the Bundesbank – at least in the aggregate. Thus whereas the refinancing volume attributable to German institutions amounted to €250 billion at the start of 2007 it had fallen to €103 billion, by the end of 2010. Conversely, since then banks domiciled in a number of other euro-area countries have been receiving larger amounts of central bank money through the Eurosystem.

The TARGET2 balances accumulated at the national central banks thus also reflect the changed distribution in refinancing operations in the euro area since the start of the financial crisis. This has been facilitated by the ample supply of Eurosystem liquidity as a result of the full allotment of all bids in the refinancing operations since October 2008, which was intended to counter the dislocations on the money market. It is, however, not possible to generate more liquidity than this via TARGET2 as it is a closed system that merely transfers liquidity between accounts.

The balances will contract again as the tension in the money markets abates and the situation in the national banking systems eases. There is still much uncertainty, however, especially in the euro-area peripheral countries, which suggests that balances will not shrink rapidly.

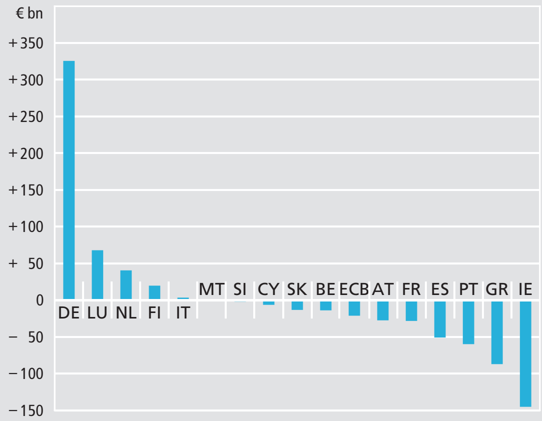
Risks from TARGET2 claims

There is no immediate change in the level of risk to the Bundesbank due to the rise in its TARGET2 settlement accounts. This risk is not directly related to the TARGET2 positions and arises from the risks associated with the Eurosystem's liquidity supply. Although the Eurosystem as a whole has indeed incurred additional financial risks by expanding its refinancing operations and adjusting the collateral framework during the financial crisis, this was the result of a deliberate decision of the ECB Governing Council aimed at maintaining the financial system's functional viability in a stress situation.

An actual loss will be incurred only if and when a Eurosystem counterparty defaults and the collateral it posted does not realise the full value of the collateralised refinancing operations despite the risk control measures applied by the Eurosystem. Any actual loss would always be borne by the Eurosystem as a whole, regardless of which national bank records it. The cost of such a loss would be shared among the national banks in line with the capital key. In other words, the Bundesbank's risk position would be just the same if the positive settlement balance from TARGET2 were accrued not by the Bundesbank but instead by another Eurosystem national bank.

TARGET2 settlement balances in the Eurosystem

As at end-2010



the first time in two years. All in all, German banks received €214½ billion worth of funds from abroad. The Bundesbank recorded official outflows in 2010 of €142 billion net, primarily due to a positive settlement balance under the TARGET2 large-value payment system vis-à-vis the European Central Bank, which is considered to be a capital export for balance of payment purposes (€147½ billion, see also the box on pages 34 and 35). Deposits by foreign central banks with the Bundesbank also rose by €5½ billion.

Reserve assets

Transactions ...

The transaction-related changes in the Bundesbank's reserve assets are shown in a separate item in the balance of payments. In 2010, the foreign reserves grew by €1½ billion, chiefly because the Bundesbank increased its reserve position with the International Monetary Fund (IMF).

... and balance-sheet adjustments

Larger than the transaction-related changes shown in the balance of payments were the balance-sheet adjustments made to the reserve assets in 2010, which are not specified in the balance of payments in line with internationally agreed conventions. This led, as in previous years, to a significant appreciation due to the customary end-of-year revaluation of the reserve assets at market prices (€35 billion). The lion's share of the revaluation gains were accounted for by gold (€31½ billion), with smaller write-ups also recorded for foreign currency reserves (€2½ billion) and the reserve position with the IMF (€1 billion). All in all, the reserve assets rose by €36½ billion in balance sheet terms to reach around €162 billion at the end of 2010.