Discrepancy between changes in net foreign assets and the cumulated financial account: an unsuitable indicator of wealth losses

In the first few years of European monetary union (EMU), increases in net foreign assets could easily be ascribed to cumulated net capital exports as captured in the balance of payments.[1] To a large degree, other determinants such as valuation effects or statistical peculiarities cancelled each other out over time. However, since around 2007, it has been possible to observe a growing discrepancy which by the end of 2013[2] had swollen to €636½ billion.[3] Differences between the cumulated net capital exports[4] and changes in foreign assets are commonly interpreted as an indicator of sizeable losses arising from German foreign investment during the financial crisis.[5] Here, write-downs and value changes are thought to have radically eaten into resident investors' cross-border claims. This has given rise to the argument that German foreign exposures as a whole generate a low yield and are therefore a "bad deal". This view is a fallacy because, when interpreting the discrepancy, it is essential to keep in mind the manifold statistical and methodological differences that exist between the flow accounts used for the balance of payments and the statements of stock used in the international investment position (IIP). In this context, crisis-induced write-downs played a role but were insignificant at the aggregated level. Ultimately, it can be shown that Germany's external assets generated a higher total return than, for example, its external liabilities – both before and during the crisis.

Factors contributing to the discrepancy

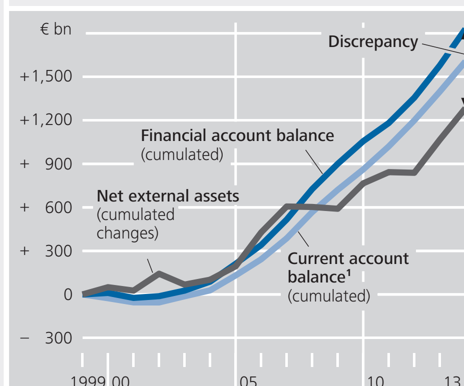
Statistical factors

Statistical factors have led to marked differences between the (cumulated) capital flows and changes in Germany's external assets (which since 2007 have totalled more than €400 billion). For many items, the two accounting systems used for the balance of payments and the IIP are based on different primary statistics. This can result in deviations which, however, simultaneously allow data collection systems to be monitored and improved. Financial derivatives, which for years have been recorded in the balance of payments where they have generated net capital exports, are one example of this. Starting with the monetary financial institutions (MFIs), data on derivatives holdings in Germany have also gradually been collected since 2010 and incorporated into the IIP statistics. Nonetheless, as 2013 came to a close the net financial derivatives item recorded in the IIP stood around €173 billion below the amount that would normally

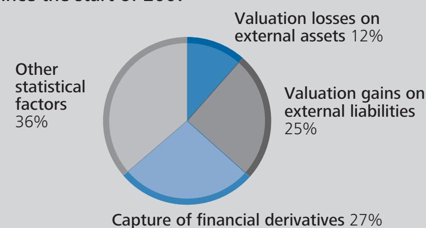
1 See Deutsche Bundesbank, Germany's international investment position since the beginning of monetary union: developments and structure, Monthly Report, October 2008, pp 15-32.
2 According to provisional data relating to the quarterly international investment position.
3 If we take the period commencing with the launch of EMU, the discrepancy narrows to €540 billion because, in the first few years of monetary union, net external assets expanded at a higher rate than that recorded for cumulated balance of payment transactions.
4 Occasionally, this is calculated using the cumulated balances of the current account. The difference between the financial and the current account (including capital transfers) is recorded under the statistical item "errors and omissions" in the balance of payments. Cross-border cash movements, which the statistics have hitherto been unable to reliably capture for the euro area, are of key significance to the (broadly positive) errors and omissions item.
5 See K Klär, F Lindner and K Šehović (2013): Investition in die Zukunft? Zur Entwicklung des deutschen Auslandsvermögens, Wirtschaftsdienst: Zeitschrift für Wirtschaftspolitik, 93 (3), pp 189-197; as well as G Baldi and B Bremer (2013), Verluste auf das deutsche Nettoauslandsvermögen – wie sind sie entstanden?, DIW Weekly Report, No 49, pp 32-40. See also European Commission, Macroeconomic Imbalances – Germany 2014, European Economy, Occasional Papers 174, March 2014, p 72.

have been expected given the cash flows in all sectors since 2007. This discrepancy is mainly attributable to temporarily large-scale purchases by securitisation vehicles of financial derivatives captured in the balance of payments[6] as a means of hedging structured securities issued in Germany (known as certificates).[7] The relevant cross-border transactions relating to the matching certificates are then recorded as portfolio investments. The securities item (which includes the securities deposit statistics) and the equity stakes of direct investment enterprises (which includes the foreign direct investment stock statistics) are another two examples of where different data sources are used. Leaving aside financial derivatives, the combined effect of statistical factors was to reduce the reported figure for Germany's external assets by around €240 billion compared with their expected level after taking into account capital flows.

Financial account, current account and net external assets



Factors contributing to the discrepancy since the start of 2007



1 Including capital transfers.
Deutsche Bundesbank

Valuation effects

Valuation-related adjustments can be primarily explained by market price and exchange rate effects. Among other things, market price changes can affect securities exposures, real estate, the Bundesbank's gold holdings as well as the equity stakes of listed enterprises. Exchange rate effects, meanwhile, impact on any exposures denominated in foreign currency. Given the typical fluctuations in market prices and exchange rates, valuation effects usually even out over time, at least to some degree. The IIP thus offers no more than a snapshot of the aggregate external position. All in all, market price and exchange rate effects have diminished Germany's net external assets by €233 billion since 2007. The €177½ billion drop in net external assets attributable to market price effects was notably explained by price gains on German bonds held by non-residents. The safe haven status which German bonds enjoyed during the crisis sent non-resident investors flocking to Federal bonds, which also placed additional pressure on their yields and contributed to price gains.

On balance, €55½ billion of the drop in net external assets was explained by exchange rate effects. Between 2007 and 2012, positive and negative exchange rate effects virtually cancelled each other out. In net terms, this means that the exchange rate effect can be almost entirely traced back to the appreciation of the euro during the past year which, on balance, explained the drop in net external assets on account of the higher proportion of positions denominated

6 In future, the IIP should also include derivatives holdings in the corporate sector, which also encompasses securitisation vehicles, the aim being to close another gap in the data collection system.
7 See Deutsche Bundesbank, Certificates and warrants in the balance of payments, Monthly Report, March 2008, pp 26-27.

in foreign currency included in Germany's external assets.

Lasting impairments caused by write-downs and disposals of assets are reflected, for instance, in banks' general provisions for loan losses as a separately captured item. They totalled €37½ billion in the IIP during the financial crisis.

Profitability of German external assets

This section presents two suitable methods for gauging the profitability of external assets – the return on assets (expressed as investment income over external assets), and the total return (which includes valuation effects).

Return on assets

As regards cross-border investment income (which primarily consists of dividends and interest income), since 2004 German investments abroad have outperformed non-residents' assets in Germany. At last count (2013), investment income on German external assets equated to a return of 2.8% compared with just 2.1% on non-residents' assets in the German market.

Total return

Besides considering the income flows recorded in the balance of payments, it is also possible for market price-driven and exchange rate-driven changes included in the IIP as well as valuation allowances made in respect of write-downs to be allocated to the various investment instruments, and to set them in relation to the level of external assets at the start of the period in question. Calculated in this manner, the total return on German external assets averaged 4.0% between 2005[8] and 2013, slightly outperforming the 3.8% total return on non-residents' assets in Germany. Broken down by investment instrument, German direct investment abroad yielded a higher-than-average total return of 7.2%. By contrast, foreign enterprises' direct investment in Germany generated an annual total return of just 4.9%.

Conclusion

To a very large extent, the discrepancy between cumulated net capital flows and the increase in net external assets observed between 2007 and 2013 is not the result of crisis-induced wealth losses but can be explained by differences in statistical data collection methods and by increases in the prices of German external liabilities. All in all, both the return on German external assets and the total return (which also includes valuation effects) exceed the return on external liabilities. What this ultimately indicates is that German investors have fared relatively well with their investment abroad. In any case, it is flat-out inaccurate to say that German foreign investments have performed particularly poorly.

8 A lack of detailed data from earlier years prevents the total return from being calculated for the period before 2005.