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German investments abroad – a bad deal?

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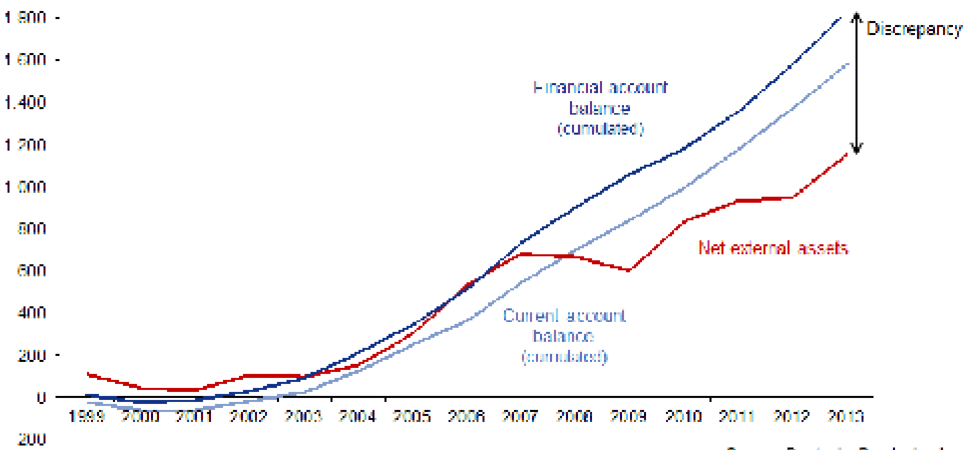
German investments abroad – a bad deal?

In 2013 the German economy generated the world's highest current account surplus, overshooting the EUR 200bn mark with further rises likely in the future. The trend provides plenty of new ammunition to critics of Germany's current account surplus, which has been a hot topic of debate for years now. In the one camp, there are those who see the current account surplus as testimony to Germany's economic strength and solid competitive standing. In the other, we have those who believe that it is an upshot of weak domestic demand. There is a mounting chorus of critical voices abroad claiming that, with its wage dumping tactics, Germany is putting foreign competitors at a disadvantage while at the same time exporting deflation and unemployment.

In Germany itself, critics are focusing on the fact that Germany's export surpluses are financed by lending to foreign countries, raising the question as to what the real value of our receivables actually is. Are we not getting fair value for our exports? Recent research on the matter suggests that Germany has suffered value losses on its net foreign assets corresponding to more than twenty percent of its economic output since 2006, fueled by the financial crisis.[1] If the analysis is indeed correct, dramatic losses on this scale raise a whole number of questions. Do the Germans have a certain penchant for speculative or purely tax-motivated investments ("dumb German money"), frittering away hard-earned current account surpluses in the process? Is it a bad idea after all for a country like Germany, subject to unfavorable demographic trends, to invest a chunk of its savings abroad on diversification grounds and given the more attractive return opportunities? Should German investors keep their money at home instead? The answer to all of these questions is "no", as a closer analysis shows.

German external assets a bad investment?

Current account and net external assets (EUR bn)



Source: Deutsche Bundesbank.

[1] G. Baldi and B. Bremer (2013), Verluste auf das deutsche Nettoauslandsvermögen – wie sind sie entstanden?, German Institute for Economic Research (DIW) weekly report, no. 49, 2013, pp. 32-40. See also:
- European Commission, Macroeconomic Imbalances Germany 2014, European Economy Occasional Papers 174, March 2014, p. 72.
- 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.

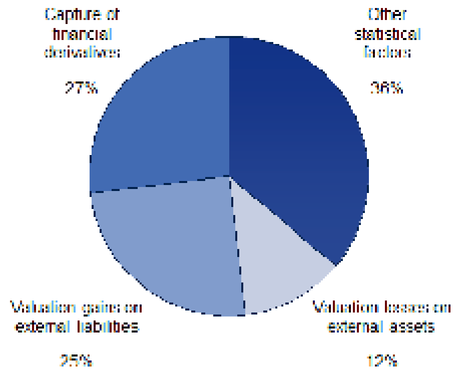
So how did these losses arise?

The matter is not as clear as it might appear at first glance. The authors of a recent DIW study dedicated to the subject, Baldi and Bremer, who believe that deadweight losses are on the cards for the generations to come, mention that valuation fluctuations could also be caused by possible measurement errors and insufficient data recorded on certain transactions or stock levels.[2] This does, however, go some way to explaining the situation. The Bundesbank – which is, after all, the primary source of the statistics that are up for discussion – commented on the matter in its Monthly Report for May 2014.[3] It concludes that the theory that German investors have lost hundreds of billions in savings with foreign investments is a fallacy. We share the Bundesbank's view.

The Bundesbank reaches this conclusion by looking at the driving forces behind the growing gap between net foreign assets and the cumulated financial account since 2007, which is often viewed as an indicator of hefty wealth losses incurred by German investors abroad. If the critics are right in claiming that German investors abroad are destroying assets on a massive scale, then the discrepancy, which has swollen to no less than EUR 636.5bn, should largely be made up of write-downs and value changes that have radically eaten into foreign assets in recent years.

The Bundesbank's analysis shows, however, that more than 60% of the discrepancy in the period from 2007 to 2013 can be explained by statistical factors. This is because there are marked methodological differences between the flow accounts used for the balance of payments and the statements of stock used in the international investment position (IIP). For many items, the two accounting systems are based on different primary statistics. The difference is particularly pronounced when it comes to recording financial derivatives, which for years have been recorded in the balance of payments, but have only been gradually incorporated into the IIP statistics since 2010.

Factors contributing to the discrepancy since the start of 2007



Source: Deutsche Bundesbank

[2] G. Baldi and B. Bremer (2013), Verluste auf das deutsche Nettoauslandsvermögen – wie sind sie entstanden?, DIW weekly report, no. 49, 2013, p. 33
[3] Bundesbank, Discrepancy between changes in net foreign assets and the cumulated financial account: an unsuitable indicator of wealth losses, Monthly Report for May 2014, pp. 52-54.

So valuation-related factors, which can be primarily explained by market price and exchange rate effects, only account for 37% of the discrepancy. Since we are looking at a net asset position, it is not only the valuation changes affecting assets (German investments abroad) that are relevant, but also those affecting liabilities (foreign investments in Germany). An analysis of both reveals that around 25% of the discrepancy between the financial account and net foreign assets can be attributed to valuation gains on foreign investments in Germany. The tendency to flee towards lower-risk securities during the financial crisis fed higher demand for German government bonds, which were considered a "safe haven". The resulting price increases contributed to the substantial valuation gains in foreign liabilities. This means that valuation losses on foreign assets only explain 12% of the discrepancy. Here, however, exchange rate effects (the appreciation of the euro against other currencies), which often cancel each other out over time, at least partially, are more significant than permanent losses caused by write-downs and disposals of assets.

An analysis of the valuation losses shows that these have arisen mainly since 2007 as a result of the global financial crisis and the ensuing euro debt crisis and that they concern in particular portfolio investments. Money was lost, by way of example, on Greek government bonds and US mortgage securities, but also on real estate investments in euro crisis countries. This is hardly surprising given that the eurozone and the US rank among the most popular destinations for German foreign investment. So the asset losses inflicted on German investments abroad since 2007 are extremely limited in view of the financial crisis. Consequently, it is flat-out inaccurate to speak of fundamentally bad investment decisions being made with investments abroad: if we look, for example, at the losses incurred by German investors on shares held abroad, these are in line with the development of the global indices.

German foreign investment fairly profitable

A closer analysis of the data reveals that German foreign investments certainly can be described as generating substantial returns. This is evident from both the nominal returns (excluding valuation effects in the portfolios) on, and the overall performance (including valuation effects in the portfolios) of foreign assets. Like the Bundesbank, we will refer to the former as "return on assets" and the latter as "total return". The former only looks at cross-border investment income (which primarily consists of interest and dividends). According to the calculations, the return on assets has been consistently outperforming non-residents' assets in Germany since 2004. Last year, 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. If we only look at securities investments, our calculations, based on the available statistics for 2013, produce a return on German investments abroad of 3.6% and a return on foreign investments in Germany of 2.3%. The fact that the difference in returns is so pronounced for portfolio investments is hardly surprising given the "safe haven" status of German government bonds during the crises of recent years, pushing returns down considerably.

The calculation of the total return on German foreign assets includes not only income flows, but also market price-driven and exchange rate-driven valuation effects, as well as valuation allowances made in respect of write-downs, and sets them in relation to the level of external assets at the start of the period in question. In the period from 2005 to 2013, the total return on German external assets averaged 4.0%, while investments by non-residents in Germany achieved a return of "only" 3.8%. The discrepancy is even more pronounced for direct investments. German direct investment abroad yielded an average total return of 7.2% during this period. By contrast, foreign direct investment in Germany generated an annual total return of just 4.9%. To sum things up: while it may be the case that Germans are ploughing their money into unprofitable investments abroad in isolated cases, this certainly does not apply across the board.

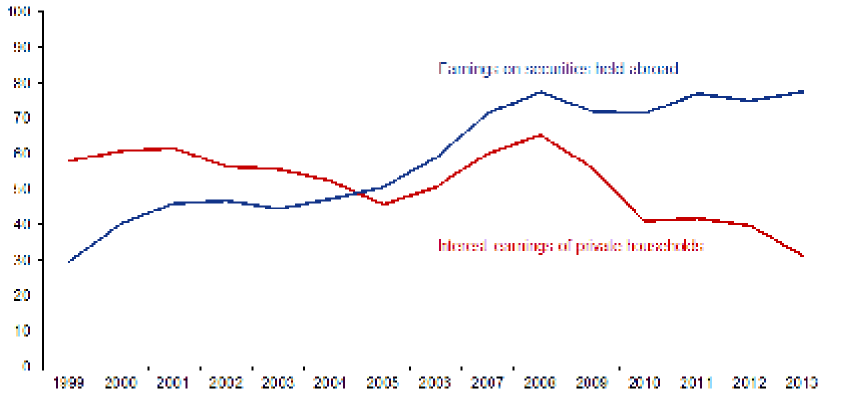
Capital accumulation abroad is necessary and worthwhile

An aging society requires additional savings to ensure that it can meet the demand for goods extending beyond the volume that can be produced domestically in the future. As a result, the accumulation of assets abroad by Germans can be seen as a form of funded retirement provision for our society. Given the satisfactory returns that have been generated, this has been a successful strategy to date. As in other contexts, any criticism regarding capital funding proves unfounded in this case.

In 2013, German income from investments abroad came in at around EUR 186bn, compared with investment income paid abroad totaling around EUR 111bn. This positive balance of around EUR 75bn corresponds to around 2.7% of German gross domestic product. So this investment income surplus could already help to cushion the blow of a fairly sizeable goods trade deficit. This means that Germany certainly has the potential to continue to meet its demand for goods as its production output falls due to demographic trends.

Growing importance of foreign investment income

in EUR bn



Sources: Deutsche Bundesbank, Statistisches Bundesamt

Despite the increase in financial assets, the interest income of private households has been on a downward spiral for several years now. The average interest rate on deposits (including cash) and debt securities has plummeted, falling from a good 4% in 2000 to only 1.4% last year. The low interest on domestic bank deposits is a key factor in this development, which hits savers hard. Although the return on assets for German securities investments abroad is also not as high as it used to be these days, it is still fairly substantial at 3.6% on average. German income from foreign securities has, after all, almost doubled since 2000.

Given that the interest rate level in Germany is very low in an international comparison as well, there is no getting round international diversification for anyone wanting to put their savings into a promising investment. Professional asset managers have been putting this into practice for some time now. For the average saver, balanced products are also available on the market.

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