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International Investments and Current Account Imbalances: The Importance of Valuation Changes

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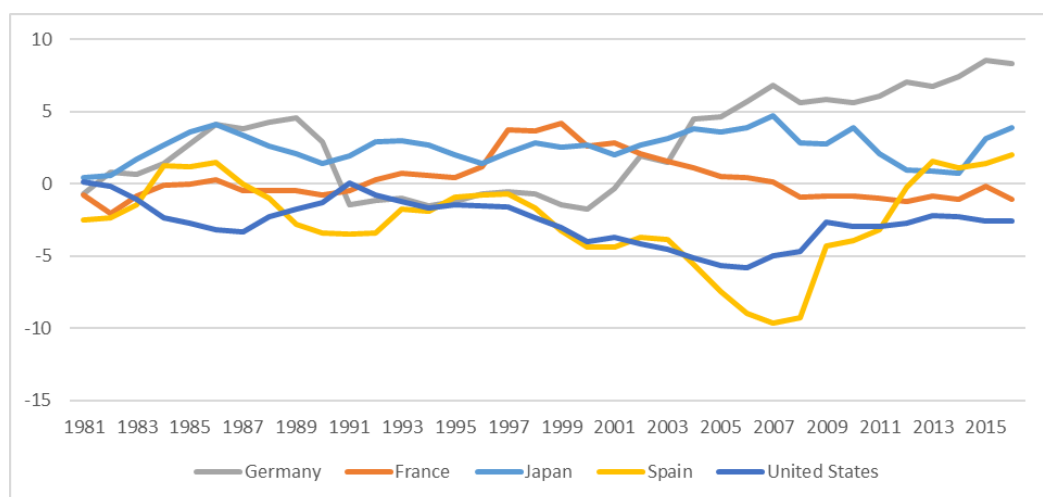
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Global capital flows have strongly increased from the 1980s until the outbreak of the financial crisis. As a result of this development, Germany's foreign investment has risen to around 250 percent of gross domestic product while foreign investments in Germany have increased to about 200 percent of Germany's gross domestic product. This positive difference between Germany's assets and liabilities is a result of the country's continuous current account surpluses, which represent net financial flows – the difference between outflows and inflows. Investments abroad offer investors the opportunity to diversify their savings and possibly generate higher returns than in Germany. In return, however, foreign investment also entails risks; fluctuations in price and exchange rates can lead to high losses. Potential value fluctuations on international investments are relevant for Germany. German policy advisors controversially discuss whether additional investment in domestic infrastructure or research and development would yield higher and less volatile returns than some of Germany's foreign investments.

In the past decades, Germany has mostly shown a current account surplus, except in the 1990s, which was marked by reunification (Figure 1). Since 2001, there has been an ongoing increase in current account surpluses for Germany, which is the subject of intensive discussions among economists and commentators alike (see, for example, [Petersen, 2015](#); [Grömling et al., 2016](#); [Südekum and Felbermayr, 2017](#)). Some countries in the euro area such as Spain had high current account deficits before the financial crisis, which have since then declined or changed into surpluses. On the other hand, France had a current account surplus before the outbreak of the financial crisis, which has now given way to a small deficit. The current account deficit of the United States first declined significantly after the outbreak of the financial crisis, but it has not declined further in the last few years. Japan, like Germany, usually has high current account surpluses.

An important reason for the increase in Germany's current account surplus is the specialization of the German economy in the production of intermediate and capital goods; such goods are particularly in high demand during periods of high economic growth in emerging economies such as China (Council of Experts, 2014). In addition, the long period of German wage moderation in the 2000s led to an improvement in the price competitiveness of German companies (Joint Economic Forecast, 2017a). At the same time, weak wage developments slowed the growth in private consumption, which dampened domestic demand and imports. Germany's demographic development has also supported the growth of its current account surplus for some time; for reasons of old age provision, the German population has a high savings rate of households. These savings have implied a loss in domestic consumption and, instead, some of the savings have been invested abroad. In addition, higher corporate savings have contributed to the increase in the current account surpluses (Joint Economic Forecast, 2017b). However, it should also be noted that special effects have increased the current account surplus in recent years – for example, the weak exchange rate of the euro or the dampening effect of low oil prices on nominal imports.

Figure 1: Current account surpluses of a few selected countries (1981-2016)

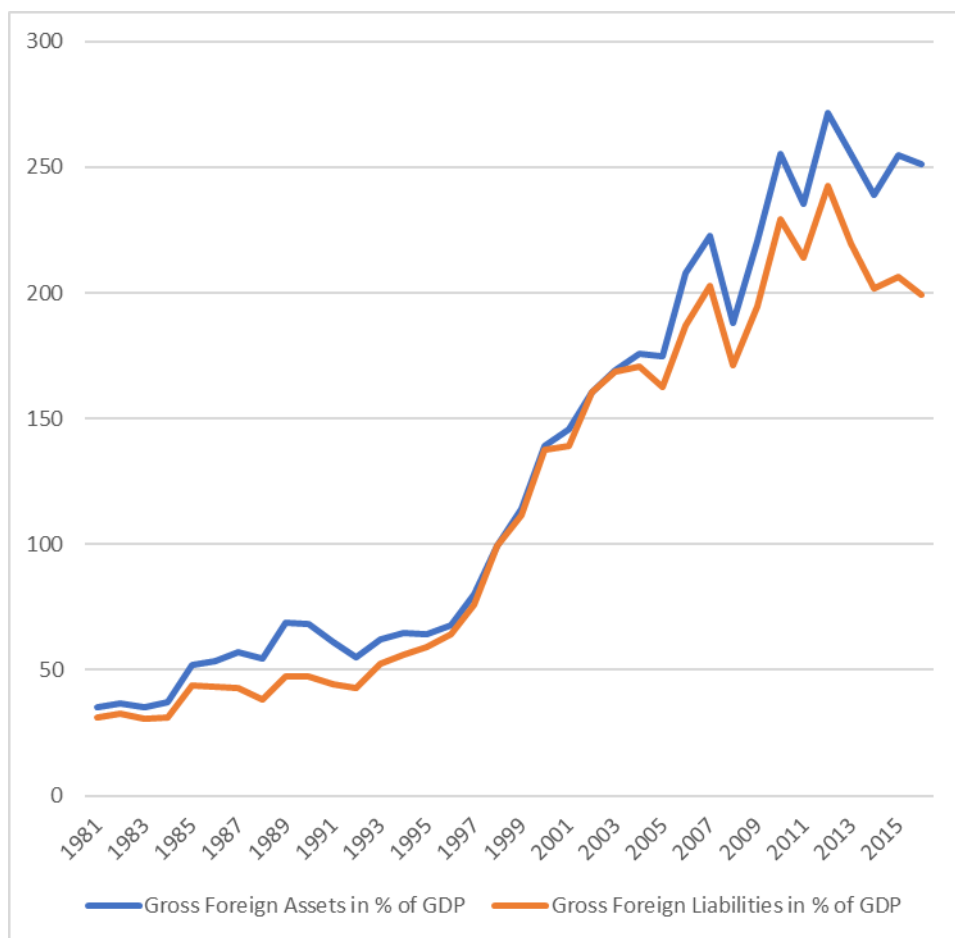


Source: IMF

The growing importance of foreign assets and liabilities

Germany's current account surpluses imply that households and companies viewed as a whole use a portion of their income to invest abroad. As a result of the continuous current account surpluses, German foreign assets have risen significantly in recent years. The net foreign assets, that is the difference between foreign assets and liabilities, now account for about 50 percent of Germany's gross domestic product. Growth in the gross positions has been even higher. For example, Germany's gross foreign investment since the 1980s has grown by around 200 percentage points to around 250 per cent of annual economic output (Figure 2). For other developed economies, a similar development can be observed in gross positions; however, since the outbreak of the financial crisis, global financial flows have been subdued. In the course of this development, the gross positions of many countries have stabilized or even somewhat declined.

Figure 2: German Foreign Assets and Liabilities (1981-2016)



Source: IMF

The accumulated gross foreign investments result in high international income, such as in the form of dividends or interest payments. For example, roughly one-fifth of the German current account surplus can be attributed to the income generated by rising net foreign assets (Deutsche Bundesbank, 2017a). The high level of international investments also means that even small changes in the value of investments can cause large changes in the value of foreign net assets relative to the gross domestic product. As a result, the development of net foreign assets is increasingly decoupled from the current account, which only reflects net financial flows. For these reasons, it seems useful to discuss current account imbalances in the context of the growing international assets and liabilities and the resulting valuation changes (see Obstfeld, 2012; Lane, 2013; Lane, 2014). For instance, evidence has emerged that, since the beginning of the financial crisis, countries with average current account deficits have been more likely to experience valuations gains than losses, while countries with average current account surpluses have been more likely to experience losses (Bergant, 2017; IMF, 2017). If these results prove to be robust in future studies, countries with current account surpluses, such as Germany, should expect valuation losses on their net foreign assets.

In terms of valuation changes, cross-border capital flows promote "international risk sharing" since positive or negative economic developments of a given country also lead to capital gains or losses in other countries (see, for example, Obstfeld and Rogoff, 1996; [Lautenschläger, 2016](#)). The existing literature suggests that this risk sharing mechanism works at least to some extent. Studies show that changes in the value of foreign assets and liabilities contribute significantly to the international risk sharing mechanism (see [Schmitz, 2010](#); [Bracke and Schmitz, 2011](#); [Balli et al., 2012](#)).

Germany so far without exorbitant privilege – should it increase domestic investments?

The literature points out interesting patterns in the structure of German foreign liabilities (see, for example, [Lane and Milesi-Ferretti, 2007](#); [Lane and Milesi-Ferretti, 2008](#); [Gourinchas and Rey, 2014](#); [Baldi and Bremer, 2015](#)). Foreign companies and savers hold a relatively high proportion of their investments in Germany in the form of fixed-interest investments. A similar pattern can be observed for the United States and Japan. Germany, thus, takes on the role of a so-called "safe haven" for foreign capital and the interest rates on German bonds are low in international comparison.

The role of Germany as a safe haven raises the question whether Germany, like the United States, can benefit from a so-called "exorbitant privilege". The term "exorbitant privilege" was coined in the 1960s to describe the unique position of the United States in the Bretton Woods system of fixed exchange rates (see [Eichengreen, 2011](#); [McCauley, 2015](#); [Rogoff and Tashiro, 2015](#)). Due to the position of the dollar as the reserve currency, there was a high demand for U.S. government bonds from abroad, resulting in a relatively low interest rate. Nowadays, the term is usually used in a broader sense to point to the continued high demand for low-interest US government bonds. This enables the United States to generate, on average, higher returns from its foreign assets, and especially its direct investment, than it pays for its liabilities. As a result, the United States can afford a continuous trade deficit. Existing studies with respect to the United States point out that the American exorbitant privilege is not only due to the low rate of return on domestic bonds, but that it is mainly the result of high income on American direct investment abroad. However, some studies argue that the exorbitant privilege is smaller than often claimed (for a review see, for example, [McCauley, 2015](#)). In addition, during global recessions, the US may incur large valuation losses because risky U.S. assets abroad tend to decrease in value during such periods of time ([Gourinchas and Rey, 2016](#)).

Germany can also be viewed as a country that could enjoy an exorbitant privilege due to its role as a safe haven for foreign investors. However, developments in the past point to losses rather than to significant gains on Germany's net foreign assets. Previous analyses of Germany's international stocks and flows for the period 2006-2012 find valuation losses for Germany of more than 20 percent of gross domestic product (see [Bach et al., 2013](#); [Baldi and Bremer, 2015](#)). However, [Frey et al. \(2014\)](#) pointed out that the actual losses are likely to be smaller after considering measurement and delimitation problems. For the period starting in 2013, valuation changes for Germany and other advanced economies are shown in official statistics,

and divided into market price and exchange rate fluctuations (see [Deutsche Bundesbank; 2014a](#); [Schipper, 2015](#)). These data do not reveal significant valuation gains on Germany's net foreign asset position, either ([Deutsche Bundesbank, 2014b](#); [Deutsche Bundesbank, 2015](#); [Deutsche Bundesbank, 2016](#); [Deutsche Bundesbank 2017b](#)). [Knetsch and Nagengast \(2017\)](#) even found a small positive difference in international investment income, but they did not investigate valuation changes.

Overall, there seems to be no evidence for an exorbitant privilege of Germany. This could be related to the fact that German investors have preferred fixed-income investments abroad as opposed to riskier equity investments (see, for example, [Baldi und Bremer, 2013](#); [Gourinchas und Rey, 2014](#)). This distinguishes Germany from other advanced economies, especially the United States but also the United Kingdom or France, which have a greater proportion of their total foreign investment in equity investments; that is, foreign direct investment or equity investments. Also, countries such as Japan and Switzerland with high current account surpluses similar to Germany have invested a greater part of their foreign investment in equity. However, some of the German fixed-income investments abroad – particularly those invested in the European periphery - experienced high valuation losses during the financial crisis ([Gourinchas and Rey, 2016](#)). While Germany did not enjoy an exorbitant privilege in the period preceding the financial crisis, it still incurred losses during the crisis similar to the United States, which enjoys an exorbitant privilege during good times.

The development of the German current account surpluses and the German net foreign assets are discussed controversially among German economists. [Sinn \(2017\)](#) doubts, for example, that German savings are invested well. [Fratzscher \(2017\)](#) and [Hellwig \(2017\)](#) also argue that Germany's foreign assets are not optimally invested. Other economists, on the other hand, argue that the possible losses on German foreign assets are exaggerated ([Council of Experts, 2014](#); [Frey et al., 2014](#)). Some economists argue that the current account surpluses do not only reflect a high domestic savings rate, but also a low level of private and public investment in Germany (see, for example, [Bach et al., 2013](#); [BMW, 2015](#); [Hellwig, 2017](#)). In particular, they argue that domestic investments, which would increase the domestic capital stock, could also be associated with higher macroeconomic returns than Germany's investments abroad. In general, there seems to be a broad consensus on the fundamental desirability of policy measures to increase public investment and stimulate private investment in Germany. However, the extent of the domestic investment weakness and the effectiveness of economic measures to address this weakness are evaluated differently (see, for example, [Bach et al., 2013](#); [Council of Experts, 2014](#); [Joint Economic Forecast, 2017a](#)).

Conclusion

Against the backdrop of the sharp rise in foreign investment over the last forty years, valuation changes have become increasingly important for net foreign assets. Even if the global capital flows developed less dynamically since the financial crisis, the high foreign assets and liabilities are likely to persist in the future. Discussions about current account balances should, therefore, be conducted by taking into account the high levels of international investment positions and the associated valuation

changes, which are potentially large. Against the backdrop of these value changes on foreign assets and liabilities, a discussion is being held in Germany as to whether additional investments - for example in domestic infrastructure or in research and development - could generate higher and less volatile returns than some of Germany's foreign investments.

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