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Returns on Germany's Foreign Savings: Equity rather than TARGET balances?

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The true nature of Germany's foreign investment is often misunderstood or misrepresented. This misunderstanding can be illustrated by the following three statements:

1. The net international investment position (NIIP) of Germany is €1.8 trillion. The TARGET[1] balance of the *Bundesbank* currently amounts to €850 billion. Conclusion: the TARGET balance represents close to one-half of the German NIIP, therefore half of the balance position is invested in an asset that yields zero.

2. The NIIP of Germany is €1.8 trillion. German foreign direct investment abroad amounts to €1.9 trillion. Conclusion: all of German savings abroad are invested (wisely?) in equity.

3. The NIIP of Germany is €1.8 trillion. Portfolio debt assets represent around €1.9 trillion. Conclusion: Germany has invested its surpluses only in low-yielding debt instruments.

All of these statements are true. But they are also misleading because they look only at partial gross positions. The lesson is clear: one should not make sweeping statements after looking only at one particular item or only one side of the German investment position. Germany, like most other advanced countries, is enmeshed in a complex web of financial relations, which one should consider as a whole. In many cases, the gross positions are large relative to the net ones. For example, for FDI the gross positions are 5.7 times larger than the net one, for portfolio equity 6.0 times, for portfolio debt even 66,[2] and for 'other' (which includes TARGET balances) they are 7.0 times larger.

In order to truly evaluate whether the return on German excess savings is 'normal', one has to regard both the asset and liability side and not just individual positions or the overall net balance. The latter often serves as the foundation to the claim that the huge German current account surpluses are being wasted abroad (see, for example Sinn, 2017, or a longer list in Busse & Gros, 2016). This literature often focuses on one particular item of the foreign

[1] TARGET stands for "Trans-European Automated Real-time Gross Settlement Express Transfer" system.

[2] Due to the nearly balanced portfolio position and large gross positions.

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investment position of Germany, namely the TARGET II payments system run by the ECB. These balances are an attractive item because they are clearly identifiable and carry a (nominal) return of zero.

Yet a closer examination of overall German investment abroad shows that the return on its foreign assets is comparable to that of its peers in Europe. The key difference is on the liability side. For example, in 2016 the average return on all foreign assets held by Germany (or rather those recorded in its IIP) was 2%, which is even slightly higher than the return of 1.9% recorded by France for the same year.

It is the return on its liabilities, namely that on foreign investment in Germany – especially equity investment, that is different and makes the German case special. Given the relatively strong performance of the German economy, the return foreigners have made on their investments in German equity has been substantially higher than the return German investors have made on their equity abroad. This is the root cause of Germany's relatively low net investment income, despite its huge net foreign position.

Table 1 below provides more detail for the year 2016. Investment abroad comes in two forms: with control and without control. If the investor assumes control (i.e. usually a share in the capital of more than 10%), the investment is classified as FDI (foreign direct investment). If the investor acquires less than 10% of the capital, the investment is classified as portfolio investment. Table 1 shows that the rate of return on German FDI abroad was 4.1%, equal to that of French FDI abroad. For portfolio equity, German investors did even better than French investors as the return on German portfolio equity investment abroad was 1.9%, compared to only 1.7 % for France.

Table 1. Returns on investment, 2016

	Return on assets abroad		Return on liabilities at home	
	Germany	France	Germany	France
Overall	2.0	1.9	1.8	1.4
Direct investment	4.1	4.1	3.0	2.4
Portfolio investment	2.3	2.1	2.4	2.1
- Equity	1.9	1.7	3.7	2.3
- Debt	2.5	2.3	1.9	2.0
Other investment (incl. TARGET balances)	1.0	0.7	0.8	0.6

Note: The average returns (both on assets and liabilities) have been in decline in both countries since the financial crisis. The higher return on equity and FDI investments in Germany (relative to other euro area countries) has persisted since the introduction of the euro, although the gap has widened considerably since 2013, in favour of France.

Source: Eurostat, 2017.

The significant difference arises for FDI in Germany. The recorded return on FDI was 3% in Germany, but only 2.4% in France. For portfolio equity, the difference was even greater: investing in the German equity market yielded a return of 3.7%, but doing the same in France only yielded 2.3%. A difference of about 1 percentage point might appear insignificant, but given that the gross positions are so large, a small difference in the return can have a significant impact on the overall net return.

One way to illustrate the importance of the liability positions for the measured return on Germany's overall (net) foreign investment income is to ask what would have been the income for Germany if the return on equity (portfolio and FDI) in Germany had been similar to that of France. In this hypothetical case, the German net investment income would have been €60 billion (in 2016) versus the actual amount of €45 billion, or a third higher than actual net investment income.

Returning to the TARGET balances, one has to keep in mind that if any country were to leave the euro its government would be responsible for indemnifying the ECB for any net claims that remained at the time of separation. This claim would not be without value since, as the Brexit negotiations show, the EU has a strong negotiating position. Moreover, even if the country leaving the euro were unable or unwilling to indemnify the ECB, the ensuing losses would be shared among the countries that remain in the euro area, according to their capital keys in the ECB. This implies that Germany's TARGET claims enjoy a 'joint and several' guarantee of the other euro area members, such as France, Spain, the Benelux, etc. They are thus some of the safest foreign assets that Germany can accumulate.

Moreover, to the extent that the counterpart to the TARGET balances are short-term German government bonds, a positive carry would still remain with Germany since the yield on the latter is negative.

Our overall conclusion is that the TARGET balances might not represent the best investment instrument, but they have a rather limited impact on what Germany earns on the huge amount of excess savings that have been invested abroad. What is more important is that the yield on the foreign equity investment in Germany (which is also considerable) has been higher than that of German equity investment abroad because the German economy has been stronger. It remains to be seen whether this pattern continues. There is no guarantee that the German economy will continue to out-perform the rest of Europe, especially if the problems in the German motor vehicle industry continue. In this case, Germany's net returns could suddenly increase.

The more general lesson is that two-way cross-border equity investment can be very useful as a shock absorber. The better-performing economies pay more to their foreign investors, and the countries with stagnant economies pay less. With inward equity positions worth between 50 and 80% of GDP, even for the larger euro area economies, this effect can become significant.

References

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