German foreign investment, especially direct investment, is better than its reputation. Criticism of Germany’s net capital exports in the debate over the country’s current account is based on too narrow a view. Revenue from foreign assets is not the cause of high current account surpluses, nor are there any indications that investors are neglecting the return on cross-border investments. That is the conclusion of a recent report produced for the German Federal Ministry of Finance by the Kiel Institute for the World Economy.

Germany finds itself repeatedly confronted with the accusation that its current account surplus is increasing because it invests abroad rather than at home despite the poor return on foreign investments. A report for the Federal Ministry of Finance by the Forecasting Center of the Kiel Institute and its Global Division of Labor research unit shows that capital flows to and from Germany since reunification have reflected the available returns. Since roughly the turn of the millennium, German foreign investment has delivered a higher rate of return than foreign investment in Germany (previously the situation was reversed). Roughly coinciding with this phenomenon, net capital inflows gave way to net outflows. Accordingly, current account deficits became surpluses.

The switch in yield advantage is particularly evident with respect to direct investment. “The fact that international capital flows are driven by return factors is often overlooked when discussing economic policy and Germany’s high current account surpluses. The argument that the return on Germany’s foreign assets is poor, making current account surpluses a bad deal for Germany and not just for the other party, cannot be substantiated, especially with regard to direct investment,” said Stefan Kooths, Head of the Forecasting Center at the Kiel Institute. Meanwhile, the report’s findings support the view that since the early 2000s, German net capital exports have increasingly involved companies outside the financial sector, which have exhibited high overall financing surpluses. The report, entitled “Foreign Direct Investment – Effects on the German Current Account and Spillover Effects in the Recipient Countries” (https://www.ifw-kiel.de/fileadmin/Dateiverwaltung/IfW-Publications/-ifw/Kieler_Beitraege_zur_Wirtschaftspolitik/wipo_16.pdf, original publication in German), was recently published in the Kieler Beiträge zur Wirtschaftspolitik series.

Direct investment continues to finance current account surplus

The researchers compared the return on German investments in other countries with the return on foreign investment in Germany. In macroeconomic terms, there is a tendency for yield differentials and the direction of net capital flows to converge. In the case of direct investment, the yield advantage for foreign investment has been just under 2 percent since the 2000s. The profitability of such investment is actually likely to be underestimated, since the productivity effects of direct investment cannot be fully assessed at the macroeconomic level. Establishing a service network in another country, for example, can increase the profitability of domestic capacity geared to the production of export goods.

Overall, the researchers expect that foreign investment will continue to generate higher returns in the medium term and that net capital exports from Germany will thus continue. In their assessment, the associated shift in purchasing power
to the rest of the world serves to finance Germany’s current account surpluses, which are therefore likely to continue for the time being. “If investment by companies and other investors flows to countries where higher returns are likely, that will boost gross national income and by extension, consumption both in Germany and around the world,” Kooths said. “No one in Germany needs to apologize for that.”

Investment income: confusing cause and effect

In addition to trade surpluses in goods, the German current account surplus also reflects substantial net investment income generated internationally. Last year, this amounted to more than 2 per cent of economic output, accounting for a quarter of the current account surplus. A good 70 percent of this total was attributable to income from direct investment.

“It is incorrect to blame income from foreign investment for the current account surplus, as sometimes happens, and doing so confuses cause and effect. Investment income does not automatically increase the current account balance. Rather, it is available for consumption and savings alongside domestic revenue. Income from other countries flows back in as fresh capital only if foreign investment promises an appropriate return. To sum up: the investment income balance shows the results of past investment decisions, while the current account balance reflects investors’ expectations for the future.”

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