Tale of two creditors

Political dynamite behind Germany's foreign assets

by David Marsh in London

Wed 4 Jul 2018

At times of economic and financial stress, creditor nations will have the upper hand over debtors. That is conventional wisdom, yet it does not always correspond to reality. Germany has advanced to the position of the world's No.2 net creditor (after Japan), taking over the position during the past 12 months from China, according to data from end-2017 assembled by OMFIF.

The statistics – published in OMFIF's [Global Public Investor 2018]– show that China has been more adept than Germany in recent years in adapting its net creditor status to support the country's perceived long-term interests.

Germany's net international investment position – the gap between the value of German investments abroad and that of foreign investments in Germany – rose to $2.21tn at end-2017 from $1.8tn at end-2016, 61% of GDP against 52% 12 months earlier. This compares with China, whose NIIP declined to $1.71tn at end-2017 from $1.8tn (14% against 16% of GDP) and Japan, whose NIIP rose to $3.12tn from $2.99tn (64% against 61%).

China has been moving its foreign surpluses into strategically important equity holdings in infrastructure ventures and technology companies abroad, and away from holdings of other governments' debt. Much of Germany's build-up is in non-interest-bearing, unconditional advances within economic and monetary union – much of which will probably never be fully repaid. These are the so-called Target-2 balances registering claims on and liabilities towards the European Central Bank from constituent national central banks. The German Bundesbank's claims under Target-2 look likely to approach or exceed €1tn as of the end of June, against €956bn at end-May, according to statistics to be released in the next few days.

In this tale of two creditors, China's system of state control and long-term planning is displaying some ostensible benefits.

Economically, Germany's large positive NIIP might bring strength. A rich, aging country like Germany running near-permanent current account surpluses arguably needs large foreign savings, to be run down systematically as it copes with future demographic decline.

Politically, though, Germany's large foreign assets represent dynamite that could explode against the country's own interests. This is because Germany is the largest asset owner in a potentially highly unstable nexus of 19 European debtor and creditor EMU members.

Italy, the largest EMU debtor, has a eurosceptic government that is using its Target-2 liabilities as leverage over Germany. The aim is to push through demands for a softening of European financial and monetary conditions and to take pressure off undue migration into Italy that Rome blames for exacerbating social and economic tensions.

One of the principal arguments behind a high-profile German constitutional court case being brought against the ECB's quantitative easing programme by well-funded plaintiffs is that the danger of government bond defaults in Europe exposes the Germans to unacceptable budgetary risks. Linked to the lawsuit at the German constitutional court, which the German constitutional judges appear to be taking very seriously, the European Court of Justice is organising a public hearing on the matter in Luxembourg on 10 July.

The issue at the heart of the court case – the risk of QE-related losses to German taxpayers – has been brought into dramatic relief by policy statements from politicians connected to Rome's two new governmental parties, the League and Five Star Movement.

Target-2 balances are the bedrock of Germany's overall net foreign assets that, according to Bundesbank figures, totalled €1.93tn at end-2017 against €1.7tn at end-2016, €1.46tn at end-2015 and only €471bn in 2007 before the financial crisis. When EMU started in 1999, Germany had virtually no net foreign assets, since it had run down its previous large foreign savings to help finance German reunification.

China, by contrast, has turned to foreign direct investment and portfolio investment as important vehicles for deploying Beijing's international reserves. China has financed infrastructure projects abroad, including in countries connected to Beijing's Belt and Road initiative, as well as resource-rich economies in Africa and Latin America. China has already invested heavily in real estate and technology in advanced economies, particularly in Europe. This trend is reflected in the impressive growth of Chinese FDI assets over the past decade to around $1.5tn in 2017 from just $115bn in 2007.

Financial historians in coming years may puzzle over an intriguing conundrum: which of the world's No.2 and No.3 creditor nations has deployed their foreign reserves more wisely during the years since the financial crisis. On present showing, China may have the stronger hand.

David Marsh is Chairman of OMFIF.