DEVELOPMENT IN AND RETURN ON NET FOREIGN ASSETS

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INTRODUCTION AND SUMMARY

Over the last more than 20 years, Danish residents have moved from having a foreign debt of just under 30 per cent of the gross domestic product (GDP) in the mid-1990s to having net foreign assets of almost 38 per cent at the end of 2012. As a result of this development, Danish households and firms are today receiving considerable net foreign investment income. This article examines the development in net foreign assets and investment income over time and across countries, including the effects of the financial crisis and the extraordinarily low interest rates.

Changes in prices and exchange rates entail capital gains or losses on financial assets. Although they seem to net out over time in the measurement of a country's net foreign assets, they may have a rather marked impact on net foreign assets in some periods. Developments in equity and bond prices and exchange rates in the period 2008-12 have indicated capital losses on net foreign assets in countries with high credit ratings, although this masks some variation due to country-specific factors. In Denmark, one contributing factor has been the substantial pension wealth, as falling interest rates have generated large capital gains especially for the pension sector. In the period from end-2008 to end-2012, Danish residents thus received net capital gains exceeding kr. 300 billion on foreign assets. If interest-rate levels were to normalise, this is expected to partially reverse the countries' capital gains and losses accumulated since the onset of the financial crisis – including parts of Danish investors' capital gains on their foreign assets.

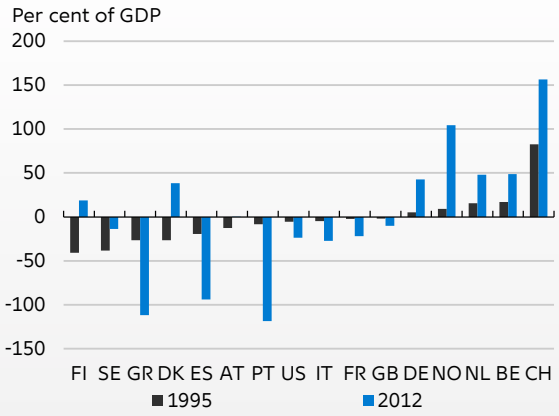
Net foreign assets generate investment income in the form of interest and dividend payments, which thus increase in step with the net foreign assets. Moreover, investment income is also influenced by the composition of the net foreign assets. The financial crisis has resulted in lower return on all asset types, given the decline in both interest rates and return on equities. Nevertheless, the impact on net investment income has been limited, reflecting lower income and expenditure, among other factors. This indicates that normalisation of the return on foreign direct investment (FDI), equities, bonds, etc. will have only a limited effect on investment income in most countries.

In recent years, the return on Danish residents' net foreign assets has been higher than what could be expected in an international comparison, viewed in isolation. One of the reasons is that interest-rate levels have decreased slightly more in Denmark than the average fall abroad, entailing a more pronounced decline in Danish residents' interest payments to non-residents than vice versa. Normalisation of the return on equities and FDI – entailing positive net wealth for Danish residents – will, however, have the opposite effect. All in all, interest and dividend payments to abroad have decreased slightly more than income. As a result, investment income would tend to decline in the event

of normalisation of interest rate and dividend levels, although this development is subject to uncertainty.

However, Danish residents' foreign investment income is determined especially by the size of the net foreign assets, so it can be seen as the result of prudent economic policy – generating current-account surpluses – over the last 30 years. Consequently, continued current-account surpluses and thus growing net foreign assets will ensure that considerable investment income can be expected in future, notwithstanding a possible slight increase in Danish residents' interest payments to abroad.

Net foreign assets in 1995 and 2012 Chart 1



Note: Ireland and Luxembourg have been excluded from the chart due to their very large balances. For three countries observations for 1995 are missing. Instead, observations for 1998 have been applied as regards Greece and Norway and observations for 1996 regarding Portugal.
Source: IMF.

NET FOREIGN ASSETS

At the end of 2012, Danish residents – defined as all domestic sectors taken as one, i.e. households, firms, the public sector and Danmarks Nationalbank – held assets abroad for kr. 5,130 billion, while non-residents held Danish assets amounting to kr. 4,440 billion. Consequently, Danish residents held net foreign assets of kr. 690 billion, or just under 38 per cent of GDP. In gross terms both Danish residents' assets abroad and non-residents' assets in Denmark have increased strongly in step with the growing integration of the global economy and the financial markets. The same trend is seen in other countries.

But not only gross amounts have grown. Over the last 10-15 years, net foreign assets have generally increased in a number of advanced economies.[1] Countries with foreign debt in 1995 typically had larger foreign debt in 2012, whereas countries with net foreign assets in 1995 had more pronounced net foreign assets in 2012, cf. Chart 1. Only in Denmark, Finland and Austria has net foreign debt been changed to net foreign assets, while Sweden has reduced its net foreign debt.

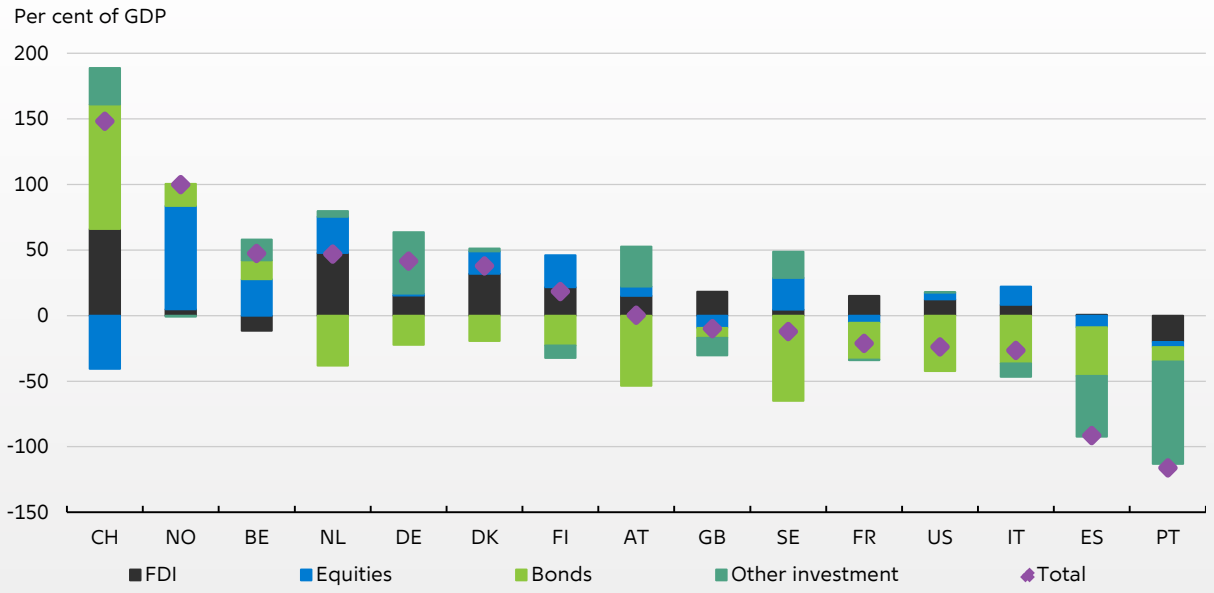
Net foreign assets comprise various types of financial instruments, the main categories being FDI (i.e. the investor has an ownership share with controlling influence), portfolio investment in equities and bonds as well as derivatives and other investment (particularly loans and deposits and central banks' foreign-exchange reserves), cf. Chart 2.[2] The composition of the net foreign assets of a given country has great influence on both the return on net foreign assets and the size of capital gains and losses. In countries where the net equity portfolio is positive, capital gains will, all else equal, be achieved over time due to rising equity prices. Danish residents have large positive net portfolios of FDI and equities, but a negative net portfolio of bonds.

The key driver of the long-term trend in the countries' net foreign assets is their accumulated current-account surpluses and deficits. In the event of a current-account surplus, i.e. a savings surplus, net foreign assets tend to grow. Moreover, there may be capital gains and losses on the net foreign assets. Although they seem to net out over time, they may have a rather strong impact on net foreign assets in certain periods.

1 In this article, the definition of net foreign assets implies that foreign debt is measured as negative net foreign assets.

2 The individual instruments are described in more detail in Wederkinck (2011).

Net foreign assets in 2012 Chart 2



Source: IMF.

CAPITAL GAINS AND LOSSES

Capital gains (losses) on residents' net foreign asset arise if the price – in local currency – of the foreign assets increases (decreases), or if the price of domestic assets held by non-residents falls (rises). Globally, the sum of capital gains should be zero, since a gain in one country is always offset by a corresponding loss in other countries. In practice, capital gains and losses do not always net out due to errors and omissions in the measurements.

It should be noted that if, for instance, the value of Danish equities held by non-residents increases, Danish residents will generally suffer a capital loss. If, for instance, the ownership of a Danish firm is distributed as half foreign investors, half Danish households, a rising equity price will result in capital gains for both non-residents and Danish households. In the measurements of Danish residents' net foreign assets, this will entail a higher value of Danish equities (assets) held by non-residents, thus – all else equal – reducing Danish residents' net foreign assets. This implies that Danish residents have to pay more to buy Danish equities held by non-residents. On the other hand, it cannot be interpreted as a loss of welfare, since the firm in question has not become poorer in reality; only the value of its equity has risen. Actually, rising equity prices in Denmark reflect expectations of higher future income, i.e. strong economic performance in Denmark.

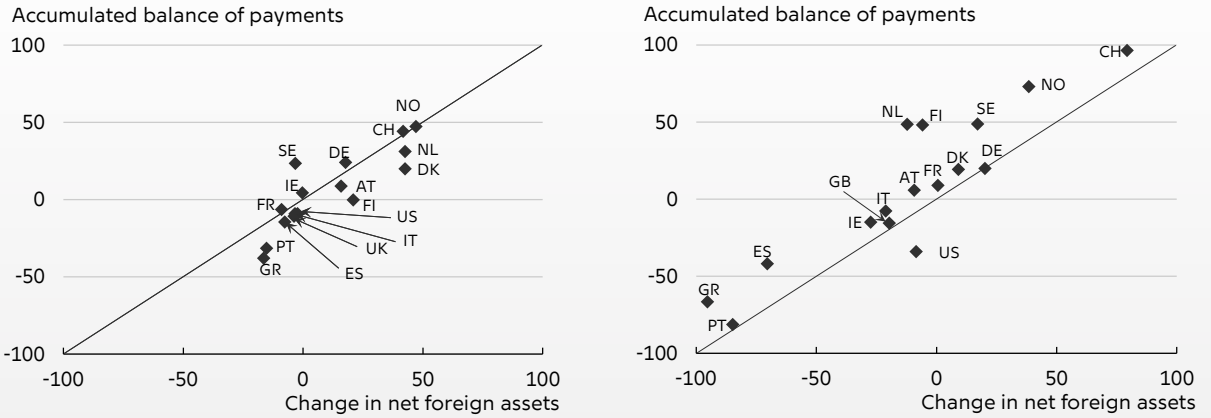
Since 2008, net foreign assets have generated substantial capital gains for the residents of a number of countries, such as Denmark, Finland, Portugal and Greece, but capital losses for the residents of other countries, particularly Sweden, cf. Chart 3 (left).[3]

The sovereign debt crisis – which escalated strongly in 2011 – entailed capital inflows into countries with high credit ratings, such as Denmark, Norway, Switzerland and Sweden. As a result, the Norwegian krone, the Swedish krona and the Swiss franc strengthened, illustrated by the nominal effective exchange rate of the Swedish krona, which was approximately 18 per cent stronger in 2012 than in 2008. The development in the Danish krone was far more stable due to the fixed-exchange-rate policy. A

3 Besides capital gains/losses, the difference between accumulated balances of payments and changes in net foreign assets is also attributable to errors and omissions, i.e. the divergence between the measure of the current account and the financial account of the balance of payments. Errors and omissions can arise because the payment for a product or service is not necessarily executed at the same time as the actual transaction, among other factors.

Changes in net foreign assets and accumulated balance of payments, percentage of GDP, 2008-12 (left) and 1995-2007 (right)

Chart 3



Note: Countries above the 45-degree line have had accumulated capital losses, while countries below the line have had accumulated capital gains. The accumulated balance of payments has been calculated as the accumulated nominal balance of payments normalised using GDP in 2012. Changes in net foreign assets are nominal changes over the period normalised using GDP in 2012. Right-hand chart: For Greece, Ireland, Italy and Norway the observations are for 1998-2007, for Portugal the observations are for 1996-2007.
Source: Eurostat, IMF and own calculations.

strengthening of the currency tends to reduce the value of net foreign assets in local currency and hence entail net capital losses. Sweden is a case in point, in that the appreciation of the Swedish krona reduced the value of Swedish residents' net foreign assets measured in Swedish kronor.

Capital gains/losses are influenced by exchange rates, but also by the relative price developments in domestic and foreign assets, especially equities, although bond prices may also play a role in the event of substantial interest-rate increases. Equity price developments in a number of southern European countries, including Greece, Italy and Portugal, have been very weak in recent years due to the severe recession in these countries, while equity prices in countries with higher credit ratings – including Denmark – have performed relatively well during the crisis. This has led to net capital losses in countries with high credit ratings, as the value of their outward FDI has risen only slightly or perhaps even decreased, while the value of inward FDI in highly-rated countries has risen. However, Finland is an exception, due to non-residents' considerable capital losses generated by the strong drop in the value of Nokia equities, which has increased Finnish residents' net foreign assets. It should be noted that this cannot be interpreted as a welfare gain for Finnish residents; it only means that it has become cheaper for them to buy non-residents' Nokia equities.

Government bond prices have shown almost the same pattern as equity prices, i.e. a decline in southern Europe due to higher interest rates, and an increase in countries with high credit ratings as a result of falling interest rates. This directly entails capital gains in lower-rated countries and capital losses in higher-rated countries. Sweden is a case in point. Denmark and to some degree the Netherlands stand out from other highly-rated countries, because the drop in interest rates has also yielded considerable capital gains. As regards Denmark, the main reason is that Danish pension funds have achieved large capital gains on interest-rate hedging particularly with non-resident counterparties. This is mirrored in the Netherlands, where pension wealth is also very substantial.[4]

Consequently, effects of the financial crisis are the main factor behind the capital gains and losses observed since 2008. To get a picture of a more normal situation it is useful to compare with the period 1995-2007, i.e. the period leading up to the financial crisis, cf. Chart

4 It should be noted that for most Danish pension funds these capital gains are offset by corresponding losses on pension obligations (liabilities), although the latter are predominantly domestic accounts with no effect on net foreign assets.

3 (right). It is notably different from the period since 2008, because all the countries shown, except the USA, recorded capital losses.

As regards the USA, it is well known that the patterns of the balance of payments and foreign debt have diverged, entailing continuous capital gains for the USA. There are several possible explanations, e.g. that US firms obtain capital gains on their foreign subsidiaries to a higher degree than firms in other countries.[5] Another possible explanation is the high risk profile of US investment abroad.

The capital losses in the other countries may be due to inflation differentials between the relevant country and abroad. For instance, higher inflation in Brazil relative to the euro area should entail a weakening of the Brazilian real against the euro over time. Consequently, a European investing in Brazilian bonds will suffer a capital loss on the principal, measured in euro, but in return achieve a high investment income. Since all of the countries shown have low inflation compared with countries in e.g. South America or Asia, their nominal exchange rates have generally strengthened during the period, resulting in capital losses.

The comparison of capital gains and losses in the periods 1995-2007 and 2008-12 justifies the view that some countries will record capital gains, while others – including Denmark – will record smaller capital losses in step with the subsiding effects of the financial crisis on exchange rates, interest-rate levels and equity prices. However, the net effect in Denmark is subject to uncertainty, since derivatives and bonds will probably generate losses, while equities will generate gains, as described in more detail below. All in all, the relative capital gains and losses on the various instruments indicate that the net effect on all Danish sectors taken as one will be a small capital loss.

CAPITAL GAINS IN DENMARK

In recent years, Denmark has differed from the other countries with net foreign assets and current-account surpluses by recording considerable net capital gains on foreign assets. The total accumulated price and exchange-rate regulations have increased Danish residents' net worth by around kr. 350 billion from end-2008 to end-2012. The largest positive value adjustments stem from exchange-rate gains on FDI (due to the strengthening of the Swedish krona, among other factors), bonds and derivatives, but also from the foreign-exchange reserve.[6] The key driver of the capital gains on bonds and derivatives is the generally lower interest rates, resulting in substantial capital gains in the insurance and pension sector in recent years, cf. Box 1.

The value of Danish residents' portfolio equities abroad rose from end-2008 to end-2012, but the value of FDI in Danish equities rose even more. This has entailed a negative net impact on the international investment position. Non-residents' equity investments are primarily concentrated in liquid Danish equities, including in the pharmaceutical industry, which have performed relatively well during the financial crisis.

It should be noted that the choice of period has a strong influence on the size of capital gains on net foreign assets. The reason is that the gross portfolios are very large, so that even minor changes in interest-rate levels or exchange rates can lead to large capital gains or losses. For example, in the period from end-2005 to end-2008, Danish residents' capital losses on net foreign assets totalled almost kr. 200 billion, and in the period from November 2007 to March 2008 alone, the total net capital loss amounted to around kr. 90 billion.[7]

5 One possible reason is that US firms have transferred knowledge to their foreign subsidiaries, e.g. in China. This knowledge transfer is not part of the current account of the balance of payments, but it increases the value of the foreign subsidiaries, generating capital gains for US firms, see e.g. Bureau of Economic Analysis (2006).

6 Most of the accumulated capital gains from FDI are attributable to exchange-rate regulations, but price changes in connection with purchases and sales have also been positive in net terms.

7 The main reason for the capital loss is that Danish residents recorded substantially larger losses on their portfolio investments in foreign equities compared with non-residents' losses on Danish equities.

Danish residents' capital gains on net foreign assets

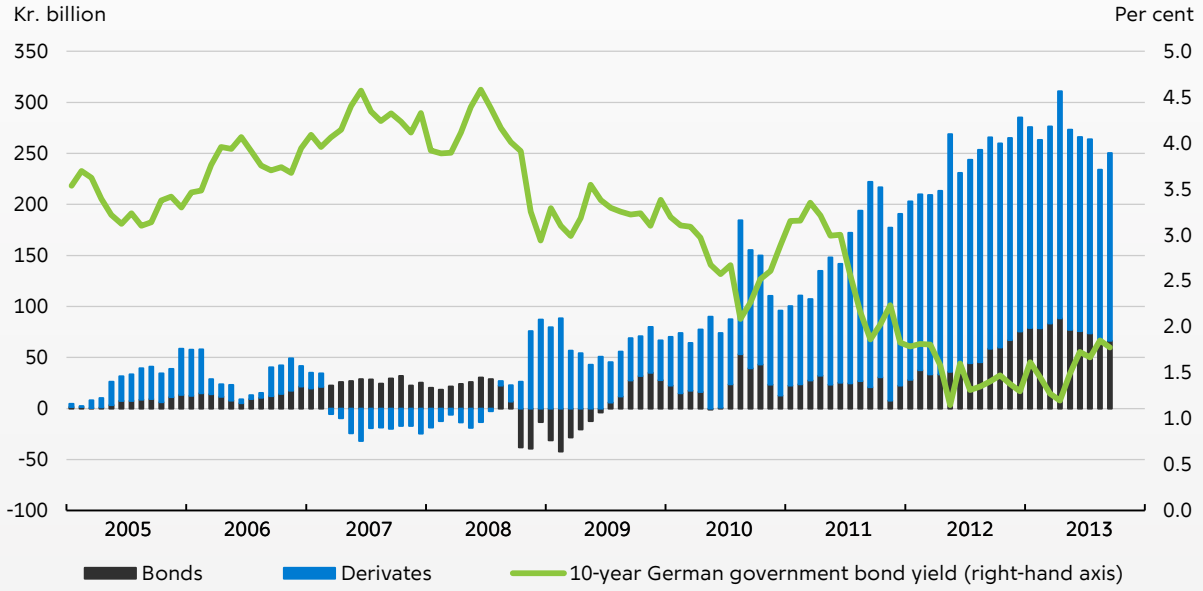
Box 1

At the end of 2012, Danish residents held foreign bonds for kr. 1,160 billion, and non-residents held Danish bonds for kr. 1,514 billion. Consequently, Danish residents' net foreign assets are negative by kr. 353 billion for bonds alone. The insurance and pension (I&P) sector's investments in foreign bonds account for more than half of the total investments in foreign bonds.[1]

The I&P sector typically invests in long-term bonds (with a maturity of more than 5 years), or concludes derivative contracts increasing the duration of their assets. The purpose is to hedge the interest-rate risk on their liabilities.[2] On the other hand, non-resident investors hold mainly Danish short-term bonds (less than 5 years), which should be viewed in the light of the markedly higher growth in the supply of short-term Danish bonds compared with the supply of long-term bonds.

The difference in maturity (duration) between Danish residents' assets and liabilities in bonds has resulted in large capital gains on both bonds and derivatives due to falling interest rates. From January 2005 to September 2013, the accumulated price and exchange-rate adjustments have increased Danish residents' net foreign assets by kr. 66 billion on bonds and kr. 184 billion on derivatives, cf. Chart 4, of which value adjustments on derivatives held by the I&P sector alone account for kr. 119 billion.

Accumulated price and exchange-rate adjustments bonds and derivatives, net



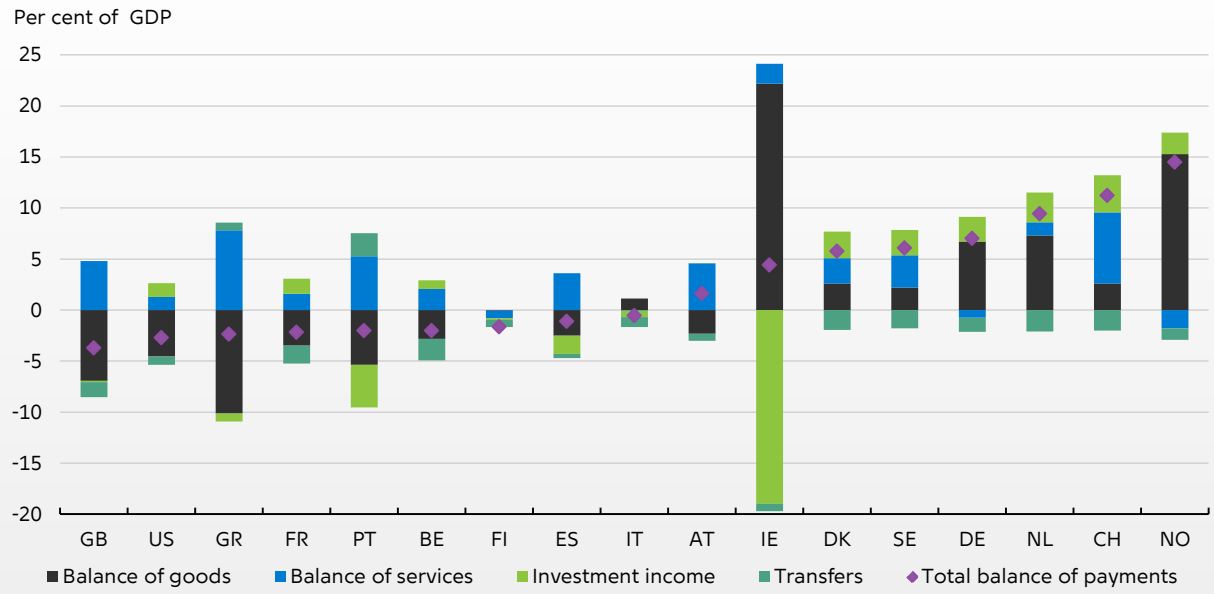
Source: ECB and Danmarks Nationalbank.

The I&P sector's interest-rate hedging generated losses in 2013 due to rising interest rates. Continually increasing interest rates will, all things being equal, lead to further losses on both derivatives and bonds. On the basis of reporting from the I&P sector, the Danish Financial Supervisory Authority calculates the expected losses/gains on the sector's holdings of bonds and derivatives in a scenario involving a change in long-term interest rates of 0.7 percentage points.[3] In 2012, the expected loss attributable to such an interest-rate increase was around kr. 75 billion. The calculation covers the whole I&P sector's accounts with both Danish and foreign counterparties, so it cannot be used directly for assessment of capital losses on net foreign assets. However, the counterparties for most of the derivative contracts are non-residents, while the counterparties for most of the bond holdings are Danish residents. If long-term interest rates abroad rise to the 2006 level, i.e. around 4 per cent, it can be expected that the gains on derivatives will be more or less reversed, but the capital loss strongly depends on the I&P sector's hedging strategy. Should the level of interest rates remain lower than before the financial crisis, e.g. due to lower structural growth in the advanced economies, only a minor part of the capital gains on derivatives will be reversed, however.

1. Investment funds in which the I&P sector has an ownership interest of more than 90 per cent are included in the sector.
2. The I&P sector's commitments consist of pension provisions and guarantees, typically with long duration. The purpose of interest-rate hedging is to ensure that the expected future income corresponds to the future pension commitments, and that the value of assets follows the commitments, should the level of interest rates change. The I&P sector typically hedges interest rates by ensuring a fixed rate on their investments irrespective of the course of the general level of interest rates. This can be achieved by e.g. buying fixed-rate bonds with very long maturities and by concluding derivatives contracts. If the level of interest rates declines, the market value of the I&P sector's hedging portfolio will rise (capital gain) and, conversely, an increase in interest rates will result in a lower market value of the hedging portfolio (capital loss). Given that most counterparties for I&P interest-rate-hedging derivatives are non-residents, the drop in the general level of interest rates in recent years has generated large capital gains on the I&P sector's net foreign assets. See e.g. ATP (2012).
3. See Danish Financial Supervisory Authority (2012) and (2007).

Balance of payments, 2012

Chart 4



Source: IMF.

THE CURRENT ACCOUNT AND ITS COMPOSITION

As mentioned earlier, a current-account surplus or deficit is the main driver of changes in countries' net foreign assets. The current account of the balance of payments is the sum of three components: the trade balance for goods and services, investment income and transfers, e.g. contributions to the EU and development assistance. For the large majority of countries, trade in goods and services plays the most important role, cf. Chart 4.

For a few countries, however, investment income is important. Switzerland's investment income is substantial due to considerable net foreign assets. At the other end of the spectrum, Ireland has high expenses as a result of dividend payments to non-resident corporate owners.

Investment income can be expected to gain importance for a number of countries as their net foreign assets or net debts grow.

INVESTMENT INCOME

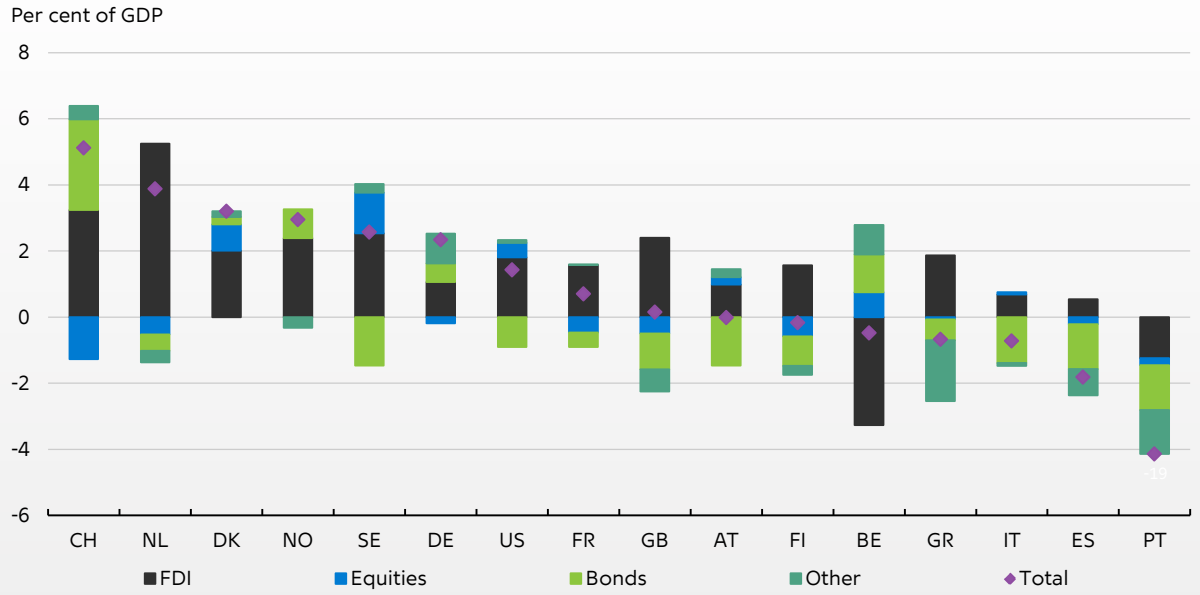
Investment income in the national accounts consists of interest and dividends received and paid, thus changing in step with the size of net foreign assets. Positive investment income increases a country's income and hence the scope for consumption and investment. In 2012, investment income accounted for more than 3 per cent of GDP for several countries, including Denmark, cf. Chart 5. Investment income thus makes a positive contribution to Denmark's overall prosperity.[8]

Besides being affected by the size of the net foreign assets, investment income is also influenced by fluctuations in returns, i.e. the percentage return, and by the composition of net foreign assets. Returns are typically higher during boom periods, because corporate earnings are higher, resulting in higher dividend payments, and because interest rates are higher. Moreover, returns are determined by risk profiles; the return on FDI is typically higher than the return on other instruments, as a case in point. This contributes to the fact that most of the investment income in the majority of countries is generated by FDI.

8 The gross national product, GNP, includes wage and investment income to and from abroad, thus usually providing a more accurate picture of a country's level of prosperity. On the other hand, the relationship between GNP and employment is weaker than the relationship between GDP and employment.

Net investment income in 2012

Chart 5



Note: No data about equity income in Norway. Income from Other thus contains income from both equities and other investments..
Source: IMF.

RETURNS ON NET FOREIGN ASSETS OVER TIME AND ACROSS INVESTMENT CLASSES

The declines in both corporate earnings and interest rates in the wake of the financial crisis have impacted considerably on the returns on net foreign assets. The returns on interest-bearing assets have decreased, returns on bonds have almost mirrored the development in longer-term interest rates, while returns on other investment, mainly loans, have largely followed money-market interest rates, cf. Chart 6.

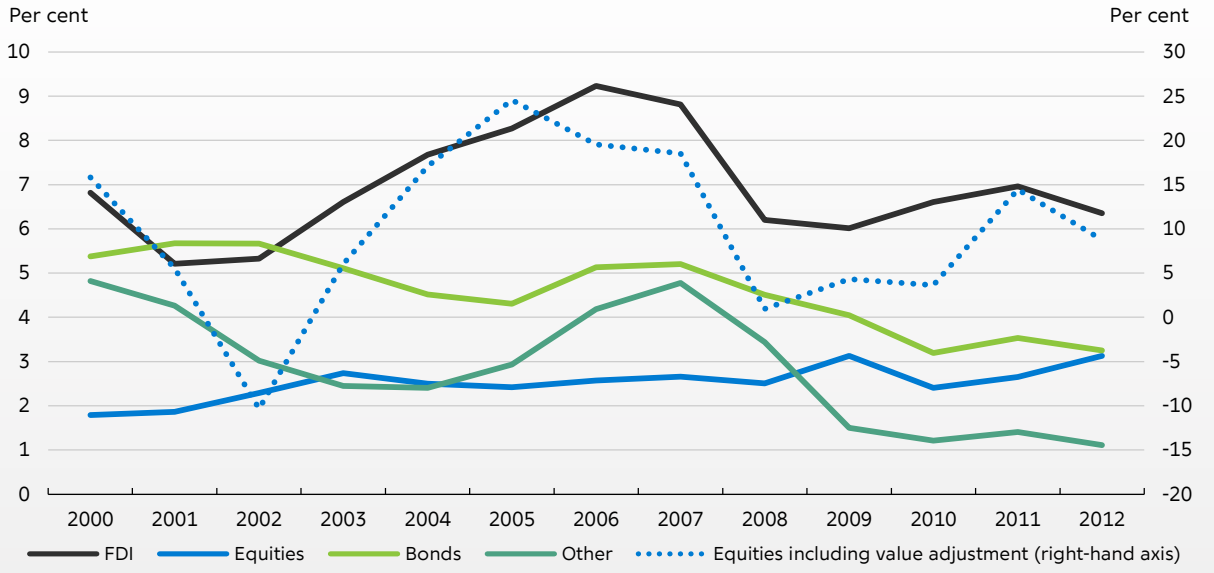
The return on FDI across countries fell from around 9 per cent in 2007 to 6 per cent in 2012, probably reflecting the decline in corporate earnings in the period. The compilation of investment income from equities in the national accounts, i.e. dividend return, differs from the return on FDI in that it does not include firms' retained profits (reinvested earnings). This results in a low registered return in the national accounts. Instead, retained profits will increase the equity price, generating a capital gain for the owners. Hence, corporate owners may choose to retain the firm's profits or pay out the profit – or parts thereof – as dividend or as buy-back of own equities or a combination of the two. The method of disbursement of profits to the owners depends on tax-related factors, among other factors. The return on equities has been relatively stable and low – stable because dividends have fluctuated in step with the firms' market values, and low because parts of the profits have not been paid out as dividend.

To an investor, it is more relevant to look at the overall return on equities including capital gains. The total return on equities is highly volatile, but on average it has been slightly higher than the return on FDI.

CROSS-COUNTRY VARIATIONS IN RETURN

In the last 10 years, a number of countries have recorded higher returns than warranted by their net foreign assets viewed in isolation – especially France, Sweden (but with capital losses), the UK and the USA. Returns have been lower in other countries, particularly Belgium and Norway, cf. Chart 7 (left). Both Norway and Belgium are characterised by a large share of their net foreign assets being placed in portfolio equities, for which only the dividend return is registered as investment income, whereas countries with high returns have a relatively large share of FDI, which generally yields higher investment income.

Average annual return on assets Chart 6

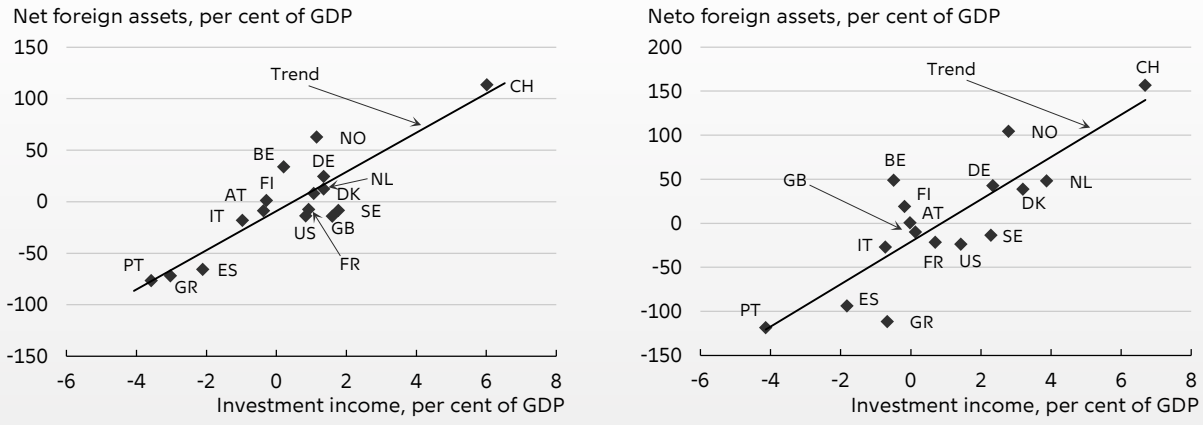


Note: The annual return is in US dollars, calculated as an aggregate for all of the countries. No observations for return on equities in Norway. No observations for Ireland before 2001 or for Belgium before 2002. Equities including value adjustments are 3-year moving averages..
Source: IMF.

Given the weak cyclical position in 2012 – entailing very low interest rates and relatively moderate corporate earnings – net foreign assets could be expected to be lower than normal. But this does not seem to be the case, cf. Chart 7 (right). The average rate of return was around 4.5 per cent in 2012, which was only slightly lower than the level of 5.3 per cent in the period 2002-12. This indicates that normalisation of the return on FDI, equities, bonds, etc. across countries will have only a relatively limited effect on total investment income, reflecting both lower income and expenditure, among other factors. The total return for a single country is thus the sum of several individual factors.

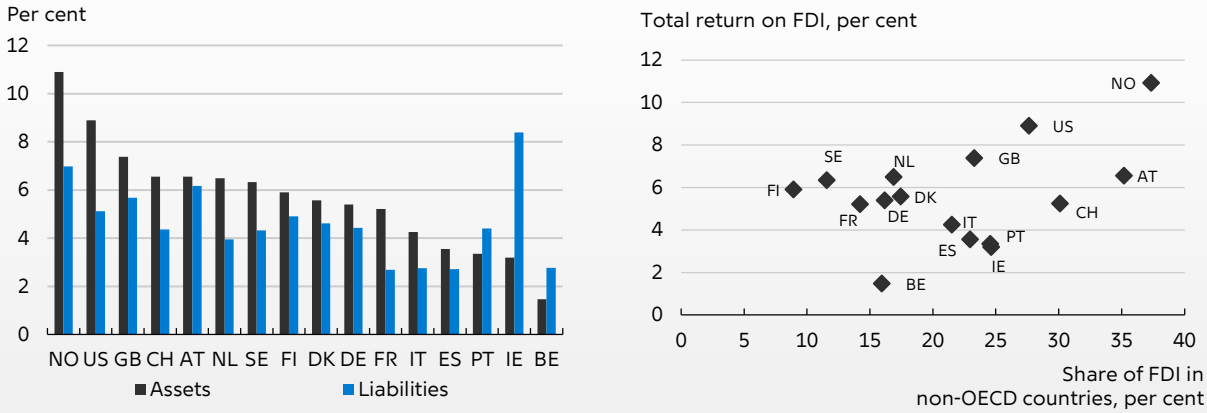
In Denmark, the return on bonds on the liabilities side has declined more than on the assets side since 2008, mainly reflecting the

Net investment income and net foreign assets, average for 2002-12 (left) and 2012 (right) Chart 7



Note: Ireland has been omitted, since both net foreign assets and investment income differ markedly from those of the countries shown.
Source: IMF.

Return on FDI, 2012 (right), and FDI in non-OECD countries, and return, 2012 Chart 8



Source: IMF and OECD (observations for the share of FDI in non-OECD countries).

stronger fall in interest rates compared with the average fall abroad. Investment income from bonds has actually been positive since 2010 despite Danish residents' net debt in bonds. The underlying factors are e.g. that non-residents' investment in Danish bonds is primarily in short-term government and mortgage bonds associated with low interest payments, while Danish residents have invested in longer-term foreign bonds. Viewed in isolation, an increase in interest rates will thus reduce investment income from bonds and loans, especially if Danish interest rates rise relatively more than interest abroad, cf. Staghøj and Jensen (2013).

Conversely, normalisation of the return on equities and FDI may increase investment income, given Danish residents' net worth in these instruments. The total net effect on the return on Danish residents' net foreign assets and hence the investment income from normalisation of all returns is thus subject to uncertainty. Rising interest rates will reduce investment income, while increasing returns on equities and FDI will probably lead to higher income.

However, Danish residents' foreign investment is determined especially by the size of the net foreign assets, so it can be seen as the result of the prudent economic policy – generating current-account surpluses – over the last 30 years. Consequently, continued current-account surpluses and thus growing net foreign assets will ensure that considerable investment income can be expected in future, notwithstanding a possible slight increase in Danish residents' interest payments to abroad.

Return on FDI across countries

The return on FDI varies strongly across countries, cf. Chart 8 (left). In the majority of the countries reviewed, assets have yielded far higher returns than liabilities. One possible reason is that the risk on outward FDI is greater than that on inward FDI, e.g. if parts of the investment are placed in emerging markets where the return is often higher than in the advanced countries.

Part of the cross-country difference in returns indeed reflects the volume of investment in emerging market economies. There is thus a certain tendency for the return on FDI to be higher in countries with more investments in non-OECD countries, cf. Chart 8 (right). The return on FDI may also be affected by a number of other factors, such as variation in corporate age (younger firms typically have lower profits), deferred tax, etc.[9]

In Denmark, net investment income from FDI has been positive and rising since 2003, mainly due to increased investment abroad. The return on both assets and liabilities varies year on year, but has been higher, on average, for assets than for liabilities over the last 13 years. With the exception of Danish pharmaceutical

9 See e.g. Curcuru et al. (2013).

companies, which have posted strong returns on their outward FDI, returns on assets and liabilities have been almost the same in recent years, cf. Andersen et al. (2013).

Denmark's outward FDI is concentrated geographically on its principal trading partners, i.e. the USA and the EU member states, which together accounted for 69 per cent of Denmark's outward FDI at the end of 2012. In 2005-12, the average rate of return was 4.7 per cent on investment in EU member states and the USA. By comparison, Danish investment in the BRIC countries (Brazil, Russia, India and China) yielded an average return of 8.5 per cent in the same period.

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