

Euro area balance of payments and the financial markets

28 November 2007

The euro area current account has remained balanced throughout the entire period of European Monetary Union (EMU). Country-specific differences have, however, been extremely large. Spain's current account deficit has in recent times been as much as 10% of the country's GDP. Monetarily, it is the second largest current account deficit in the world after the United States, amounting to substantially more than USD 100 billion in annualised terms. In contrast, Germany has a current account surplus that is slightly higher still, in dollar terms. It is, in fact, nearly as large as Japan's. The euro area balance is thus explained by the steep opposition between the Spanish and German current accounts, combined with other euro area countries' small – if in some small countries relatively large at national level – deficits or surpluses in dollar terms.

The role of balance of payments

This article concentrates on capital flows in the euro area as a whole and their impact on the euro area financial markets. Euro area capital flows, which can, as such, be very different in nature, have not exhibited any major imbalances, while their direct impacts on investment and economic growth have also not been particularly significant. The most

significant feature is perhaps the almost constant capital outflow in direct investment and inflow in portfolio investment. For the financial markets themselves, however, international capital flows have been significant. At times, they have had a major impact on monetary (M3) growth in the euro area, at times even greater than bank lending.

A particularly striking liquidity surge from the balance of payments was first seen in 2001–2003. In this connection, the European Central Bank (ECB) has spoken in terms of portfolio shifts due to exceptional uncertainty, but this can be taken as just a partial explanation. A strong and even faster liquidity surge occurred at the end of 2006 and beginning of 2007. The primary source of liquidity in both cases seems to have been the inflow of capital into euro area securities, in the first case primarily into equities, and in the second, into debt securities.

The balance of payments depicts the external balance of the economy

Balance of payments statistics describe the external balance of the real and monetary economies. The current account is a summary of real economic transactions between an economy and the rest of the world. It describes the impact of foreign economic activities on national income, and the balance between savings and investment in the



*Jarkko Kivistö
Economist
Monetary Policy and
Research*



*Tapio Korhonen
Economist
Monetary Policy and
Research*

economy. The capital account includes gratuitous capital transfers and purchases and sales of patents, trademarks and other intangible assets. The financial account shows changes in external assets and liabilities. It describes the financing of the current account deficit or the investment abroad of the current account surplus.

By definition, the sum of the component accounts – ie net income and expenses in the balance of payments – is zero. Sometimes, however, reference is made to a balance of payments surplus or deficit. What is actually meant is a surplus or deficit on the current account or one of the other component accounts within the balance of payments. Within the balance of payments we can also distinguish an overall account, which is the sum of all the component accounts excluding the change in foreign reserves. Foreign reserves is the item that is ultimately

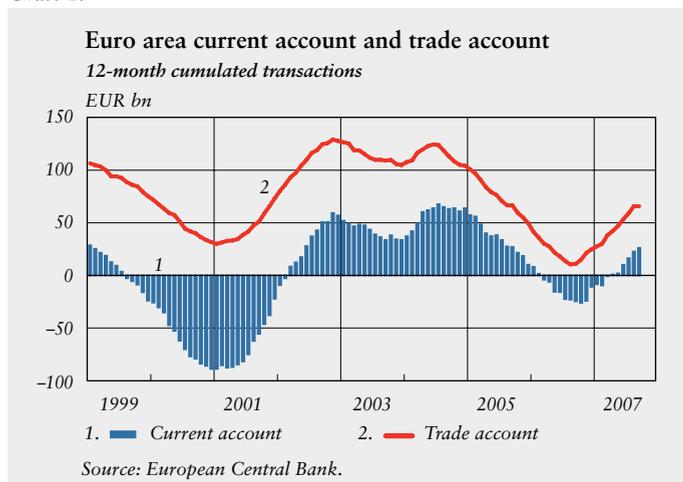
used to finance foreign transactions when the exchange rate needs to be held steady.¹

As the balance of payments is a flow statistics, a related concept is net external assets, which describes the stocks of external assets and liabilities. A current account deficit increases the (net) external liabilities of an economy, while a surplus adds to the (net) assets. In addition, stock statistics take account of changes in exchange rates and other valuation items that may often have a major impact on asset levels even though they are not shown in the flow statistics.

Developments in the euro area current account

The euro area current account has fluctuated monthly from a deficit of around EUR 12 billion at its highest to an equally large surplus. In cumulative 12-month terms, the euro area current account was in deficit in the early stages of the euro era, rising to surplus in 2002 (Chart 1). At the end of 2005, cumulative data shows that the current account went once again into deficit, mainly due to the higher price of oil. Euro area current account deficits and surpluses have, however, been very small, accounting

Chart 1.



¹ The terminology used in the balance of payments varies in the statistics produced by different institutions. The financial account in particular is defined in different ways. It may or may not include change in currency reserves (and an error item). For example, the IMF publication International Financial Statistics (IFS), does not include the change in currency reserves in the financial account, unlike the monthly publications of the European Central Bank (ECB) and the Bank of Finland.

Box.

Compilation of balance of payments statistics

Taken as a whole, the balance of payments account is always in balance. In principle, all transactions are entered in accordance with double-entry bookkeeping. For example, exports of goods are entered as a positive figure in the current account, while the associated financing is entered as a negative figure in the financial account in terms of an increase in external assets. Because data on real flows and monetary flows come from different sources, they do not totally match in the balance of payments statistics, at least not in the short term. This is why the balance of payments contains an item that covers errors and missing transactions.

An error term may result from, for example, entry of the same transaction at different times in different accounts, or from insufficient data. Errors arising from timing differences offset each other in due course. Cumulatively, errors and omissions should be close to zero. The cumulation of an error may be an indication of a systematic fault in the compilation of statistics. In the balance of payments for the euro area, errors and omissions have

been negative cumulatively since 2003, which indicates either a shortfall in the statistics for increase in assets or an excessive increase in liabilities. The error may also originate from the real economy, ie current account statistics. For example, there could be problems with the statistical compilation of trade in services. It is possible that part of the increase in the error term is due to internal euro area asymmetries, ie different statistical treatment of the same economic transactions between euro area countries.

Globally, the balance of payments statistics are also in imbalance, even though the sum of real and financial flows should be zero. The world current account shows an aggregate deficit. While the trade account is in surplus, the income account is especially strongly in deficit. The 'surplus' in the trade account probably stems from the fairly comprehensive entry of exports in source country statistics, while importers may have a reason to avoid official registering of imports. The income account 'deficit', for its part, suggests that payment of income is entered but

recipients may seek to avoid paying tax on their income. In addition, not all offshore financial centres, such as the Cayman Islands or Bermuda, report their balance of payments statistics to the IMF. As regards services, deficiencies in reporting may arise from the flagging out of vessels to countries that do not report the transportation income received.

Responsibility for the compilation of euro area balance of payments is divided between the ECB and Eurostat. The ECB is responsible for preparation of the financial account and of the investment income account within the current account. Computation of euro area balance of payments statistics is based on relevant data submitted by euro area countries on their transactions with non-euro area countries. By aggregating these statistics we obtain the balance of payments for the euro area. For some items, such as the debit side of portfolio investment, the information available is not sufficient. In such cases, data on economic transactions between euro area countries is used to help gain a fuller picture.

at their highest for only about 1% of the area's GDP.

Recent months have seen the deficit shrink close to balance, driven by robust euro area exports. Part of this growth in exports originates from sales to oil-producing countries that have channelled part of their higher income from oil into import growth.

The current account is dominated by the trade account. Goods exports account for an average of 60% of current account income, with the import-to-expenses ratio being somewhat smaller. The trade balance has been systematically in surplus. Euro area exports are dominated by the United Kingdom, the United States and Switzerland, but other non-euro area EU countries together constitute another major export market. Euro area imports originate mainly from the United Kingdom, the United States and China.

The key items in the services account are transportation and travel. The euro area services account has been in surplus for many years.

The income account includes labour compensation costs and investment income, of which the latter – comprising income from direct investment, portfolio investment and other investment – is more important. Net investment income has been in deficit since the introduction of the euro. This is mainly due to interest and dividend expenses related to portfolio investment.

The euro area services account has been in surplus for many years.

In contrast, current transfers have been systematically in deficit. This is because EU institutions (excluding the ECB) are considered non-euro area parties. Thus, all economic transactions between euro area countries and EU institutions are registered in the balance of payments. Current transfers include, for example, member states' EU membership fees.²

Data on euro area balance of payments, broken down by country, is available from 2003 onwards.³ The euro area has had a systematic current account deficit only with Japan and EU institutions.

The euro area as investment target and as investor

Structure of investment

The main items of the financial account are direct investment, portfolio investment, other investment, financial derivatives and reserve assets. Portfolio investment is divided into investment in equities, bonds and notes, and money market instruments. The portfolio investment account differs from the other

² Income transfers with EU institutions show a deficit of EUR 40 billion to the euro area; ie that is the net sum paid by the euro area to EU institutions. In contrast, the capital account is EUR 19 billion in surplus. This sum includes items such as transfers from EU support funds.

³ Country-specific data has been available for the following countries: Sweden, Denmark, the United Kingdom, other EU countries, EU institutions, Canada, Japan, the United States, Sweden, offshore financial centres, international organisations and others. This list has recently been extended to include China, Brazil, India and Russia.

investment account in containing marketable instruments.

The other investment account includes financial claims that are based on bilateral agreements and do not have a secondary market. Such items comprise loans, deposits and trade credits. The predominant item is loans and deposits by financial institutions on both the credit and the debit side. International payments cleared through financial institutions are mainly reflected in this item.

Flow data in respect of derivatives includes premia on derivative contracts, interim and net value disbursements and actual net payments between parties. Although the value of underlying assets in derivatives contracts may be extremely high, derivatives do not play a major role in euro area balance of payments. The derivatives item is only available in net terms.⁴

Reserve assets include assets denominated in foreign currency and owned or managed by the Eurosystem. These include monetary gold, special drawing rights and foreign exchange. The largest items in the Eurosystem reserve assets are gold and foreign-currency-denominated securities assets. Because the euro is a floating currency, the Eurosystem does not normally carry out currency interventions. This is why changes in reserve assets are minor and are primarily based on changes in

the external value of the euro. Reserve assets are, therefore, not discussed separately below.

Direct investment

Direct investment describes international mergers and acquisitions and financial flows between units of multinational conglomerates. It is necessary to underline that statistics only describe the financing of direct investment from and into the euro area and not actual productive international investment. Direct investment is divided into equity financing, reinvested earnings, and other capital. Reinvested earnings are also entered under investment income in the current account, and the financial account has a counteritem as part of direct investment.

In multinational conglomerates, financing is often arranged via special financing centres, many of which are located in Luxembourg, the Netherlands or Ireland for tax reasons. Direct investment statistics only tell the direct target country of the financial flow, which is not necessarily the country where the actual investment will eventually be made. However, if the investment is channelled via a finance company located in the euro area, it does not necessarily skew euro area statistics as much as it might skew the statistics of individual euro area countries, provided that either the investor or the ultimate investment target are also in the euro area.

Statistics only depict the financing of direct investment from and into the euro area, not actual productive international investment.

⁴ This applies to flows, whereas the figures for stocks denote the market value of current contracts. Contracts in the black are claims, while those in the red are liabilities.

From time to time, large acquisitions and related financial arrangements can be seen in the statistics.

The volume of direct investment varies a great deal from month to month. From time to time, large acquisitions and related financial arrangements can be seen in the statistics, such as the ownership arrangements for Shell in July 2005. Often large acquisitions – particularly mergers – are associated with mutual financing arrangements, which means that the transaction is entered as direct investment abroad and in the euro area, or the direct investment is matched by a corresponding portfolio investment.⁵ The merging company may become a partner in the joint venture to be established and pay its share by handing over its business to

⁵ In February 2000, for example, the British company Vodafone bought Mannesmann from Germany for EUR 145 billion. The transaction was paid for with Vodafone shares, so a direct investment in the euro area was entered in the balance of payments along with an increase in portfolio claims and a decrease in portfolio debt (because the majority of Mannesmann shares were already held by foreign investors).

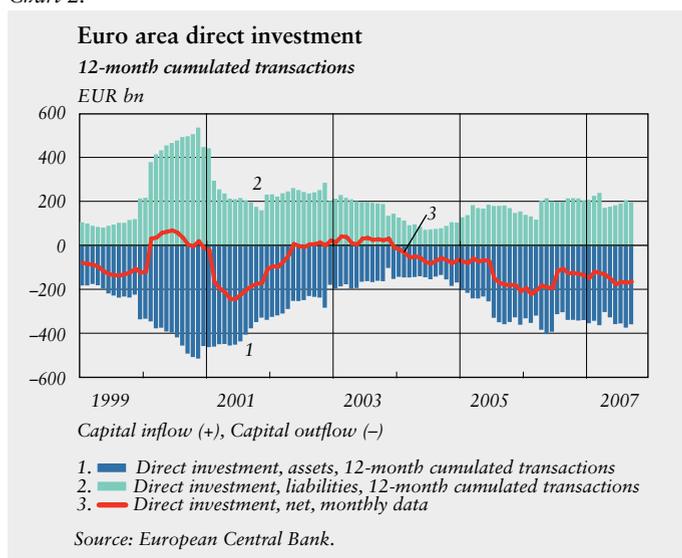
the joint venture. These types of arrangements are reflected in financial flows in different directions, but not in net flows.

Direct investment from the euro area has been higher than inward investment from abroad (Chart 2). Net flows in direct investment have been clearly outward from the euro area, especially since 2004.

Direct investment peaked at the turn of the millennium, when investment in US-based ICT-sector companies in particular was very pronounced.⁶ At the end of 2006, the stocks of euro area direct investment in the United States and US direct investment in the euro area were close to balance. Based on the stock of investment, the most important investment target at the moment is the United Kingdom. At the end of 2006, euro area investment in the United Kingdom stood at EUR 800 billion, compared with approximately EUR 600 billion in the United States. Another major investment target are offshore financial centres, where euro area direct investment totalled slightly less than EUR 330 billion at the end of 2006. All in all, the stock of outward direct investment at this time stood at EUR 3,076 billion.

Inward direct investment in the euro area in 2006 was similarly dominated by the United Kingdom at slightly over EUR 1,020 billion, with direct investment from the United

Chart 2.



⁶ Anderton et al. 2004.

States standing at approximately EUR 630 billion. Altogether, the stock of inward direct investment at the end of 2006 stood at EUR 2,660 billion.

Growth in investment from new EU member states has been particularly rapid since 2004. Investment has grown more than sevenfold compared with the situation at the end of 2003. However, at EUR 23 billion the stock of investment is still rather modest. The stock of euro area investment in new member states shows a smoother development path, although in 2004–2005 this also grew at an annual pace of approximately 30%. Overall, the stock of euro area investment in new member states amounts to EUR 190 billion, with privatisation arrangements initiated in the 1990s, liberalisation of economies and expectations regarding EU membership being the main contributors to the accelerated investment flow into the new members.⁷

At USD 1,300 billion, global direct investment was close to its historical peak in 2006,⁸ with approximately a quarter of this investment being into the euro area. This record figure also includes bilateral investment between euro area countries, which is not included in the euro area balance of payments. With this investment excluded, capital flows into the euro area in the form of direct investment totalled

some EUR 177 billion, ie slightly more than USD 220 billion. Global direct investment has grown at an annual pace of nearly 30% for several years in a row. The majority (USD 857 billion) of this investment was channelled into the industrial economies, but investment in emerging economies has also reached record levels. Investment in Asia increased by 15%. In 2006, China was among the three largest recipients of direct investment, with the investment flow into China an estimated USD 70 billion.⁹

Low interest rates have contributed to an increase in corporate acquisitions by private equity funds.¹⁰ These acquisitions can be largely financed through debt securities or by means of a leveraged buy-out. Corporate acquisitions by funds nearly doubled from 2004 to 2005. In 2006, equity investment in the euro area was 50% higher than in 2005 (at approximately EUR 170 billion).¹¹ In contrast, there has been little increase in comparable outward investment from the euro area.

In economics, the scale of direct investment has traditionally been explained by bilateral trade flows and

Low interest rates have contributed to an increase in corporate acquisitions by private equity funds.

⁷ Lane and Milesi-Ferretti (2006a) provide a more thorough analysis of capital flows in eastern Europe.

⁸ UNCTAD (2007).

⁹ The quality of these statistics is, however, not yet fully reliable: statistical compilation practices are not fully compatible with international standards and statistics are prepared by two different methods at two separate institutions.

¹⁰ UNCTAD (2006).

¹¹ Admittedly, the 2006 first quarter balance of payments for the Netherlands included an exceptionally large acquisition that resulted in euro area direct investment swelling to more than EUR 80 billion in both directions.

by a gravity model adopted from physics whereby the economic size (mass) of a country and the distance between countries affect direct investment flows. On the corporate level, the motive for direct investment may be to gain a competitive edge in the market through cheaper factors of production or improved products, production processes, marketing and distribution networks. In addition, direct investment may be a way to circumvent administrative restrictions such as customs and quotas. Direct investment has been considered an important factor in transferring technology from one country to another. On the other hand, closer links between economies via direct investment also mean cyclical changes are carried over more easily from one area to another.¹²

¹² Jansen and Stokman (2007).

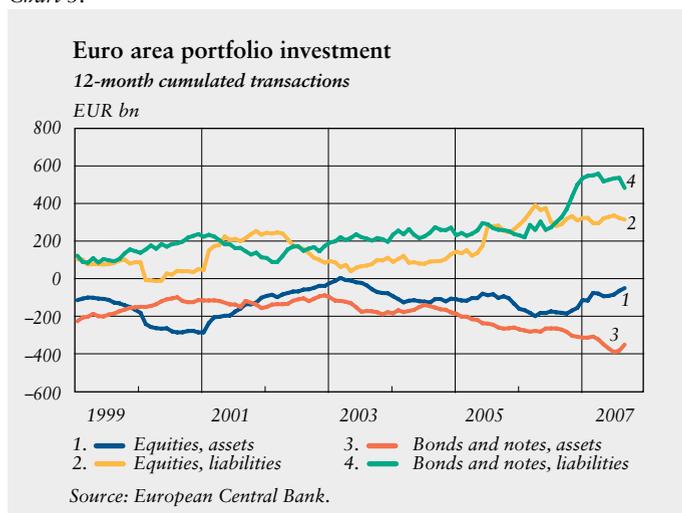
Portfolio investment

Contrary to direct investment, portfolio investment shows a net inflow into the euro area. Throughout almost the entire existence of the euro, portfolio investment into the area has, in fact, exceeded outward portfolio investment. This applies to both equity investment and (particularly) investment in debt instruments.

At the turn of the millennium, outward net investment in equities from the euro area was strong, particularly to the United States. Since 2001, the direction of equity investment has been predominantly into the euro area (Chart 3). The equity investment inflow has been particularly strong since the middle of 2005, indicating that investors have considered euro area growth potential to be higher than that of other key market areas. Indeed, euro area share prices have been rising faster than those of US shares since 2004. The performance of the euro has further supported this investment trend insofar as, on top of the return on capital invested, foreign investors have also benefited from exchange rate gains.

Outward equity investment from the euro area has been predominantly to the United States and the United Kingdom, with the stock of investment at the end of 2006 amounting to approximately EUR 670 billion and EUR 390 billion, respectively. The total stock of outward investment stood at EUR 2,012 billion. Besides flows, this also includes various

Chart 3.



valuation factors such as changes in prices and exchange rates. Hence the stock of equity investment increases as share prices rise.

In 2006, outward equity investment from the euro area rose to slightly more than EUR 150 billion in terms of the 12-month moving total, but this had fallen to EUR 100 billion by the beginning of 2007, the same level as prior to 2006.

Particularly noteworthy in equity investment is the recent rise of bonds. In cumulative 12-month terms, investment in euro area bonds doubled in the second half of 2006 from EUR 250 billion to EUR 500 billion. In 2005, foreign investment in euro area shares grew even more in relative terms. In June 2007, portfolio investment in euro area shares amounted to some EUR 330 billion in cumulative terms.

Investment in bonds is partly a reflection of the securitisation of mortgages, which has been particularly significant in Spain. Indeed, Spain has been a major contributor to the increase in bond debt. Germany has been the biggest issuer of bonds in the euro area over the long term.

Euro area investment in foreign bonds is dominated by the United States and the United Kingdom. A country-specific breakdown of data is not available for portfolio investment liabilities. Some picture of inward investment in the euro area can be derived from the balance of payments data for investor countries, provided country-specific data is available. The

Coordinated Portfolio Investment Survey (CPIS) by the IMF also offers additional information, albeit not the most recent data. Key countries with the highest investment in euro area bonds at the end of 2005 were Japan (25% of all investment), the United Kingdom (18%) and the United States (10%).¹³

Globally, portfolio investment has increased. According to the CPIS survey, between 2001 and 2005 the stock of foreign investment doubled to more than USD 10 trillion. Euro area countries together account for 32% of this investment stock.¹⁴ Comparable developments have been witnessed in the bond markets: the stock of international holdings at the end of 2005 totalled USD 15 trillion, of which euro area investment accounts for 40%. Approximately half of inward investment in the euro area originates from the United States, followed by the United Kingdom (18%) and Switzerland (11%).

In theory, as markets expand, international investment flows increase as a result of the diversification of risk.^{15,16} Investors aim to

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¹³ Globally, Japan has favoured portfolio investment in bonds, whereas the United States and the United Kingdom, along with other industrial countries, emphasise investment in equities (Lane and Milesi-Ferretti (2006b)).

¹⁴ The euro area is not included as an aggregate in the CPIS survey, and this figure therefore includes investment within the euro area that is netted off from euro area balance of payments aggregates.

¹⁵ De Santis (2006).

¹⁶ According to the International Capital Asset Pricing Model theory, international investors should build their portfolios in such a way that they contain investments in different countries in proportion to the relative size of each market.

Investment is channelled into areas where the expected growth or real interest rate is higher.

diversify their portfolios geographically, too, in proportion to the size of different markets.¹⁷ On the other hand, financial market globalisation means that, when risks do materialise, impacts will not be restricted to a single area but will be borne by all investors.¹⁸ However, the actual impacts depend on the characteristics of the investment portfolio (shares, bonds, currency, maturity, liquidity).

Movements in portfolio investment can generally be explained by differences in growth prospects for different economic areas and by differences in interest rates. Investment is channelled into areas where the expected growth or real interest rate is higher. The natural and empirically tested explanation for flows in equity investment is the actual earnings per share obtained in the market.¹⁹ In other words, realised profits entice new investment (the feedback explanation). On the other hand, investment flows can themselves boost share prices. This may be due to expected developments in economic fundamentals or to short-term price pressures caused by the flow of capital into the stock markets. Recent research shows this

¹⁷ In practice, investment has not been spread in accordance with the theory, as portfolios contain a home bias, meaning that considerably more investment is made in the home market than would be optimal according to the theory. One explanation put forward for this is asymmetric information (non-resident investors have less information about the status of foreign companies). The home bias has decreased significantly within the euro area since the launch of EMU (De Santis (2006)).

¹⁸ Lane and Milesi-Ferretti (2005a).

¹⁹ Froot (2001).

kind of impact to be even stronger than the impact of yields, especially in developing markets.²⁰ A closer analysis shows the above-mentioned feedback explanation is more applicable to European countries.

As with direct investment, gravity models have also been relatively accurate in explaining investment flows in equities. It has been observed that gross flows in equity investment depend on the size and distance of markets and on the costs and technology of trading. The distance of markets as a variable is probably a very good indicator of informational asymmetries. In international investment, geography has not been observed to have a major impact on government bonds, which is probably due to the availability of adequate information.²¹

Investment yields and influencing factors

Debate about the large current account deficit in the United States has highlighted the contradiction that the US investment income balance has for long been in surplus at the same time as the country has been running a large net external debt. In 2005, US net external debt amounted to as much as USD 2,500 billion. In the investment income balance, yields on direct investment in particular show a surplus. One explanation proposed for this is tax planning by multinational

²⁰ Lin and Swanson (2007).

²¹ Portes and Rey (2005).

corporations. The long-term nature of US investment also seems to be an important contributor. However, a comprehensive and entirely credible explanation for this statistical contradiction has yet to be found.²²

In euro area statistics, direct investment income received and paid out are very similar in size. In contrast, there are differences in the statistics for individual countries. The situation in France is similar to that of the United States, whereas in Ireland outgoing income is much higher than the income received on direct investment abroad by Irish residents. Undeniably, this is a reflection of tax planning by US companies. In France, the corporate tax rate is 33%, while in Ireland it is 12.5%.²³

In 2006, euro area direct investment income received was approximately EUR 170 billion, while direct investment income paid out amounted to nearly EUR 110 billion. Relative to the stock of investment, the euro area received a yield of 5.5% and paid out 4.2%. A longer-term examination shows that the income received and yields paid by the euro area on direct investment have been more or less equal.

In 2006, yields paid by the euro area on portfolio investment amounted to EUR 190 billion, while income from portfolio investment

outside the euro area totalled EUR 140 billion. Relative to the stock of investment, income from euro area investment abroad and yields paid by the euro area on investment made by non-residents totalled some 3.2%.

International investment position

At the end of the second quarter of 2007, the euro area international investment position showed a net debt of EUR 1,174 billion, corresponding to 13.6% of euro area GDP. The negative net investment position is due to portfolio investment showing a negative EUR 1,702 billion. In direct investment, euro area net assets amounted to EUR 495 billion.

The investment position is affected not only by the transactions entered in balance of payments statistics, but also by changes in exchange rates and other valuation items. In 2001, the euro area net international investment position was a negative 5.6% of GDP. The subsequent growth of this debt to more than 13% of GDP is largely due to the appreciation of the euro.²⁴ The positive development of share prices in the euro area has been another contributory factor.

At the end of 2006, the US net international investment position was negative, in the amount of approximately 20% of GDP. At the same time, Japan's international investment position showed net assets of some 40% relative to GDP.

²² A good overview of this issue can be found in Heath (2007).

²³ KPMG (2007).

²⁴ ECB (2007).

Balance of payments and money supply

The view of the ECB regarding the monetary policy significance of the balance of payments is reflected in the fact that since 2003 the statistical section of the ECB's Monthly Bulletin has provided a monetary presentation of the balance of payments. The external transactions of sectors other than the MFI sector are shown in the balance of payments as changes in external assets and liabilities insofar as the transactions are cleared through banks. Items in the current and capital accounts and errors and omissions cannot be divided between MFIs and other sectors. It is, however, reasonable to assume that the resulting distortion is not significant.

The monetary presentation of the balance of payments thus shows the transactions that affect changes in

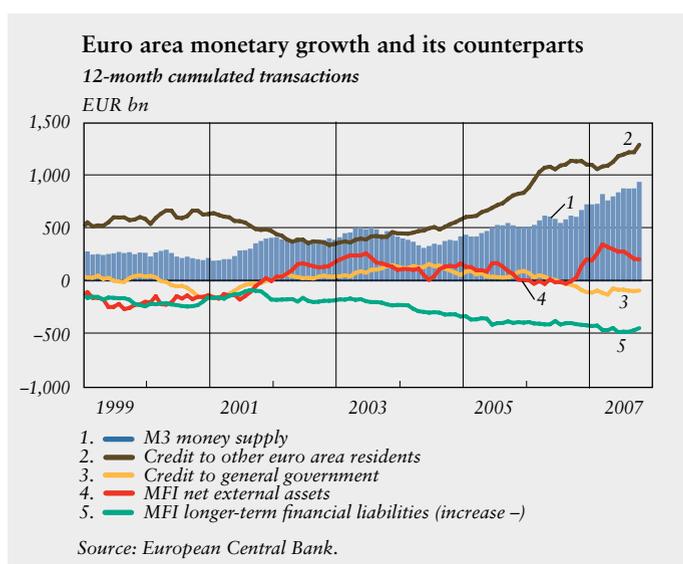
MFI sector net external assets. The net external assets of MFIs are shown in the MFI balance sheet as counterparts to the M3 monetary aggregate, namely

- loans to euro area residents
- euro area MFIs' net external assets
- minus MFIs' long-term liabilities
- plus other MFI counterparts.

The causes of money supply developments can be assessed by examining developments in these counterparts (Chart 4). For example, when an MFI grants a loan, the counterpart is generally a deposit with another MFI, which means that loans and deposits grow in parallel. A balance of payments transaction that reduces the money supply is generally one where a domestic economic unit that purchases goods or monetary assets from abroad pays the purchase with its deposits. This money is then transferred abroad, with the result that the net external assets of the MFI decrease (when the MFI credits the account of the foreign exporter). Correspondingly, exports of goods or imports of capital (increase in the exporter/importer's external liabilities or decrease in its external assets) means an increase in the domestic money supply, and also in the net external assets of the MFI.

In the early phase of the euro era, in 1999–2000, lending by MFIs was very strong, but M3 growth was retarded by the impact of other supply factors, particularly the balance

Chart 4.



of payments, ie capital outflow. First and foremost, capital outflow was due to the scale of euro area equity investment abroad (Chart 3). In 2001, the flow of equity investment turned sharply towards the euro area, through both an increase in investment by non-residents and a decrease in equity investment abroad by euro area residents. When shares were sold to non-residents, the sellers' deposit accounts gained from incoming payments.

The ECB's explanation for the simultaneous growth in monetary aggregates cited the portfolio shifts associated with the exceptional uncertainty prevailing at this time. This referred to investors changing the composition of their portfolios by replacing long-term investments with more liquid and less risky instruments. This was partly reflected in the balance of payments, when shares were sold to non-residents. A similar phenomenon could be seen in the strong growth of investment in money market funds, which are a component of M3.²⁵

It is, however, likely that other, quite normal market factors provide a more plausible explanation for the shift in investment than the 'exceptional uncertainty' referred to above. Although the reversal in the direction of equity investment at the time was strong, it was largely due to the normalisation of the preceding

exceptional investment flows. In fact, part of the change can probably be explained simply by developments in interest rates. The US policy rate fell rapidly in 2001 to well below the ECB's policy rate (Chart 5).

Since the introduction of the euro, changes in the net external assets of MFIs have stemmed partly from the current account. Chart 6 presents developments in the current

Chart 5.

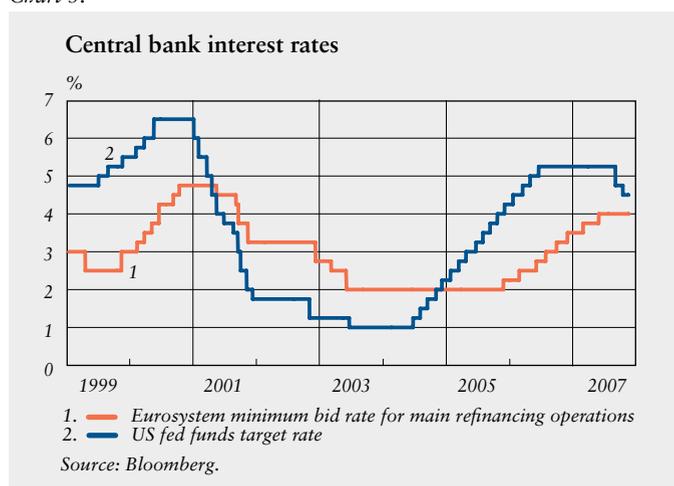
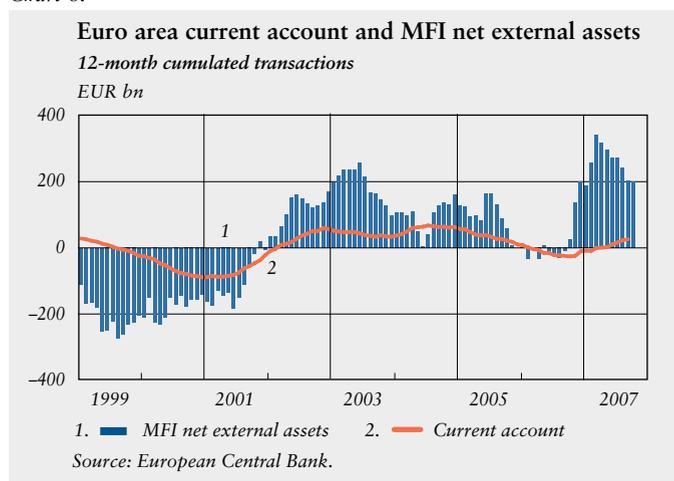


Chart 6.



²⁵ ECB (2004).

account and changes in banks' net external assets in cumulative 12-month terms. The difference between the series describes the volume of other capital flows. The current account and capital flows have generally moved in parallel, and hence they have both contributed to fluctuations in the money supply. However, the growth in the money

supply at the turn of 2006–2007 was entirely due to capital inflow.

In 2007, growth in M3 has been strong, even hitting record levels. Of M3 counterparts, particularly striking was an increase in MFIs' net external assets at the end of 2006 and during the first few months of 2007. For example, in November 2006, growth in foreign counterparts (EUR 69 billion) was particularly due to investment by non-residents in euro area bonds (EUR 80 billion). Investment in bonds has remained strong (Chart 7), although the share contributed by MFI lending has increased. The analysis is partly complicated by large errors and omissions in the balance of payments. Within the euro area, the most noticeable growth in net external assets in the MFI sector has taken place in Germany.

Chart 8 compares non-residents' investment in euro area bonds with MFI net external assets, and both of these with developments in M3. After 2001, developments in MFIs' net external assets have closely followed investment in bonds. This connection is particularly noticeable in recent months' strong growth, and the connection between this and M3 growth. Although still originating in the balance of payments, the explanation for M3 growth this time can be found in different instruments than in 2001–2002.

One key explanation for growth in debt securities may be carry trades,

Chart 7.

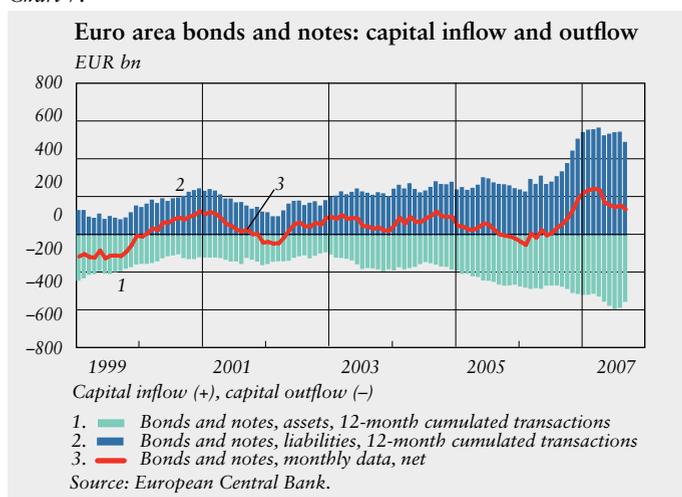
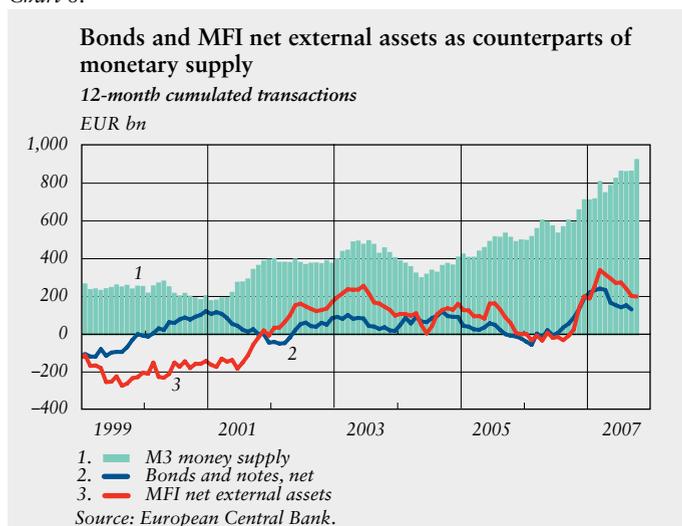


Chart 8.



which have recently been under the spotlight. In carry trading, funds are borrowed in markets with low interest rates and reinvested in markets with a higher yield, at the same time becoming subject to a degree of exchange-rate risk (admittedly, part of the trade can be hedged, for example with options, but in this event part of the interest rate difference will also be lost).²⁶ The appreciation of the euro and developments in euro area short-term interest rates make the euro area attractive for carry trading. At the same time, some of the increase in supply of debt securities based on housing mortgages has probably been channelled abroad. As well as investment in debt securities, non-residents have also invested to some extent in euro area equities.

Nevertheless, the main reason for growth in non-residents' investment in the euro area is probably the relative strengthening of economic performance in the euro area. From the point of view of interest rate policy, these developments have led to a classical conflict situation. Rising market rates have dampened inflationary pressures in

the euro area, but the increased capital inflow has boosted euro area liquidity supply, thereby adding to inflationary pressures. On the other hand, the continued capital inflow feeds the appreciation of the euro, which in turn serves to alleviate inflationary pressures.

Concluding remarks

The euro area current account has remained close to balance, although major differences between individual countries can be identified. The euro area has been characterised by capital outflow in direct investment and inflow in portfolio investment. Capital flows have had a major impact on money supply. Recently, non-resident investment in euro area bonds has particularly contributed to an increase in MFIs' net external assets.

Financial market globalisation increases the interdependency of economies and the spillover of disturbances from one economy to another. Balance of payments statistics and statistics on the international investment position offer one way to examine these impacts. Although the euro area as a whole is a more closed economy than its individual member states, it is nonetheless more open than the United States or Japan.

Keywords: balance of payments, financial markets, capital flows

The euro area has been characterised by capital outflow in direct investment and inflow in portfolio investment.

²⁶ In practice, carry trading is rather hard to separate from other investment activity. For example, the OECD (2007) states: 'The exact extent of the carry trade is difficult to deduce from statistics on cross-border flows, which generally do not point to a recent upturn of outflows from Japan. Most carry trades are probably undertaken through over-the-counter derivatives markets, on which statistical evidence is rather meagre. It seems, nonetheless, that derivatives markets played a role in both the upturn and subsequent unwinding of the yen carry trade at the beginning of the year.'

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