Box 2

EXTERNAL CAPITAL FLOWS AND DOMESTIC MONETARY DYNAMICS IN THE EURO AREA

The strong growth of M3 since mid-2001 has led to an accumulation of excess liquidity in the euro area. These developments have been driven, in part, by exceptional portfolio shifts between money and long-term securities in a context of heightened economic, financial and geopolitical uncertainty.[1] In substance, these portfolio shifts have taken the form of large sales of securities against money by euro area non-MFI residents.

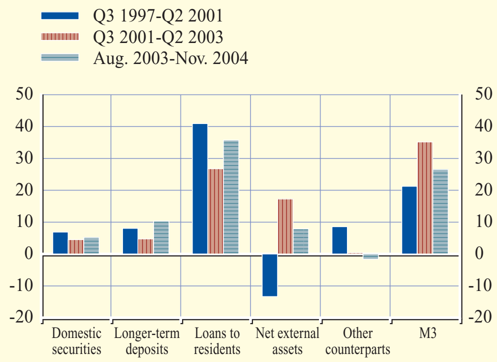
To better understand the nature of such portfolio shifts, it is useful to analyse which sectors were the counterpart sectors for the sale of long-term securities by euro area residents.[2] If one

1 For a thorough analysis of monetary development in previous years and their implication for price stability, see the article entitled "Monetary analysis in real time" in the October 2004 issue of the Monthly Bulletin.
2 See also Box 1 in the above article entitled "What were the counterparts to the extraordinary portfolio shifts into monetary assets between 2001 and 2003?"

euro area household sells a bond or equity to another household, there is no impact on the overall money stock: money simply circulates within the money-holding sector. Only transactions vis-à-vis MFIs and non-residents typically have an impact on money holdings. This box focuses on transactions between euro area residents and non-residents, which are reflected in the development of the net external assets of the MFI sector.

Chart A Counterparts to M3 in the MFI consolidated balance sheet

(monthly flows; EUR billions; period averages; not adjusted for seasonal and calendar effects)



Source: ECB.
See footnote 3 of this box for an explanation of the main differences between this presentation of the counterparts to M3 and that in the main text of the ECB's Monthly Bulletin.

The sale of a security by a euro area household to a non-resident will typically increase the domestic money stock. For instance, if a non-resident purchases a security from a euro area household by means of a cheque drawn on his bank account with a domestic bank (not included in the money stock), which is paid into the bank account of the household (included in the money stock), the overall domestic money stock will increase. In parallel, the net external assets of the MFI sector will increase because the bank account balance of the non-resident, which is an external liability of the bank, will fall.

Chart A shows that, in accounting terms, the cumulated increase in M3 between 2001 Q3 and 2003 Q2 was associated with an increase in net external assets, while the changes in other counterparts (e.g. the transactions of banks on domestic securities[3]) were either of a modest size or – in the case of loans extended to residents – evolved in a direction that, all other things being equal, should have constrained rather than boosted monetary growth.

Another point illustrated by Chart A is that the strong capital inflows from 2001 to 2003 to the euro area (represented by the changes in MFI net external assets over this period) had been preceded by large capital outflows from the euro area between 1998 and 2000. In the late 1990s, euro area companies and households (via mutual funds) built up large holdings of foreign shares, partly in the context of the "New Economy" boom in the United States. In addition, the propensity of economic agents to diversify their portfolio across countries as a way to reduce their overall vulnerability to risk may have led to some internationalisation of portfolios during this period, with a potential impact on domestic monetary growth.

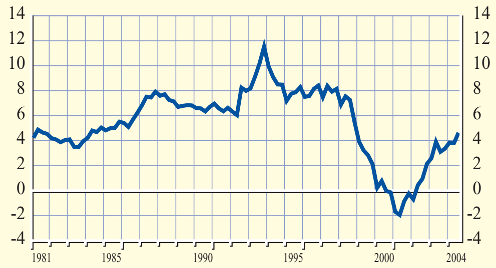
Subsequently, in an environment of heightened financial market and geopolitical uncertainty after 2001, the euro area money-holding sector reallocated its portfolios from equity holdings into money holdings, in search of safer returns and more liquidity. One consequence of this

3 In Chart A, the counterparts to M3 are presented in a different way than in Chart 4 in the main text. In particular, an aggregate "domestic securities" is shown, which is constructed as the sum of MFI longer-term financial liabilities (including capital and reserves) minus longer-term deposits minus the securities issued by non-MFIs held by MFIs. This presentation allows the transactions of MFIs in domestic securities to be distinguished from other counterparts, in particular from net external assets. As a consequence, credit to euro area residents is not shown in the chart. Rather, only loans to residents are presented, since the securities held by MFIs are included in the aggregate "domestic securities".

reallocation was a repatriation of funds previously invested in foreign equity. In this context, the euro area may have been considered a “safe haven” relative to the rest of the world, leading to the accumulation of capital flows from residents and/or non-residents in the euro area, with a positive impact on monetary growth.

Chart B Ratio of net external assets of MFIs to GDP

(in percentages)



Source: ECB.

The analysis of developments over the past few years can also be placed in the context of the longer-term development of the stock of net external assets of the euro area MFI sector. Chart B shows that, as a consequence of the large capital outflows between 1998 and 2000, the stock of net external assets of the MFI sector reached unprecedented lows in relation to the level of GDP in 2001,[4] before being partially reversed between 2001 and 2003. In that respect, a reversal of past portfolio shifts would most likely imply a renewed decline in net external assets to very low levels.

Overall, this form of analysis highlights the importance of external financial flows as an explanation of domestic monetary dynamics over recent years. It appears useful to account explicitly for this external dimension when assessing the motivations underlying excess money holdings, in particular those associated with heightened risk aversion.[5]

4 This is based on a back series of net external assets published for the first time in this issue of the Monthly Bulletin (and available in the statistical section of the ECB’s website).
5 See Box 2 entitled “Risk aversion and developments in monetary aggregates” in the December 2004 issue of the Monthly Bulletin.