

Box 1

LINKAGES BETWEEN DEVELOPMENTS IN MFI NET EXTERNAL ASSETS AND OTHER COUNTERPARTS OF M3

Flows in MFI net external assets reflect the transactions of the euro area money-holding sector with counterparties in the rest of the world that are settled through the MFI sector. The associated international capital flows can have an important impact on developments in the monetary aggregates (see the article entitled “The external dimension of monetary analysis” in this issue of the Monthly Bulletin). For instance, in the period from late 2006 to spring 2007 the rising inflow in net external assets was clearly mirrored in the strengthening of euro area M3 growth.¹ However, even large developments in the net external asset position are not automatically reflected in monetary dynamics, as they may be offset by developments in other M3 counterparts such as credit and longer-term financial liabilities. Examples of this type of decoupling include the period between

¹ See Box 1 entitled “MFI net external assets and their impact on monetary developments” in the ECB’s Annual Report 2007.

mid-2005 and mid-2006 and the period since spring 2007, particularly up to the end of 2007. Against this background, this box discusses recent cases that could cause developments in net external assets which would be offset by those in other M3 counterparts, thereby leaving M3 growth unaffected.

Following the recent peak of approximately €330 billion recorded in March 2007, the annual flow into the MFI net external asset position declined markedly, eventually turning negative and reaching approximately -€290 billion in June 2008. At the same time, the annual flow into M3 has remained relatively stable, moving in the range of €750 to €950 billion (see Chart A). From an accounting perspective, this implies that the movements in net external assets have been counterbalanced by movements in the other counterparts of M3. What is less clear by looking at the MFI balance sheet is the extent to which these counterbalancing movements are directly linked in an economic sense, or whether they are independent. In the context of the current financial market tensions, it is possible to imagine a number of cases in which developments in net external assets are directly linked to movements in other counterparts.

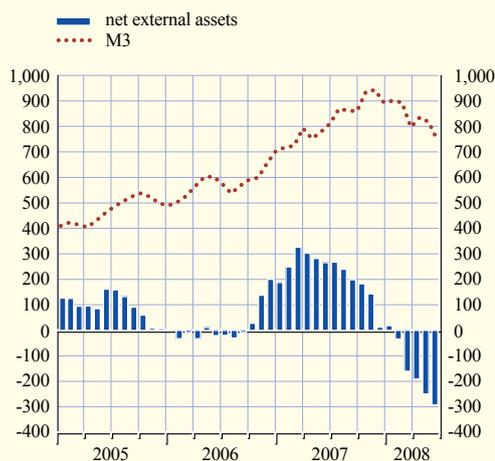
One example is the liquidity support that MFIs have had to provide to asset-backed commercial paper (ABCP) issuers (SIVs or conduits) who failed to roll over their maturing commercial paper. This support has often entailed acquiring the securities issued by these entities. To the extent that the issuers are resident in the euro area and the securities acquired were previously held by investors who are not resident in the euro area, these transactions generate both a negative flow in the net external asset position and a positive flow in MFIs' holdings of securities issued by euro area other financial intermediaries (OFIs). Chart B shows that the decline in the annual flow of net external assets since spring 2007 has coincided with a pick-up in MFIs' acquisition of securities other than shares issued by the euro area private sector (which are predominantly securities issued by OFIs).

Another, related, example concerns the relocation of some such issuers from outside to within the euro area, in the context of the restructuring and streamlining of ABCP-related activities that some banking groups have undergone. In this case, euro area MFI holdings of securities issued by these entities, which were previously foreign assets, become domestic securities. Such a restructuring would therefore also give rise to a fall in net external assets and a concomitant increase in MFIs' holdings of securities other than shares issued by the euro area private sector.

There may also be a direct link between developments in net external assets and MFIs' longer-term liabilities (excluding capital and reserves). For instance, in an environment of financial market tensions, MFIs reduced the supply of long-term debt securities from the second half of 2007 onwards, given that investors found it less attractive to hold longer-term debt securities (with

Chart A M3 and net external assets

(annual flows; EUR billions; adjusted for seasonal and calendar effects)

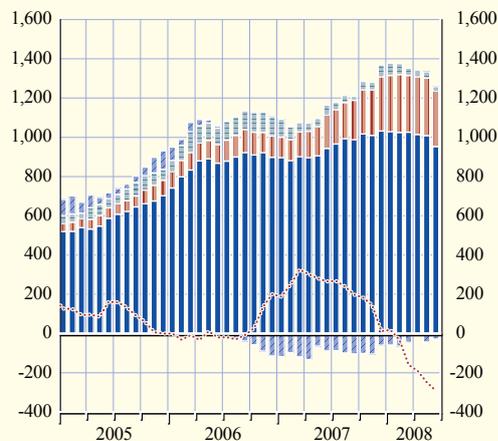


Source: ECB.

Chart B Net external assets and credit to euro area residents

(annual flows; EUR billions; adjusted for seasonal and calendar effects)

- loans to the private sector
- securities other than shares issued by the private sector
- shares and other equities issued by the private sector
- credit to general government
- net external assets

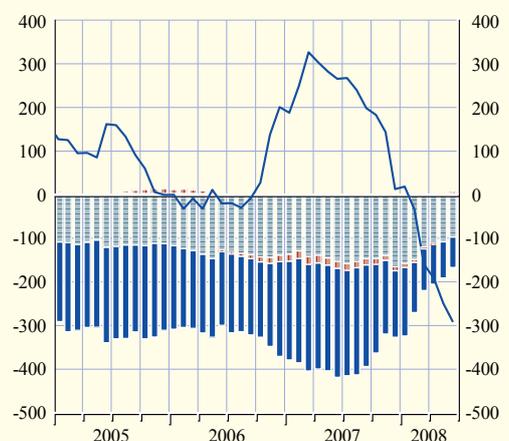


Source: ECB.

Chart C Net external assets and longer-term financial liabilities (excluding capital and reserves)

(annual flows; EUR billions; adjusted for seasonal and calendar effects)

- debt securities issued with maturity of over two years
- deposits redeemable at notice of more than three months
- deposits with agreed maturity of over two years
- net external assets



Source: ECB.

Note: Longer-term financial liabilities (excluding capital and reserves) are shown with an inverted sign since they are liabilities of the MFI sector.

a maturity of more than two years) and therefore required very high risk premia. In this context, it is likely that non-resident investors also have not replaced maturing securities in their portfolios with new ones. In principle, this development does not involve the euro area money-holding sector and therefore should not affect net external assets. However, owing to the considerable difficulties in identifying the ultimate holders of long-term MFI debt securities, the statistical convention is to assume that these securities are all held by euro area residents. The redemption of maturing securities by non-residents thus reduces the flow of net external assets and is mirrored in a decline in the net issuance of longer-term MFI debt securities. Chart C points to such counterbalancing movements for the period since mid-2007.

True-sale securitisation transactions are another example where, in the context of financial market tensions, developments in net external assets and longer-term financial liabilities may have moved in a counterbalancing way. Depending on the accounting standards used, these transactions are sometimes portrayed on the MFI balance sheet as the creation of a long-term time deposit (a deposit with an agreed maturity of more than two years) vis-à-vis the financial vehicle corporation (FVC) – which belongs to the OFI sector – through which the securitisation transaction is carried out.² To the extent that the moderation in the securitisation

² In some euro area countries, where securitisation activity has been particularly intense in recent years, the application of International Financial Reporting Standards also for statistical reporting purposes implies that loans transferred in the context of a true-sale securitisation transaction are often not removed from the original credit institution's balance sheet (see also Box 3 entitled "The importance of accounting standards for interpreting MFI loan statistics" in the March 2008 issue of the Monthly Bulletin). In this case, the proceeds from the sale of the loans are counterbalanced on the credit institution's balance sheet by a non-transferable liability, typically a long-term time deposit (see also the box entitled "The impact of bank loan securitisation on monetary analysis" in the February 2008 issue of the Monthly Bulletin).

market implies that foreign investors have largely refrained from purchasing new asset-backed securities from euro area FVCs, the servicing of the outstanding securities in their portfolios would have generated negative flows in the MFI net external asset position. At the same time, the amortisation of the securitised loans, in the absence of strong new securitisation activity, would tend to reduce the flow of long-term time deposits held by FVCs. Chart C shows that since the end of 2007 the reduction in the net external asset position flow has coincided with a decline in long-term time deposits. The sectoral breakdown suggests that it was mainly those held by OFIs. However, it is important to note that this decline may reflect – more prominently than developments in securitisation activity – the impact of a flat yield curve on OFI portfolio allocation, as it favours instruments at the shorter end of the maturity spectrum.

The types of transaction outlined above are examples of cases where a reduction in the flow of net external assets is linked to a matching change in other counterparts, thereby leaving headline M3 dynamics unaffected. These examples are quantitatively relevant for the euro area at the current juncture, but they should not be understood as accounting for all of the dynamics in net external assets in recent months. Nevertheless, they demonstrate the complexity and possible interlinkages of transactions portrayed on the MFI balance sheet, which are compounded when these transactions also involve counterparties outside the euro area. In this respect, they warn against a purely mechanical interpretation of developments in the various counterparts of M3.