Box 2

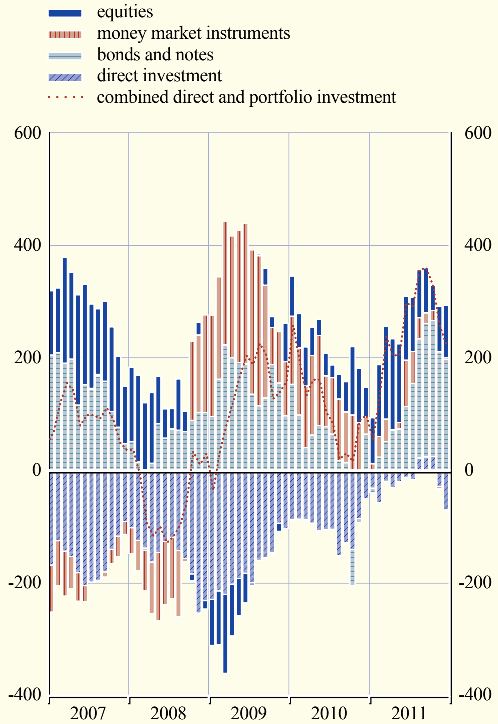
RECENT DEVELOPMENTS IN THE FINANCIAL ACCOUNT OF THE EURO AREA BALANCE OF PAYMENTS

This box analyses recent developments in the financial account of the euro area balance of payments. Net inflows in combined net direct and portfolio investment increased to €223.7 billion in 2011, up from €98.1 billion a year earlier, and were broadly offset by larger net outflows in other investment (see table and chart). After the exceptionally large net inflows in portfolio investment that were recorded in the first half of 2011, net inflows decreased substantially in the second half of the year. At the same time, a two-way repatriation process began, whereby foreign investors withdrew funds previously invested in euro area securities, while euro area investors became net sellers of foreign securities. More recently, however, in December, some signs of a normalisation have emerged in portfolio investment patterns.

Net inflows in combined net direct and portfolio investment increased in 2011, mainly supported by larger net inflows in portfolio investment. Despite the overall increase vis-à-vis the previous year, developments in portfolio investment were rather volatile, with abrupt changes in investment patterns following shifts in market sentiment and investor behaviour. In the first half of 2011, net inflows in portfolio investment increased substantially, mainly reflecting foreign investors' sizeable purchases of euro area securities issued by both the MFI and non-MFI sectors. With regard to the non-MFI sector, foreign demand for the more liquid and highly rated debt securities was particularly elevated in the second quarter of 2011, probably reflecting safe-haven flows in a context of high volatility and heightened financial market tensions. In the third quarter of 2011, by contrast, net inflows in debt securities declined considerably, while there was a shift from net outflows to net inflows in equity securities. This masked a liquidation process, whereby euro area investors repatriated funds previously invested in foreign securities and non-residents moved out of euro area securities.

Main items in the financial account

(EUR billions; 12-month cumulated net flows; monthly data)



Source: ECB.

Main items in the financial account of the euro area balance of payments

(EUR billions; non-seasonally adjusted data)

	2011		Three-month cumulated figures 2011				12-month cumulated figures	
	Nov.	Dec.	Mar.	June	Sep.	Dec.	2010 Dec.	2011 Dec.
Financial account [1]	-6.7	-23.0	15.7	18.4	9.8	-34.7	44.1	9.3
Combined net direct and portfolio investment	-6.5	3.2	118.7	121.2	21.1	-37.4	98.1	223.7
Net direct investment	-8.0	1.3	-9.9	-29.0	-16.5	-14.4	-49.9	-69.8
Net portfolio investment	1.5	2.0	128.5	150.2	37.7	-23.0	148.0	293.4
Equities	8.3	14.9	89.2	-38.1	22.0	19.7	52.4	92.9
Debt instruments	-6.8	-12.9	39.3	188.3	15.6	-42.6	95.7	200.5
Bonds and notes	9.6	20.1	16.8	147.2	30.9	3.1	64.9	198.0
Money market instruments	-16.5	-33.1	22.5	41.1	-15.3	-45.8	30.7	2.5
Net other investment	-0.5	-13.7	-89.1	-108.9	0.3	16.8	-61.2	-180.9
Of which: money-holding sector [2]								
Net direct investment	-9.2	2.1	-5.3	-22.4	-16.4	-14.5	-35.8	-58.6
Net portfolio investment	-26.3	12.5	61.5	77.7	18.4	-46.2	-98.4	111.5
Equities	-2.2	18.0	82.3	-27.5	20.5	6.8	72.2	82.1
Debt instruments	-24.1	-5.5	-20.8	105.3	-2.0	-53.0	-170.6	29.4
Net other investment	-9.7	19.6	31.1	-32.8	29.0	6.3	-53.8	33.6

Source: ECB.
Notes: Figures may not add up, owing to rounding.
1) Figures refer to balances (net flows). A positive (negative) sign indicates a net inflow (outflow).
2) General government and other sectors of the balance of payments.

In the fourth quarter of 2011, both euro area and foreign investors continued reducing their cross-border holdings of securities. Net outflows were recorded for portfolio investment as the disinvestment by foreign residents was larger than that by euro area residents. Whereas in the euro area both the MFI and the private non-MFI sectors repatriated funds, the repatriation by foreign investors mainly concerned securities issued by the private non-MFI sector. Looking at securities issued by the euro area general government sector, net purchases were recorded in the third quarter of 2011, notwithstanding a sharp decrease in foreign inflows. The emergence of this two-way repatriation process should be seen against the backdrop of mounting financial market tensions, as well as volatile and declining equity prices at the global level. These factors seem to have weighed on market sentiment amid increasing concerns about the global economic outlook and heightened risk aversion. Moreover, the decrease in net portfolio investment inflows to the euro area non-MFI sector contributed negatively to the liquidity available in the euro area and is partly reflected in the evolution of the broad monetary aggregate M3. In fact, as can be seen from the monetary presentation of the balance of payments, these transactions involving the money-holding sector are a mirror image of the overall decrease observed in the MFI net external asset position in October and November 2011.[1]

More recent data for December, however, provide tentative signs of apparent normalisation in portfolio investment patterns. Both euro area investment in foreign securities and foreign investment in euro area securities seem to have resumed somewhat, although still at low levels. In addition, net portfolio investment inflows to the non-MFI sectors were recorded, which is also

1 To the extent that they are settled via resident banks, transactions carried out by the money-holding sector have an impact on the external assets and liabilities of the banking sector, which is one of the counterparts of the M3. The money-holding sector comprises households, non-financial corporations, non-MFI financial intermediaries and general government other than central government. For more information on the monetary presentation of the balance of payments, see Duc, L. B., Mayerlen, F. and Sola, P., "The monetary presentation of the euro area balance of payments", *Occasional Paper Series*, No 96, ECB, 2008. See also "The external dimension of monetary analysis", *Monthly Bulletin*, ECB, August 2008.

consistent with the slight resumption of inflows seen in the MFI net external asset position in this month. This resumption is probably related to some improvement in market sentiment close to the end of the year, reflecting, inter alia, not only the introduction of the ECB's unconventional liquidity measures, but also the coordinated interventions by the ECB and five other central banks – in the form of reciprocal currency arrangements (swap lines) – aimed at providing liquidity to the global financial system.

Turning to the MFI sector, euro area banks stepped up their net sales of foreign securities in the fourth quarter of 2011. This increase probably relates to a combination of two factors. The first is the ongoing process of balance sheet restructuring on account of the tightening capital requirements in the euro area. The necessary deleveraging process is usually particularly pronounced for non-core assets, in particular foreign securities, as is clearly visible in the reporting period. The second is the need to mobilise funds in a context of funding pressures, which are not only reflected in the foreign sales of securities issued by euro area banks in the last two quarters of the year, but also in the reduction of MFIs' other investment liabilities, indicating difficulties in rolling over maturing short-term deposits and loans associated with the high costs of funding in foreign currency. The disinvestment from euro area MFI securities was related, in part, to concerns among foreign investors regarding the stability of banking systems in selected euro area countries. Nonetheless, the decrease in MFIs' other investment liabilities was partly offset by the increase in the Eurosystem's other investment liabilities, on account of the aforementioned swap lines between the ECB and other central banks.