Developments in the external direct and portfolio investment flows of the euro area

Direct and portfolio investment flows between the euro area and abroad have risen substantially since the end of the 1990s. Merger and acquisition (M&A) activities influenced foreign direct investment, while – notwithstanding interrelationships with direct investments – risk diversification and expectations about relative corporate profitability were among the key factors affecting cross-border portfolio flows. During the period 1998-2001, for which data are available for the euro area as a whole, the euro area experienced sizeable net outflows of combined direct and portfolio investment (averaging €126 billion per annum), in particular vis-à-vis the United States. However, the net outflows gradually declined during this period and large fluctuations took place in the composition of euro area financial flows, particularly between investment in equity securities and debt instruments. Movements in portfolio investments seem to have been influenced by several factors: expectations in 1998 related to the formation of Economic and Monetary Union (EMU); the large increase in bond issuance by euro area residents from 1999 onwards; the optimistic market sentiment regarding US corporate profitability, particularly in the New Economy sector up to 2000; the narrowing of the interest rate differential between the United States and the euro area in 1999 and 2000; and the increased uncertainty regarding the global economic outlook at the end of 2000 and in 2001.

1 Introduction

The 1990s were characterised by sustained and extensive integration of financial markets worldwide and most notably in the euro area. The liberalisation of financial markets and technical progress in communication technologies have allowed investors to trade more easily on global markets, leading to sizeable cross-border portfolio investment flows. In addition, global competition has triggered M&A activities between euro area and non-euro area companies, which are behind the sharp increase in foreign direct investment.

The aim of this article is to highlight trends in and determinants of direct and portfolio investment flows between the euro area and abroad. Data for the aggregate flows come from the financial account of the euro area balance of payments (b.o.p.), which includes direct and portfolio investment transactions involving euro area residents and non-residents (see box) and excludes transactions between euro area countries. These data are available from 1998 onwards. More detailed bilateral data between the euro area and the United States and Japan are taken from the respective national statistical sources.

2 Recent developments in euro area direct and portfolio investment flows

M&A activities were a key determinant of developments in foreign direct investment at the end of the 1990s. Euro area companies have often strengthened their position in international markets and gained access to local technology and expertise by forming partnerships with foreign firms and by investing in them. Over the period 1998-2001, for which data are available for the euro area as a whole, euro area companies made an average yearly amount of foreign direct investment of €275 billion, mostly in the form of acquisitions of equity capital (see Table 1 as well as Table 8.4 in the "Euro area statistics" section of this Bulletin), particularly in US companies. Foreign companies also considered the euro area to be an important region in which to invest and locate. Over the same period, the amount of direct investment inflows into the euro area averaged €203 billion per annum. The euro area, therefore, experienced net outflows of direct investment throughout the period, except in 2000, when there was a particularly

Table 1

Euro area net external financial flows

(EUR billions)

	1998	1999	2000	2001	Average
Combined net direct and portfolio investment	-191	-159	-88	-68	-126
A. Direct investment	-81	-118	15	-105	-72
Assets	*-173*	*-317*	*-385*	*-228*	*-275*
Liabilities	*92*	*198*	*400*	*123*	*203*
B. Portfolio investment	-110	-40	-103	37	-54
Assets	*-363*	*-302*	*-400*	*-267*	*-333*
Liabilities	*253*	*262*	*297*	*303*	*279*
1. Equities	-12	-67	-243	143	-45
Assets	*-116*	*-157*	*-289*	*-95*	*-164*
Liabilities	*104*	*90*	*46*	*238*	*120*
2. Debt instruments	-98	26	140	-106	-10
Assets	*-247*	*-145*	*-111*	*-171*	*-169*
Liabilities	*149*	*171*	*251*	*65*	*159*
2.1 Bonds and notes	-117	-29	135	-75	-22
Assets	*-239*	*-147*	*-92*	*-153*	*-157*
Liabilities	*122*	*117*	*226*	*78*	*136*
2.2 Money market instruments	20	55	5	-32	12
Assets	*-8*	*1*	*-19*	*-18*	*-11*
Liabilities	*28*	*54*	*24*	*-13*	*23*

Source: ECB.
Note: A minus sign indicates financial outflows from the euro area. Greece is not included in the 1998 figures.

large inward investment of this type. Owing primarily to this M&A transaction in February 2000, the euro area b.o.p. registered an inflow in the category of equity capital of €158 billion from non-residents in that month alone.

As regards portfolio investment, net outflows amounting to a yearly average of €54 billion were recorded in this investment category of the euro area b.o.p. in the period under consideration. Moreover, investment in equity securities and debt instruments was characterised by high volatility and shifts in the direction of flows. In this context, the identification of the determinants of such flows becomes a rather complex task. However, risk diversification and expectations about relative corporate profitability worldwide, and particularly in the United States, appeared to be among the key factors affecting euro area portfolio flows between 1998 and 2001.

Turning to the individual components of portfolio investment, the euro area experienced average net outflows in equity securities of €45 billion during the reference period. However, behind this average figure, there are somewhat contrasting developments with regard to the direction of equity flows, as the net outflows recorded in the period 1998-2000 turned into sizeable net inflows in

Chart 1

Real GDP growth differential between the United States and the euro area

(in percentage points)

Sources: BIS, Eurostat and ECB calculations.
Note: The difference between US and euro area real GDP growth rates is measured against the same quarter in the previous year.

Box

Description of the financial account of the euro area balance of payments

The financial account of the euro area b.o.p. is divided into five main sub-components: direct investment, portfolio investment, financial derivatives, other investment and reserve assets.

Direct investment reflects the objective of a resident entity in one economy to obtain a lasting interest in an enterprise resident in another economy. In line with international standards, a "10% ownership criterion" is used to infer such a relationship. Direct investment comprises three categories, i.e. "equity capital" which includes in particular many M&A transactions, "reinvested earnings" (earnings of the "direct investor" not distributed as dividends) and "other capital" which mainly consists of inter-company loans.

The portfolio investment account shows transactions in securities, except those included in direct investment and reserve assets. It includes equity securities and debt securities in the form of bonds and notes and money market instruments. Euro area asset flows refer to the transactions by resident investors in securities issued by non-resident entities, while liability flows reflect the transactions between residents and non-residents in securities issued by residents of the euro area.

Financial derivatives are financial instruments linked to a specific financial instrument, indicator or commodity, and through which specific financial risks can be traded in financial markets in their own right.

The other investment account includes transactions in loans, deposits and repurchase agreements, while reserve assets comprise holdings of foreign liquid and creditworthy assets by the Eurosystem.

For the time being, the euro area b.o.p. does not include a geographical breakdown. It is planned to compile and publish this information as from end-2004. This article, therefore, uses statistics published by some counterpart countries, i.e. the United States and Japan, even though there may be some methodological differences between these data and the euro area b.o.p. statistics.

2001 (see Table 1). Given that a significant proportion of equity outflows was seemingly directed to the United States (see Section 3 below), a likely explanation for the 1998-2000 development is the strong performance of the US economy in the second half of the 1990s (see Chart 1). The sizeable increase in US real GDP growth made investors optimistic about the long-run profitability of US companies, especially in the New Economy sector. In addition, it should be noted that the particularly large net outflows of euro area equity portfolio investment in 2000 were also influenced by the settling of M&A transactions via the exchange of shares, highlighting the interrelationship between the flows recorded under both direct and portfolio investment.

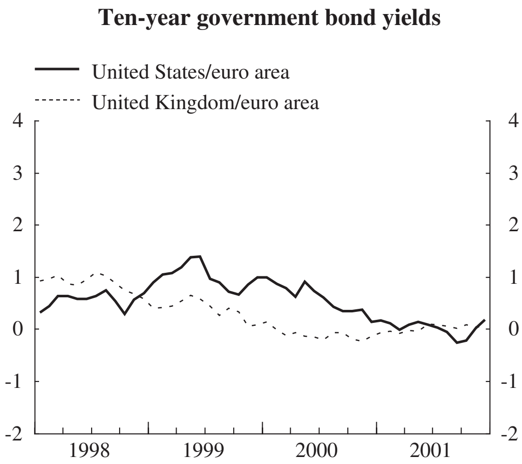
In 2001 the uncertainty generated by the economic slowdown in the United States and its effects on other regions of the world affected equity investment flows; the euro area experienced large equity inflows on the liabilities side amounting to €238 billion in 2001, while investment in equity securities abroad by euro area residents declined. As a result, the euro area registered net inflows of €143 billion in 2001, compared with significant net outflows in previous years, particularly in 2000.

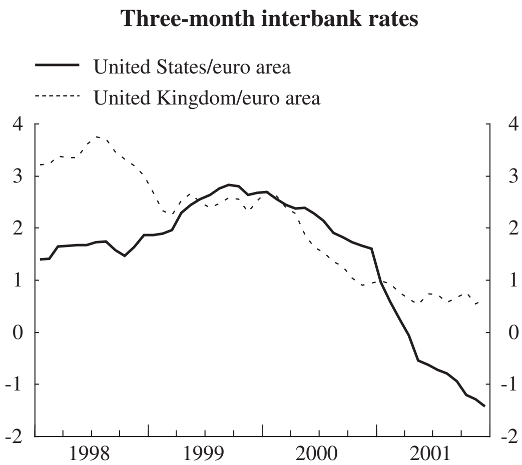
Investment in debt instruments was broadly balanced, as it recorded an average net outflow of €10 billion during the period 1998-2001. However, while net outflows were registered in 1998 and 2001, net inflows marked developments in both 1999 and 2000. Expectations in 1998 that the start of Stage Three of EMU would make the returns on euro area bonds highly correlated might have led to portfolio diversification and hedging,

Chart 2

Interest rate differential between the United States, the United Kingdom and the euro area

(monthly averages, percentage points)





Sources: BIS, national data and ECB calculations.

thereby explaining, at least in part, the observed net outflows from the euro area in bonds and notes. From mid-1999 to the end of 2000, the fall in the ten-year government bond yield differential between the United States, the United Kingdom and the euro area (see Chart 2) and the rapid increase in bond issuance by euro area residents (see Chart 3) – driven partially by the introduction of the euro, the corporate restructuring within the euro area and the creation of a deeper and more liquid market for debt securities in Europe – might have caused a reduction in net outflows in bonds and notes in 1999 and a shift to net inflows in 2000. Transactions in money market instruments have been volatile on the assets and liabilities sides of the euro area financial account. The purchase of euro area money market instruments by non-residents has, however, declined since March 2000. Expected developments in the short-term interest rate differential between the United States, the United Kingdom and the euro area as well as the depreciation of the euro relative to the US dollar and pound sterling probably accounted for the decline in investment flows related to money market instruments on the liabilities side in 2000 and 2001.

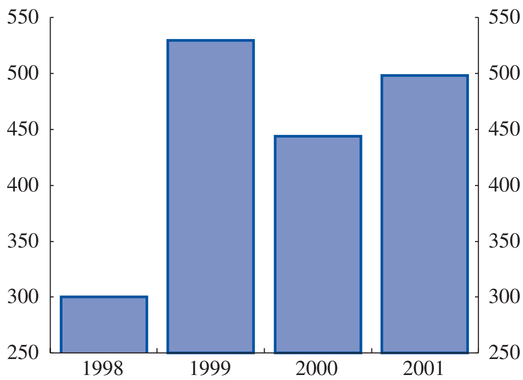
In 2001, the net outflows recorded in both categories of debt instruments may be associated with expectations by non-residents of capital gains in the US bond markets induced by monetary easing in that year.

Overall, the euro area experienced a net outflow of combined direct and portfolio investment during the 1998-2001 period. Since 1999, however, the combined net outflow has been declining, which more recently reflects a shift from net outflows to net inflows of equity portfolio investment.

Chart 3

Net issuance of debt securities by euro area residents

(EUR billions)



Source: ECB.

3 Geographical destination and origin of euro area financial flows

The euro area b.o.p. does not yet record the geographical breakdown of financial flows. However, it is possible to form an impression of the size and direction of bilateral direct and portfolio investment with the United States and Japan from data taken from the national statistical sources of these countries.

The United States appears to have been the main destination for financial flows from the euro area over the 1998-2001 period. According to the US Bureau of Economic Analysis and the US Treasury International Capital (TIC) reporting system, bilateral financial flows between the euro area and the United States rose significantly in 1999 and 2000, seemingly reflecting the strength of the US economy and market expectations about US corporate profitability.

Table 2 shows in more detail that, during the 1998-2001 period, euro area direct investment in the United States averaged €107 billion, compared with €35 billion of US direct investment in the euro area. This has resulted in average annual net outflows in this item of €71 billion from the euro area to the United States during this period. Similarly, net outflows from the euro area to the United States were recorded in portfolio investment (averaging €79 billion in the 1998-2001 period), as euro area residents' portfolio investment in the United States averaged €67 billion and the United States disinvested an average of €11 billion in the euro area over the same period. The bilateral euro area/US flows in this category contain information enabling a better understanding of developments in euro area equity portfolio investment. More specifically, the shift in euro area equity portfolio investment from net outflows in 2000 to net inflows in 2001 (see Table 1) is apparently associated with the decline in euro area investment in US equity securities; the latter fell from €91 billion in 2000 to €35 billion in 2001 (see Table 2).[1]

The euro area also has financial links with Japan, albeit weaker than with the United States. The Japanese Ministry of Finance has

1 *As a note of caution, the US portfolio investment data are not directly comparable with those of the euro area b.o.p., as they rely on different data collection methods and definitions. The US TIC reporting system, in particular, identifies the first counterpart, thus tracking the place of transactions and not the ultimate owners of securities.*

Table 2

Net bilateral direct and portfolio investment between the euro area and the United States

(EUR billions)

	1998	1999	2000	2001	Average
Bilateral direct investment	-34	-89	-93	-70	-71
- in the United States	-74	-113	-131	-109	-107
- in the euro area	40	24	38	39	35
Bilateral portfolio investment	-65	-67	-133	-50	-79
- in the United States	-59	-53	-119	-39	-67
- in the euro area	-6	-15	-14	-11	-11
1. Equities	-39	-62	-110	-38	-62
- in the United States	-33	-43	-91	-35	-51
- in the euro area	-5	-19	-19	-3	-12
2. Bonds and notes	-26	-5	-23	-11	-16
- in the United States	-26	-9	-28	-3	-17
- in the euro area	0	4	5	-8	0

Sources: US Bureau of Economic Analysis, US Department of the Treasury and ECB calculations.
Note: A minus sign indicates financial outflows from the euro area and inflows into the United States.

Table 3

Net bilateral direct and portfolio investment between the euro area and Japan

(EUR billions)

	1998	1999	2000	Average	2000 first half	2001 first half
Bilateral direct investment	1	-2	-3	-1	0	1
- *in Japan*	0	-9	-7	-5	-2	-1
- *in the euro area 7*	1	6	4	4	2	3
Bilateral portfolio investment	63	73	60	65	32	8
- *in Japan*	16	18	8	14	2	-2
- *in the euro area 7*	47	55	52	51	30	10

Sources: Japanese Ministry of Finance and ECB calculations.
Note: A minus sign indicates financial outflows from the euro area and inflows into Japan. The seven euro area countries are Belgium, Germany, Spain, France, Italy, Luxembourg and the Netherlands.

published direct and portfolio investment flows for seven euro area countries – Belgium, Germany, Spain, France, Italy, Luxembourg and the Netherlands – since 1995. According to these data, direct investment flows are relatively small between the two economic areas (see Table 3).

Conversely, portfolio investment experienced a yearly average net inflow of €65 billion during the period 1998-2000. Japanese residents invested an average amount of €51 billion in debt instruments and equity securities issued by euro area residents, particularly in bonds and notes. By contrast, euro area residents disinvested an average amount of €14 billion of Japanese securities between 1998 and 2000. A comparison of the data relating to the first halves of 2000 and 2001 (the most recently published data refer to the first half of 2001) suggests that bilateral direct and portfolio investment may have been subdued in 2001 as a whole.

4 Conclusions

Financial flows between the euro area and abroad rose rapidly at the end of the 1990s. M&A activities, perhaps reflecting competitive forces in world markets, were mainly behind the sharp increase in cross-border direct investment flows, while – notwithstanding interrelationships with direct investments – risk diversification and expectations about corporate profitability, particularly with respect to the US corporate sector, were among the key factors affecting cross-border portfolio investment flows.

The euro area recorded net outflows of direct investment during the period 1998-2001, except for 2000, when there was a particularly large inward investment. By contrast, portfolio investments in equity securities registered net outflows during the period 1998-2000 and net inflows in 2001, mainly owing to expectations about relative profitability of US and euro area companies.

The euro area b.o.p. was also characterised by shifts in debt instrument flows. The net outflows from the euro area in 1998 may have been a response to expectations that the start of Stage Three of EMU would make the returns on euro area bonds highly correlated, while those recorded in 2001 probably reflected expectations of capital gains by non-residents on US debt instruments. Conversely, the net inflows into the euro area in 1999 and 2000 were influenced by a combination of factors, in particular the rapid increase in bond issuance by euro area residents and the narrowing of the long-term interest rate differential between the United States and the euro area, especially in 2000.

Overall, combined direct and portfolio investment recorded a net outflow from the euro area in the reference period, the level of which, however, has been on the decline since 1999.