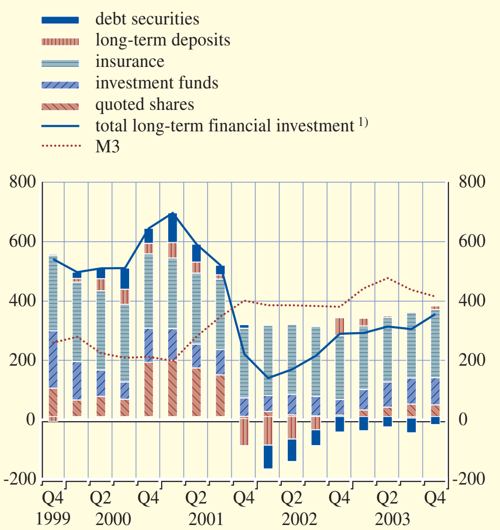
Box 1

RECENT TRENDS IN PORTFOLIO ALLOCATION BETWEEN MONETARY AND LONGER-TERM FINANCIAL ASSETS

Over recent years, developments in euro area monetary aggregates have been driven by portfolio shifts between money and longer-term financial assets. Amid heightened geopolitical uncertainties and the significant downturn in equity prices between 2001 and mid-2003, economic agents appear to have shifted funds out of riskier, longer-term assets and into safer, more liquid monetary holdings, thereby strengthening monetary growth. With the reduction in economic and financial uncertainty since the summer of 2003, some correction of these portfolio shifts has taken place. In the context of a gradual economic recovery in the euro area, monetary growth has thus moderated since the second half of 2003. Against this background, this box analyses which instruments have played the most important role in the move from longer-term financial assets into money.

Chart A Long-term financial investment of the non-financial sectors and M3

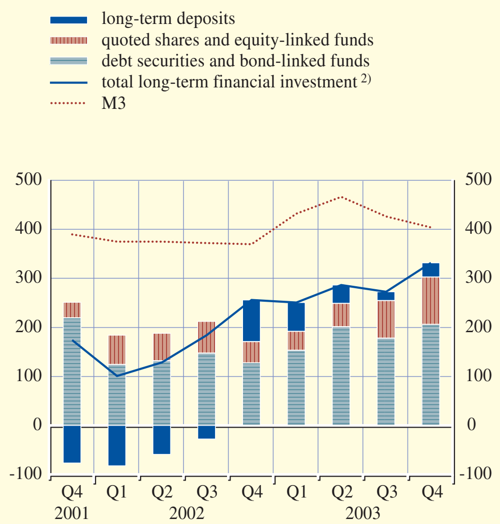
(annual flows in EUR billions)



Source: ECB.
1) Includes deposits with MFIs not included in M3 (long-term deposits), debt securities with a maturity of over one year, quoted shares, mutual fund shares excluding money market fund shares, and insurance technical reserves.

Chart B Long-term financial investment of the money-holding sector[1)] and M3

(annual flows in EUR billions)



Source: ECB, FEFSI.
1) The money-holding sector comprises essentially the non-financial sector, insurance corporations and pension funds, and investment funds.
2) Includes long-term financial investment of the non-financial sector (defined as in Chart A) excluding insurance technical reserves plus the long-term financial investment of insurance corporations.

One way to address this issue is simply to compare developments in money holdings with the long-term financial investment of the non-financial sector (essentially households and non-financial corporations),[1] as reported in the quarterly financial accounts. This exercise shows how the strong increase in money holdings from 2001 onwards was accompanied by a reduction in the long-term financial investment of the non-financial sector (see Chart A). In

1 Deposits of central government are not included in M3 (see the article entitled "Euro area monetary aggregates and their role in the Eurosystem's monetary policy strategy" in the February 1999 issue of the ECB's Monthly Bulletin).

particular, it suggests that stronger inflows into monetary assets were linked to a reduction in the purchase of shares, which was closely related to both the sharp decline in financial acquisitions abroad by euro area residents from late 2001 and the reduction in the net issuance of equity by domestic sectors. Purchases of debt securities also fell. Since early 2003, by contrast, purchases of quoted shares by the non-financial sector have increased, while inflows to monetary assets have moderated. Finally, during both periods households and firms have continued to invest steadily in insurance products and investment funds.

Given the importance of insurance and investment funds in the financial investment of the non-financial sector, a more complete approach to analysing portfolio shifts would be to consider the allocation of the funds invested by insurance and investment funds across equities, debt securities, long-term deposits and money. By consolidating the accounts of the non-financial sector and insurance corporations, and disaggregating investment funds into equity-linked and bond-linked funds,[2] it is possible to construct a proxy for the investment of the money-holding sector.

Chart B thus compares (albeit for a shorter period than Chart A owing to data constraints) the long-term financial investment of the money-holding sector as a whole with developments in money holdings. Focusing on the period since summer 2003, Chart B also shows that the moderation in monetary growth during that period is linked to an increase in purchases of equity instruments (quoted shares and equity-linked funds) by the money-holding sector. All of this can be regarded as evidence of a gradual normalisation of the portfolio behaviour of the money-holding sector over recent quarters.

2 The consolidation of the non-financial sector with investment funds excluding money market funds is currently not possible owing to the absence of data concerning financial investment by investment funds excluding money market funds.