

Box 5

EXPLAINING CHANGES IN THE NET INTERNATIONAL INVESTMENT POSITION OF THE EURO AREA

At the end of 2005 the net international investment position (i.i.p.) of the euro area showed net liabilities of 10.1% of GDP. This reflected an increase of 3.6 percentage points in the net liability position compared with the end of 1999 (see Chart A). This box describes the main factors underlying developments in the i.i.p. and shows that the increase in the euro area's net international liability position during the period from 1999 to 2005 was largely driven by revaluation effects resulting from movements in exchange rates.

According to statistical standards, the i.i.p. is valued on the basis of the prevailing market prices of assets and exchange rates at the end of each period. Developments in the i.i.p. are therefore explained by revaluations due to variations in exchange rates and asset prices, such as stock and bond prices, in addition to financial transactions. In the b.o.p., these net financial transactions are the counterpart to the movements in the current account and capital account.¹ For example, in terms of the i.i.p., a current account surplus corresponds to net financial transactions that decrease (increase) an external debtor (creditor) position.

Chart B shows the evolution of the annual changes in the euro area net i.i.p. from 2000 to 2005, broken down into their various components, such as: financial transactions in the b.o.p.; changes related to exchange rates and asset prices (revaluation effects); and changes due to "other adjustments".²

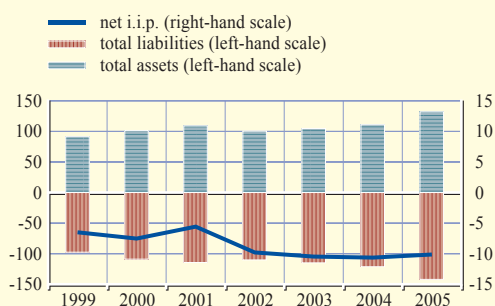
More than half of the total increase in the euro area's net liability position between the end of 1999 and the end of 2005 can be attributed to revaluations due to exchange rate effects (i.e. the appreciation of the euro), while financial transactions, changes in asset prices, and "other adjustments" contributed equally to the remainder.

1 In practice, the balance is achieved by net errors and omissions.

2 Note that "other adjustments" were derived as the residual resulting from an estimation procedure.

Chart A Net i.i.p. of the euro area

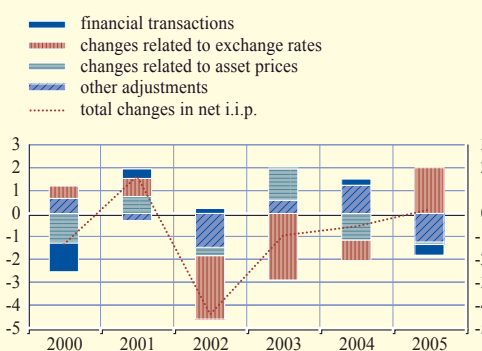
(as a percentage of GDP)



Source: ECB.
Note: Data refer to outstanding amounts at year-end.

Chart B Breakdown of changes in the euro area net i.i.p.

(as a percentage of GDP)



Source: ECB.

As in many industrialised economies, euro area cross-border assets are mostly denominated in foreign currencies, whereas cross-border liabilities are mainly denominated in the domestic currency (i.e. in euro). This makes the revaluation of external assets relatively more responsive to exchange rate movements. An appreciation of the euro therefore lowers the value (in euro) of external assets more than external liabilities and leads to an increase in net liabilities. Accordingly, increases in the euro area's net liabilities due to exchange rate revaluations mostly occurred in 2002-03 reflecting the appreciation of the effective exchange rate of the euro over the same period (see Chart B).

Revaluations due to asset price changes also contributed to the increase in the euro area's net liability position between 1999 and 2005. However, cumulative net asset price revaluations were relatively small, which might reflect broadly synchronised movements in price indices of cross-border assets and liabilities together with broadly similar compositions of the euro area's external assets and liabilities in terms of the types of financial instruments (i.e. equity, debt and other categories of investments). Finally, b.o.p. financial transactions were overall relatively close to balance and had little impact on the euro area net i.i.p. over the period examined.