

Box I

DEVELOPMENTS IN MFIS' GROSS EXTERNAL ASSETS AND LIABILITIES

Strong capital inflows into the euro area at the end of 2006 and in early 2007 raised the annual flow in net external assets of the MFI sector very rapidly to a record level of €335 billion in March 2007, from a marginal outflow in September 2006. Such changes in the MFI sector's net external asset position can be assessed from different perspectives. For example, it is possible to look at whether the capital inflows stem from non-euro area residents buying euro area assets or from residents selling foreign assets, or at whether the capital inflows reflect transactions in debt instruments, equity or other types of investment.¹ This box looks at recent developments in MFIs' net external assets from the perspective of developments in the underlying gross positions of external assets and liabilities.

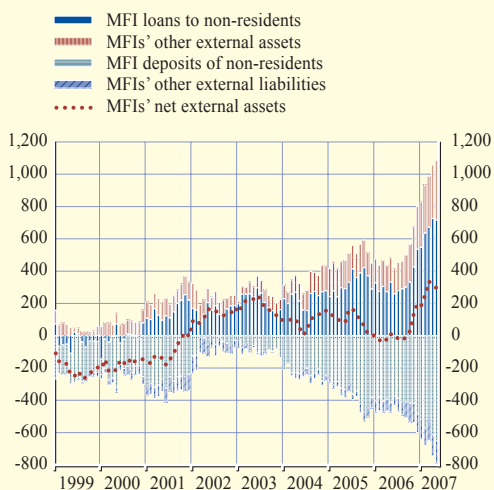
External assets of the euro area MFI sector comprise loans granted to non-euro area residents, securities issued by non-residents (debt securities, shares and other equity) held by MFIs resident in the euro area, and some items of small amounts, such as foreign cash or gold. MFIs' external liabilities comprise the deposits of non-residents with euro area MFIs, as well as non-residents' holdings of money market funds and MFIs' short-term debt securities. The external assets and liabilities of the euro area MFI sector also include the changes generated by the operations of the Eurosystem, but their impact has been relatively small over the past few years.

Chart A shows that the largest contribution to the annual flow in MFIs' gross external assets typically comes from loans to non-residents, while on the liabilities side it comes from holdings

¹ See, for instance, the box entitled "Recent developments in MFI net external assets" in the July 2005 issue of the Monthly Bulletin, and also the article entitled "Interpreting monetary developments since mid-2004" in this issue of the Monthly Bulletin.

Chart A MFIs' external assets and liabilities

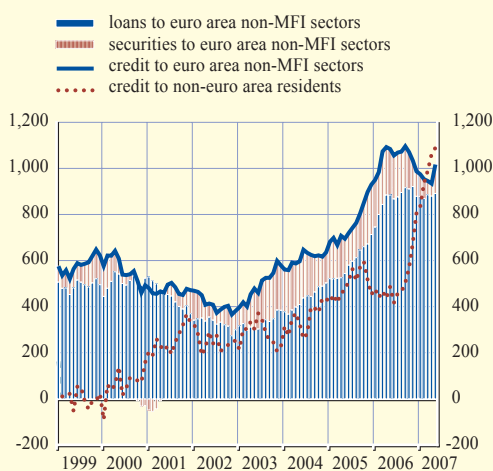
(annual flows; EUR billions)



Source: ECB.
Note: MFI liabilities are shown with an inverted sign.

Chart B MFI credit to euro area and non-euro area residents

(annual flows; EUR billions)



Source: ECB.

of deposits by non-residents. These series often grow in parallel, since loans granted to non-residents have as a counterpart deposits that the MFIs create for the non-residents. The same holds true for another form of credit to non-residents, i.e. where euro area MFIs purchase foreign securities from non-residents and compensate them by creating bank deposits. In both cases, only the gross external asset and liability positions of the MFI sector change, while the net external asset position is unaffected. The latter will change if non-residents use their deposits to purchase assets from the euro area money-holding sectors, in which case MFIs' external liabilities decline and net external assets increase. Net external assets also increase if the MFI sector purchases foreign securities from the euro area money-holding sectors rather than from non-residents, as external assets increase but external liabilities remain unchanged.

In this respect, the joint developments in gross and net external assets and liabilities shown in Chart A highlight different episodes in the period since 1999. During the new-economy boom of the late 1990s, the strong capital outflows from the euro area – mainly driven by merger and acquisition activities of euro area residents in the United States – led to a strongly negative annual flow in net external assets, with a high of more than €200 billion in mid-1999. In terms of the underlying gross positions, this high essentially reflected flows in external liabilities, i.e. the deposits euro area MFIs set up for non-residents in exchange for the securities that the latter sold to euro area residents, while the flows in external assets were, on balance, very small. The period of heightened global uncertainty between 2001 and mid-2003 led instead to the opposite situation: the annual flow in net external assets increased again to a high, this time on the positive side, of more than €200 billion in mid-2003. This high essentially reflected strong flows in external assets, while the flows in external liabilities were on balance small.

The strong positive annual flow of net external assets since late 2006 is altogether different from the former two episodes: it conceals strong flows in both external assets and liabilities of euro area MFIs. This simultaneous expansion of MFI credit granted to non-residents and deposits held by non-residents with euro area MFIs started in mid-2004. Besides MFIs granting loans to non-residents and purchasing foreign securities from them, two further factors could have contributed to the simultaneous increase in MFIs' external assets and liabilities. There are some money market funds that operate solely on behalf of non-euro area parent companies, receiving their funds from the parent company's home market but also investing it there again. This implies that their business only appears in the external assets and liabilities of the consolidated balance sheet of the euro area MFI sector. In addition, financial integration across Europe, where euro area MFIs have partly reorganised the management of assets and liabilities of affiliated entities operating outside the euro area, may also have contributed to the parallel increase in gross external positions of the MFI sector.

In order to appreciate the size of the recent annual flows in MFI credit to non-residents, it is worth comparing it with that of the flows in MFI credit to euro area residents (private sector and government). Chart B shows that in early 2007 the two annual flows were of approximately similar size, amounting in both cases to around €1,000 billion.² This has never been the case in the period under review, with credit to non-residents typically expanding at a slower pace than credit to the domestic sectors. Two factors could have contributed to this rebalancing of the MFI credit portfolio since the second half of 2006. First, rising interest rates within the euro

² This should not be interpreted as meaning that the lending activity of the MFI sector is equally split between domestic and foreign activity, as domestic lending would also include interbank loans, which do not appear in the consolidated MFI balance sheet. The annual flow of interbank loans amounted to somewhat over €400 billion in recent months.

area have dampened the demand for loans by the euro area private sector. Second, the favourable economic outlook in the euro area has strengthened the demand by non-residents for euro area debt securities, and MFIs may have facilitated the purchase of these securities by granting loans to non-residents. In this context, MFIs have themselves been a major seller of euro area debt securities to non-residents by shedding considerable amounts of their holdings of government securities and thus contributing to the slowing of growth in MFI credit to euro area residents shown in Chart B.

Overall, the increase in the annual flow of MFI net external assets to the high levels observed since late 2006 was unprecedented in the period since 1999 in the sense that it concealed simultaneous strong increases in the underlying gross asset and liability positions. The larger gross positions obviously entail the possibility that large amounts of liquidity are quickly shifted, thus possibly leading to significant changes in the magnitude and direction of the flows in MFIs' net external assets. However, when assessing the implications for monetary analysis, it needs to be borne in mind that changes in MFIs' net external asset position do not necessarily also impact on the broad monetary aggregate M3, if, for instance, they are counterbalanced by changes in MFI credit to euro area residents or in MFIs' longer-term financial liabilities.³

³ For example, if a euro area MFI sells euro area government bonds to non-residents, the MFI's domestic credit and external liabilities would decrease at the same time. As a result, net external assets increase, while the stock of M3 would remain unchanged.