

Box I

THE ROLE OF MFI EXTERNAL ASSETS AND LIABILITIES IN THE RECENT DELEVERAGING PROCESS

Positions vis-à-vis non-residents (henceforth “external” positions) have played an important role in the balance sheet developments of euro area MFIs in recent years.¹ This holds both for the period of strong leveraging from 2005 to 2007 and for the subsequent period of deleveraging from early 2008 onwards. Indeed, around half of the recent slowdown in MFIs’ asset accumulation has been accounted for by a reduction in external assets (see Chart A). Against this background, this box looks at MFI external assets and liabilities from the perspective of instruments, counterpart sectors and geographical regions.

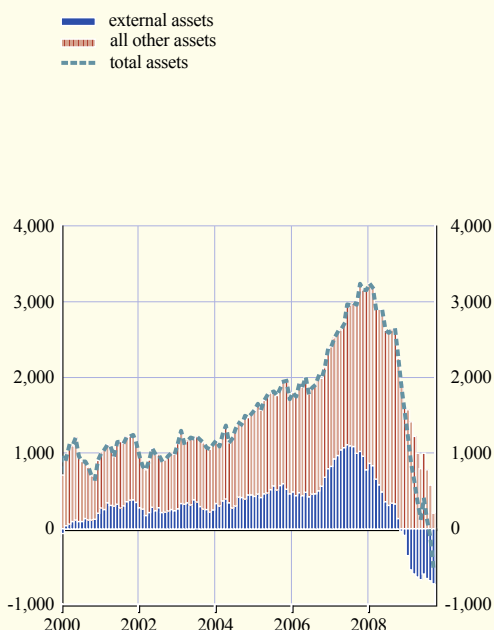
The instrument perspective

Traditionally, euro area MFIs’ transactions with the rest of the world have, on the asset side, involved the granting of loans or the purchasing of securities, while liabilities have been incurred mainly in the form of deposits. These assets and liabilities often result from transactions with the rest of the world conducted by MFIs on behalf of the euro area money-holding sector.

1 For further analysis, see the article entitled “The external dimension of monetary analysis” in the August 2008 issue of the Monthly Bulletin.

Chart A MFIs’ total assets and external assets

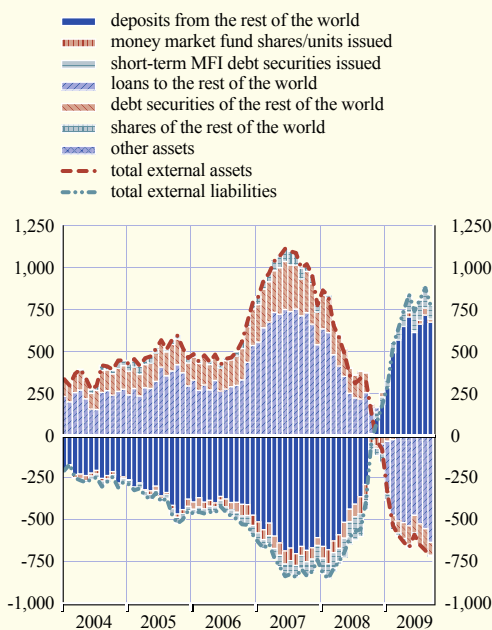
(annual flows in EUR billions)



Source: ECB.
 Notes: MFI sector excluding the Eurosystem. “Total assets” exclude remaining and fixed assets.

Chart B MFIs’ external assets and external liabilities by instrument

(annual flows in EUR billions)



Source: ECB.
 Notes: MFI sector excluding the Eurosystem. “Other assets” comprise MFIs’ holdings of investment fund shares issued in the rest of the world and non-euro currency holdings.

From 2004 to late 2006 the annual flow into external assets had a relatively stable level and composition in terms of instruments (see Chart B). In the period directly preceding the onset of the financial turmoil the volume of loans to the rest of the world then increased significantly. At the same time, purchases of debt securities, despite also increasing, played a more limited role. On the liability side, the annual flow of deposits from the rest of the world displayed a pattern similar to that of loans and accounted for the bulk of funding received from the rest of the world.

Since late 2008 the euro area MFI sector (excluding the Eurosystem) has sharply reduced all external assets and liabilities. This holds in particular for the volume of loans granted to non-euro area residents, although this contraction has been less pronounced than that observed for external deposits. At the same time, the reduction observed in MFIs' holdings of debt securities issued in the rest of the world has been more moderate than would have been expected on the basis of historical regularities. Those euro area money market funds that traditionally invest their proceeds in foreign debt securities and are marketed in the rest of the world have also recorded redemptions since late 2008. These redemptions have, however, been more limited than those observed for credit institutions' deposits. Comparing the redemptions of these money market funds with the reduction in MFIs' holdings of debt securities issued by non-residents indicates that a significant percentage of this decline has resulted from sales by credit institutions.

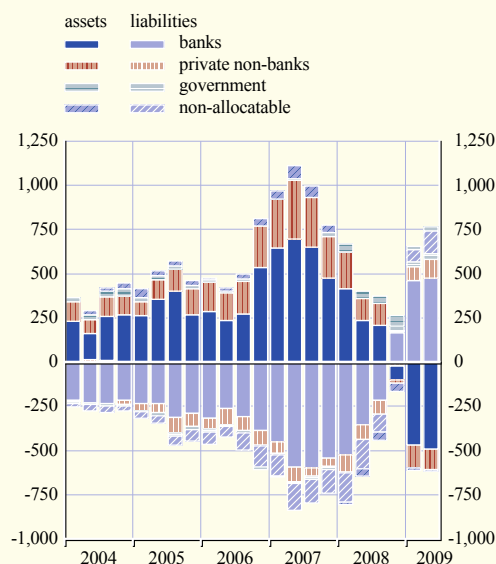
The counterpart sector perspective

In general, transactions undertaken by euro area credit institutions on their own behalf should result in symmetrical changes on the two sides of the MFI balance sheet, whereas transactions settled on behalf of non-residents and the money-holding sector will lead to asymmetrical changes in terms of the asset and liability positions concerned.²

Chart C suggests that the strong co-movement in asset/liability positions vis-à-vis non-resident banks largely reflects business conducted between banks – either with their own affiliates abroad or with other bank counterparts. This holds for both the increase in external assets in the period preceding the financial turmoil and the period of unwinding observed since 2008. The retrenchment in cross-border interbank lending represents an attempt to adjust the size of banks' balance sheets and refocus on core lending activity. At the same time, this reduction possibly reflects the drying up of activity in global financial markets following the collapse of

Chart C MFIs' external assets and external liabilities by counterpart sector

(annual flows in EUR billions)



Source: ECB.
Notes: MFI sector excluding the Eurosystem. Liabilities are shown with the opposite sign. "Non-allocatable" external assets include equity held by the rest of the world, for which no sectoral breakdown is reported. "Non-allocatable" external liabilities consist of money market fund shares/units and short-term MFI debt securities purchased by non-residents, for which no sectoral breakdown is available.

² For a conceptual explanation of the relationship between gross and net external asset developments, see the box entitled "Developments in MFIs' gross external assets and liabilities" in the July 2007 issue of the Monthly Bulletin and the box entitled "MFI net external assets and their impact on monetary developments" in the 2007 Annual Report.

Lehman Brothers. Taken together, these developments indicate a reduction in euro area credit institutions' activities through international financial centres. In the period since late 2008 euro area MFIs (excluding the Eurosystem) have also continued to increase their holdings of foreign government assets, while considerably reducing their financing of private non-banks resident in the rest of the world. Developments in the "non-allocatable" position mainly capture the reduction in non-residents' holdings of short-term marketable instruments issued by euro area MFIs on the liability side of the balance sheet.

The geographical perspective

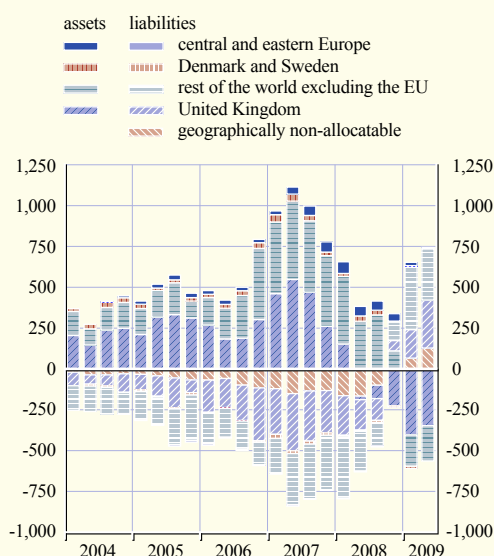
Chart D provides an estimated breakdown of external assets and liabilities held vis-à-vis residents of both EU countries outside the euro area and the rest of the world (excluding the EU). The United Kingdom has typically played a major role in euro area MFIs' external transactions, particularly as regards transactions with non-resident banks, reflecting the role of the City of London as a financial centre. Transaction volumes with the rest of the world (excluding the EU) are also very large and are much less likely to have a bank counterpart. The EU countries of central and eastern Europe play a secondary role for euro area MFIs' external position, although they may have played a more important role for the MFI sectors of individual Member States.

In the period from 2004 to early 2006 borrowers resident in the United Kingdom appear to have been the principal counterparts of euro area MFIs' lending to the rest of the world, while funding of euro area MFIs originating from the United Kingdom was much more limited. From mid-2006 until the onset of the financial turmoil increases in cross-border lending resulted largely from transactions with the rest of the world (excluding the EU). By contrast, the subsequent contraction in lending predominantly reflected a reduction in assets vis-à-vis UK residents. Turning to external liabilities, the recent outflows can be attributed mainly to withdrawals by non-EU residents.

The various perspectives help to shed some light on the driving forces behind recent developments in external positions. After significant increases in external assets (and liabilities) between 2004 and early 2008, the euro area MFI sector has considerably reduced its assets and liabilities vis-à-vis the rest of the world following the intensification of the financial turmoil. The evidence from the various perspectives suggests that this reduction in international transactions – which mainly reflects declines in loans granted and deposits received – has predominantly taken place vis-à-vis non-resident banks located in major financial centres, particularly the

Chart D MFIs' external assets and external liabilities by counterpart country/region

(annual flows in EUR billions)



Source: ECB estimates.

Notes: MFI sector excluding the Eurosystem. Liabilities are shown with the opposite sign. "Geographically non-allocatable" external liabilities consist of money market fund shares/units and short-term MFI debt securities purchased by non-residents, for which no geographical breakdown is available.

United Kingdom. By contrast with a number of previous international financial crises, in the current episode it has been banks' exposures to other industrialised countries that have deteriorated most. Overall, the implications that the reduction of the external position has for the funding of the euro area real economy and the integration of global financial markets will need to be monitored closely.