

Box 10

FINANCIAL TURMOIL AND EURO AREA CROSS-BORDER FINANCIAL FLOWS

The financial turmoil that started in the summer of 2007 and intensified in the autumn of 2008 had major implications for the external balances of the euro area through both the trade and the financial channels. While developments in external trade have been examined in detail on previous occasions,¹ this box focuses on the impact of the financial crisis on the level and

¹ See, for example, the box entitled “Recent developments in euro area trade” in the February 2010 issue of the Monthly Bulletin.

composition of euro area cross-border financial transactions and examines the evolution of these flows in the ensuing period of global economic recovery.²

In the years prior to the financial crisis, cross-border purchases of financial assets by both euro area residents abroad (assets) and non-residents in the euro area (liabilities) recorded a strong surge, in particular over the period from 2005 to mid-2007 (see Chart A). This was partly driven by global financial innovation and the extensive use by a number of financial institutions of new risk transfer instruments, such as securitised debt and other derivative contracts. In addition, further deepening of global financial integration also contributed to the rising demand for external assets, coupled with low risk aversion on the part of investors and favourable macroeconomic conditions.

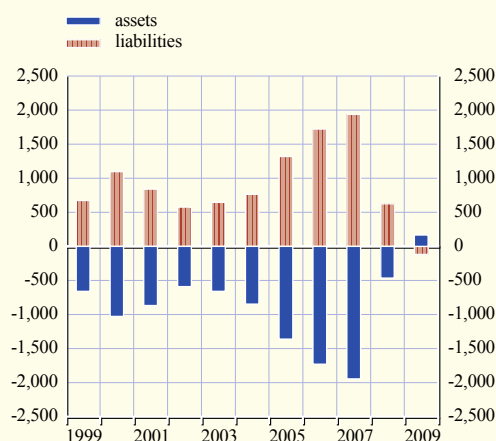
The intensification of the financial crisis in autumn 2008 marked a break in the surge of cross-border financial flows on the asset and liability sides of the euro area financial account. Overall, a significant scaling down of external financial transactions by euro area residents and non-residents was recorded in 2008, and was evident across all types of investors from the banking and non-banking sectors and across the whole range of investments or instruments.

A number of exceptional circumstances amplified the reduction in cross-border investment – or in some cases resulted in disinvestment (i.e. deleveraging) – by euro area residents and non-residents during the crisis. First, liquidity shortages owing to the breakdown of the interbank and asset-backed securities markets resulted initially in significant (fire) sales of other assets to raise cash. Second, heightened uncertainty and asymmetric information between lenders and borrowers changed investors' perceptions regarding risk, while also encouraging herd behaviour to some extent. The exceptionally high liquidity needs and soaring risk aversion were coupled with extensive balance sheet restructuring triggered by concerns about solvency. As a result, the “home bias”, as manifested in the strong repatriation of funds, increased and “flight to safety” motives gained importance. Taken together, these developments not only led to a scaling down in cross-border transactions in direct investment, portfolio investment and other investment, they also resulted in changes in the composition of euro area cross-border portfolio flows, particularly in shifts from: (i) equity to debt instruments; (ii) long-term to short-term maturity debt instruments; and (iii) private sector securities to public sector debt, as illustrated, for example, in Chart B, which shows foreign investment in debt instruments issued by various euro area sectors.

As the global economy started to show signs of stabilisation in 2009, some of the trends in cross-border financial flows by euro area residents and non-residents observed during the crisis abated

Chart A Euro area financial account

(EUR billions; annual flows)



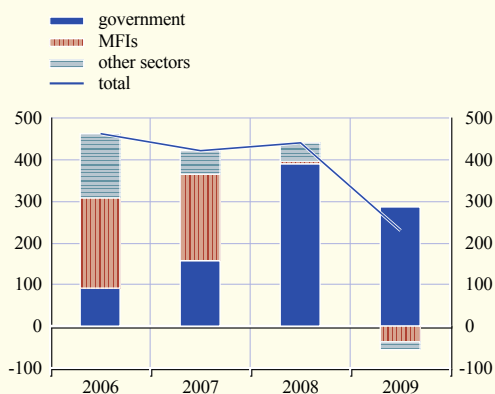
Source: ECB.

Note: The financial account includes direct investment, portfolio investment, financial derivatives, other investment and reserve assets. Inflows (+); outflows (-).

² Note that this box reports on the aggregate external financial flows of the euro area. The intra-euro area financial flows are excluded from the analysis.

Chart B Foreign investment in euro area debt across sectors

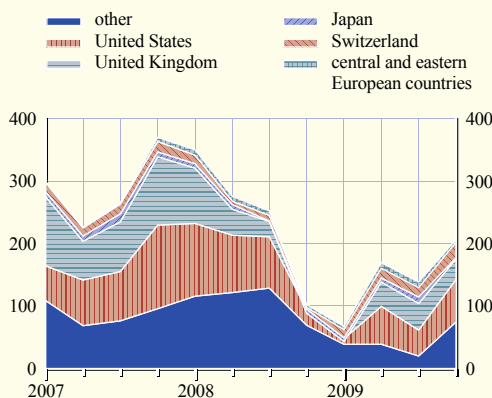
(EUR billions; annual flows)



Source: ECB.
Note: MFIs are monetary financial institutions, including the Eurosystem.

Chart C Direct investment inflows in the euro area by geographical region

(EUR billions; four-quarter cumulated flows)



Source: ECB.

or even reversed. As regards portfolio investment, low-risk assets, including short-term maturity debt and government securities, lost some of their appeal in 2009 in view of the more favourable global economic outlook and improved financial market conditions. Meanwhile, the cross-border deleveraging process in which euro area residents and non-residents engaged in 2008 came to an end for equities on the back of a partial rebound in investors' risk appetite. Deleveraging has, however, remained significant for cross-border loans and deposits, as reflected in the "other investment" flows of the euro area financial account. The need to strengthen capital positions and reduce international risk exposure largely accounted for the continued disinvestment in foreign assets and the reduction in cross-border liabilities by the euro area banking sector. Similarly, the need to adjust balance sheets and repay debt led, for the first time since 1999, to a decline in cross-border assets and liabilities in loans and deposits by the euro area non-banking sector. Finally, direct investment – which moderated but proved more resilient than other forms of private capital during the crisis – showed some signs of recovery in 2009. Inward direct investment picked up again but remained substantially subdued, notably from the United Kingdom and the United States (see Chart C). At the same time direct investment by euro area residents abroad stabilised.

In summary, the financial crisis introduced significant changes to the size and composition of cross-border financial flows by both euro area residents and non-residents. High liquidity needs, soaring risk aversion and extensive balance sheet restructuring triggered a sizeable scaling-down or disinvestment process across the whole range of investments or instruments. As a result, the euro area registered a pronounced increase in net inflows in combined direct and portfolio investment in 2008. This increase largely reflected strong net inflows in bonds and notes as well as money-market instruments, which offset net outflows in direct investment and portfolio equity investment. At the same time, the "other investment" item of the euro area financial account recorded net inflows as a result of the US dollar liquidity-providing operations by the ECB³ (see Chart D). However, in 2009 the major trends in cross-border financial activity observed during

³ With the intensification of the crisis in September 2008, elevated pressures in the US dollar funding markets emerged. The ECB initiated a temporary reciprocal currency arrangement (swap line) with the US Federal Reserve that enabled the ECB to conduct US dollar liquidity-providing operations with its counterparties against Eurosystem-eligible collateral.

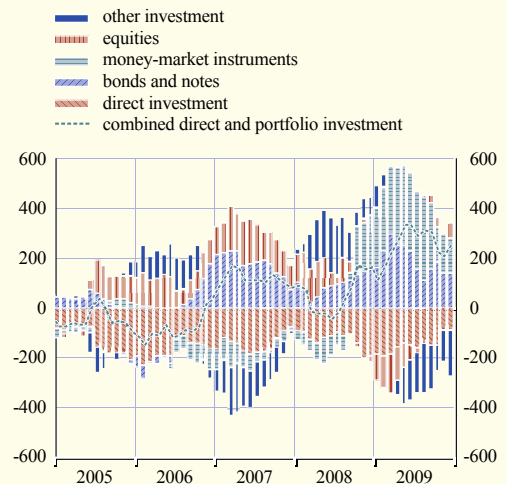
the crisis became less marked or even reversed. The shift of portfolio equity investment from net outflows to net inflows and the reduction in net outflows in direct investment more than offset the significantly reduced net purchases of euro area debt instruments by foreign investors compared with the 2008 peak levels. Overall, these developments resulted in even higher net inflows in combined direct and portfolio investment in 2009. Meanwhile, other investment recorded net outflows on account of the unwinding of the US dollar liquidity-providing operations undertaken by the ECB a year earlier and against the backdrop of continued bank deleveraging.

Looking ahead, euro area cross-border financial flows may remain below pre-crisis levels for some time as balance sheet restructuring by euro area residents and non-residents continues. Following the surge in international financial activity prior to the crisis, there may

be a normalisation of cross-border financial flows towards somewhat lower levels. The quarterly cross-border financial flows by euro area residents and non-residents in the first quarter of 2010 were, indeed, below their long-term averages. Although there has been a recent rebound in risk appetite and a subsequent revival of cross-border portfolio equity transactions, it is uncertain whether these trends will continue in the near future. In addition, much depends on the outlook for the global economy and, notably, the outlook for fiscal developments in various parts of the world.

Chart D Main items of the euro area financial account

(EUR billions; 12-month cumulated net flows)



Source: ECB.

Note: Last observation refers to December 2009. Net inflows (+); net outflows (-).