

Box 3

RECENT DEVELOPMENTS IN EURO AREA MONEY MARKET FUNDS

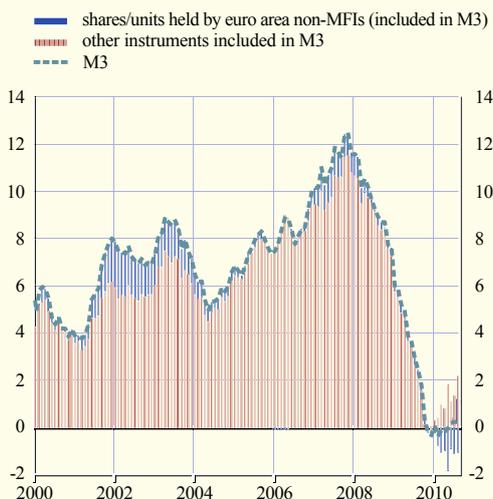
Money market fund (MMF) shares/units are one of the marketable instruments included in the broad monetary aggregate M3. An exceptional series of redemptions of these shares/units by the money-holding sector over the past one-and-a-half years has built up to a significant negative impact on the annual growth rate of M3 (see Chart A). This box looks at the factors and sectors behind these redemptions, and sheds some light on the implications for the financing of the euro area economy, in particular for banks and governments.¹

In the course of the financial turmoil, euro area MMFs faced serious headwinds. First, after the onset of the turmoil in August 2007, investors' concerns about the quality of the assets of MMFs increased, reflecting the fact that, prior to 2007, a small number of "cash-enhanced"

¹ For more information regarding the new harmonised ECB statistics on euro area money market funds, see also the box in the article entitled "Harmonised ECB statistics on euro area investment funds and their analytical use for monetary policy purposes" in the August 2010 issue of the Monthly Bulletin.

Chart A Contribution of money market fund shares/units to euro area M3 growth

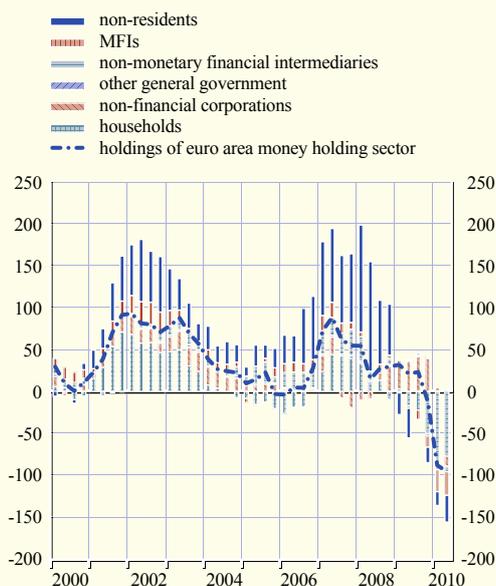
(annual percentage changes; percentage points; adjusted for seasonal and calendar effects)



Source: ECB.

Chart B Holdings of money market fund shares/units, broken down by sector

(annual flows in EUR billions; not adjusted for seasonal and calendar effects)



Source: ECB estimates.

funds had purchased asset-backed securities (ABSs) to boost their returns and beat their benchmark money market rate.² Second, after the collapse of Lehman Brothers in September 2008, European governments provided blanket insurance to bank deposits, which may have made MMFs look relatively “more risky” to investors. Third, with money market rates falling to historically low levels in spring 2009, returns on investment have been limited and have induced investors to reallocate their funds.

The response of the money-holding sectors during the financial turmoil

Euro area MMF shares/units are held both by resident money-holding sectors (included in M3) and by non-euro area residents. Chart B illustrates that all holding sectors contributed to the reduced investment into, and eventual outflows from, MMFs in the period of financial turmoil. A partial exception was the non-financial corporate sector that increased rather than decreased its investment until late 2009. Overall, the decline in the annual flows into MMFs was dominated by (dis) investment by both euro area households and non-euro area residents. Households started to reduce their investment in MMFs from the very outset of the financial turmoil, and after the collapse of Lehman Brothers they reduced their holdings by a cumulative amount of around €95 billion between the third quarter of 2008 and the second quarter of 2010. This accounted for the bulk of withdrawals from MMFs.

Non-euro area residents, by contrast, initially retained their investment in euro area MMFs and seem, on balance, only to have started to withdraw funds after the collapse of Lehman Brothers (the cumulative outflow between the third quarter of 2008 and the second quarter of 2010 was €67 billion). The pattern of

² These cash-enhanced funds were in fact not classified as MMFs in the sense of the MFI Regulation. However, the distinction between such funds and pure MMFs may not necessarily be clear to the public at large. An EU-wide initiative is underway in response to the financial turmoil to clarify and tighten the criteria for MMFs.

non-resident investment was not closely aligned to events in the euro area. This may reflect the fact that the MMFs held by non-residents in the euro area invest mainly in external assets, so that the holdings are often adjusted in response to liquidity needs and return considerations in the home countries of the non-residents involved.³

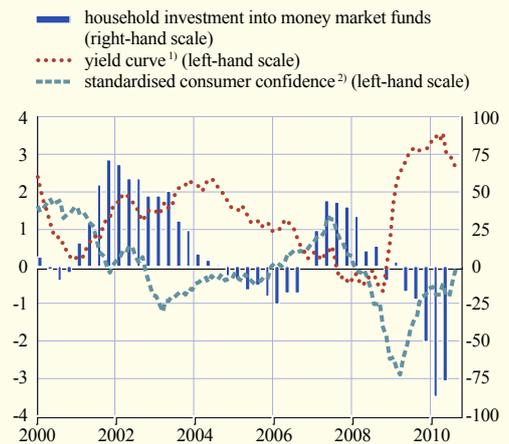
Comparing recent developments in households' investment in MMF shares/units with those observed in the previous period of heightened financial market uncertainty in the aftermath of the bursting of the dot-com bubble between 2001 and mid-2003 clearly reveals different patterns of investment, with funds benefiting from large inflows only between 2001 and mid-2003. This is noteworthy on account of the fact that both periods share important defining macroeconomic characteristics (see Chart C).⁴ First, they were both characterised by a marked and protracted deterioration in consumer confidence, a factor that would normally give rise to stronger investment in MMF shares/units. Second, both periods saw a steepening of the yield curve that was driven mainly by a decline in short-term money market interest rates, a factor that should dampen investment in MMFs. There were, of course, differences in the degree to which the yield curve steepened. Indeed, the steepening was exceptionally sharp between October 2008 and June 2009 as money market rates moved to unprecedented lows. But this stronger impact may have been mitigated to some extent by the fact that the deterioration in consumer confidence between mid-2007 and early 2009 was also more marked than in the period between 2001 and mid-2003. Taken by themselves, these two factors thus cannot fully explain the differences in the pattern of households' MMF investment in the two periods. The main difference is likely to be related to the nature of the prevailing financial and economic uncertainties. In the aftermath of the bursting of the dot-com bubble, the uncertainty related mainly to the evolution of equity markets, and MMFs seemed a safe vehicle for a parking of funds for future investment. In the period of financial turmoil, by contrast, the uncertainty related largely to the health of the financial intermediaries themselves, so that the impact of the interest rate constellation could unfold to a greater degree.

The implications for financing

Given the investment fund character, redemptions of MMF shares/units on the liability side of such funds' balance sheets during the period of financial turmoil are, by nature, mirrored in reductions of holdings of assets. This has an impact on the financing of the euro area economy. The impact on the direct financing of the euro area non-financial sectors is small, as MMFs

Chart C Selected determinants of households' holdings of money market fund shares/units

(annual flows in EUR billions; percentage points; not adjusted for seasonal effects)



Sources: European Commission, ECB and ECB estimates.

Notes:

- 1) The yield curve is measured in percentage points as the difference between long-term euro area government bond yields and the three-month money market interest rate.
- 2) Consumer confidence has been standardised over the period from 1999 to 2010. It is expressed in standard deviations.

³ All in all, approximately one-fifth of the assets (loans and debt securities) underlying the euro area MMF shares/units held by both residents and non-residents are denominated in US dollars.

⁴ See the article entitled "Money demand and uncertainty" in the October 2005 issue of the Monthly Bulletin.

currently hold less than 2% of all debt securities issued by these sectors, approximately three-quarters of which are government securities. By contrast, the impact on the financing of euro area credit institutions is more important as MMFs hold slightly more than 7% of their debt securities.

Chart D shows the breakdown by counterpart sector of the annual flows of credit granted by these funds, which mainly take the form of purchases of debt securities (rather than loans). Credit to the non-bank private sector has been curtailed since the onset of the financial turmoil in mid-2007 and, as of early 2009, MMFs started to significantly reduce their credit to non-resident banks. With the emergence of the sovereign debt crisis in the euro area, MMFs also cut back their holdings of claims on both euro area governments and euro area MFIs.

In the first half of 2010, they reduced the credit extended to all sectors, reflecting the pressure associated with the cumulative outflows from share holdings.

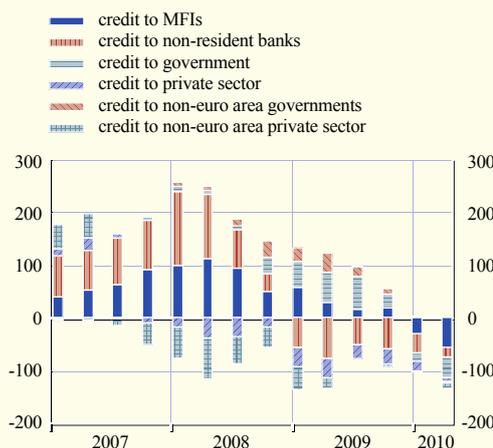
Conclusions

The reallocation of households' portfolios out of MMFs to other stores of value has contributed to dampening annual M3 growth since the end of 2009. This reflects the fact that, in the current environment, uncertainty has centred heavily on the financial sector itself. Hence, investment in MMF shares/units could not benefit from generally high economic uncertainty, so that the impact of the exceptionally steep yield curve and the low level of short-term interest rates could unfold. In August 2010, MMFs saw positive inflows for the first time in a year, but the extent to which this reflects a renewed attractiveness of this investment vehicle remains to be seen.

The implications of redemptions of MMF shares/units for the overall financing of the euro area economy are likely to be contained. While they could potentially be more significant for euro area banks, given that MMFs may buy fewer bank bonds, this impact may be attenuated by the fact that euro area households may place some of the proceeds from their withdrawals from MMFs in bank deposits.

Chart D Money market funds' asset holdings

(annual flows in EUR billions; not adjusted for seasonal and calendar effects)



Source: ECB.