

Box 3

**DEVELOPMENTS IN THE INTERNATIONAL INVESTMENT POSITION OF THE EURO AREA IN 2008 AND 2009**

The international investment position (i.i.p.) shows the stock of total holdings of foreign assets by domestic residents (assets) and of total holdings of domestic assets by foreign residents (liabilities). The net position (assets minus liabilities) measures the net creditor or debtor position of a country, or group of countries, vis-à-vis the rest of the world. This box reviews developments

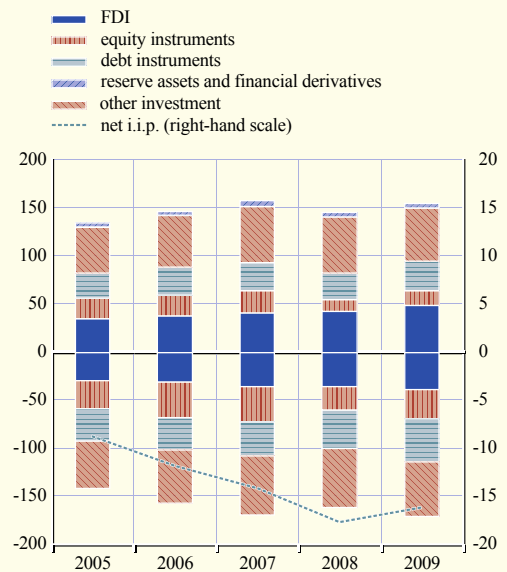
in the euro area i.i.p. in 2008 and 2009 (as at year-end), with a particular emphasis on the effects of the recent financial crisis, which are mostly evident in portfolio investment. A geographical breakdown of the portfolio investment position of the euro area shows some shifts in the relative importance of country groups as investors in the euro area during 2008 and 2009.

In recent years both the asset side (i.e. investment abroad by euro area residents) and the liability side (investment in the euro area by foreign residents) of the euro area i.i.p. followed an increasing trend, before contracting with the intensification of the financial crisis in 2008. However, in 2009 both the asset and the liability positions rebounded, standing at year-end at 154% and 170% of euro area GDP respectively (see Chart A). The net liability position of the euro area also followed an increasing trend, peaking in 2008 at 17.7% of GDP, before declining to 16.2% in 2009. The main contribution to the increasing net liability position stemmed from portfolio investment (equity and debt instruments). In fact, the net liabilities of euro area portfolio investment reached 28% of GDP in 2009. The negative contribution of portfolio investment to the euro area net investment position was partly counterbalanced by developments in the net asset position of foreign direct investment (FDI), which reached 9% in 2009. By contrast, the contribution of “other investment” to the euro area i.i.p. was relatively stable, with net liabilities of 2% of GDP recorded in 2009.<sup>1</sup>

Changes in the net i.i.p. can be explained by three factors: (i) net financial flows (transaction effect), (ii) revaluations due to changes in exchange rates and asset prices and (iii) “other adjustments”<sup>2</sup>. Traditionally, “other adjustments” and “valuation adjustments related to exchange rate changes” have been the main factors influencing changes in the net i.i.p. of the euro area. During the recent financial crisis, however, “financial transactions” and “valuation adjustments related to price changes” played an important role (see Chart B). In particular, in 2008 the total disinvestment in foreign assets by euro area residents exceeded the disinvestment in euro area assets by non-residents (a transaction effect), thus contributing negatively to the change in the net i.i.p. In 2009, revaluations due to price changes contributed positively to the change in the net i.i.p., as increases in a number of major non-euro area stock market indices were greater than those of the euro area.

**Chart A Euro area international investment position and its breakdown by instrument**

(as a percentage of euro area GDP)



Source: ECB.

Notes: Negative figures reflect euro area liabilities while positive figures reflect assets. Data refer to outstanding amounts at the end of the year.

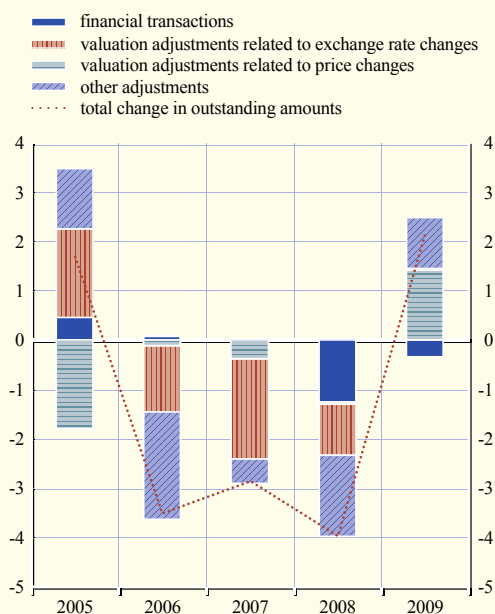
1 In order to obtain the final net i.i.p., reserve assets and financial derivatives need to be taken into account. This block only amounts to about 4% of euro area GDP on average over the period 2005-09 and has no “liability side”, thus contributing positively to the net i.i.p. Note that as the components of the i.i.p. are expressed as a percentage of GDP, a “growth effect” is present. However, as changes in GDP are common to all components and do not affect the analysis, they are not discussed.

2 “Other adjustments” include, for example, reclassifications, company write-downs, changes in survey coverage and changes in the residency of companies.

The recent financial crisis led initially to a significant reduction in the i.i.p. position of the euro area, with total assets and liabilities declining in 2008 by 11 and 7 percentage points of GDP respectively. In 2009, positions were built up again, with investment abroad by euro area residents (asset side) partly recovering, by 10 percentage points of GDP, while investment by foreign residents in the euro area (liability side) recovered fully. The significant effects of the crisis were most evident in the developments in the portfolio investment instruments of equity and debt (see Chart C). In 2008 the elevated level of volatility in financial markets, the exceptionally high level of global economic uncertainty and the gloomy global economic outlook increased the home bias and triggered significant reductions in asset prices and sales of equity instruments by both residents and non-residents of the euro area. However, later on, as the global economic outlook started to improve and asset prices increased, equity instrument holdings by both

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

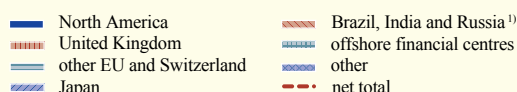
(as a percentage of euro area GDP)



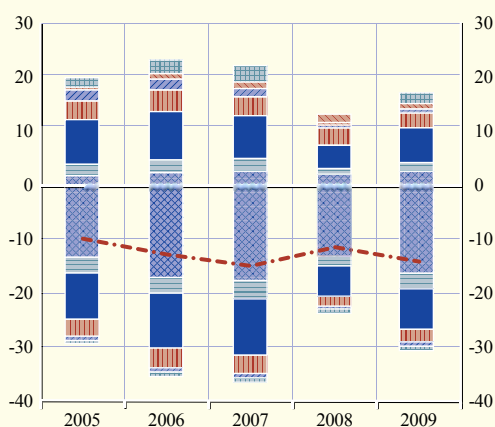
Source: ECB.

Chart C Country breakdown of euro area equity and debt instrument positions

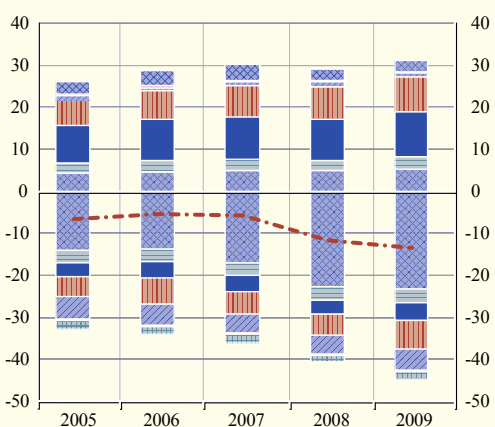
(as a percentage of euro area GDP)



Equity instruments



Debt instruments



Sources: ECB and IMF CPIS.

Notes: Negative figures reflect euro area liabilities, while positive figures reflect assets. Data refer to outstanding amounts at the end of the year.

1) As China is not covered by the IMF survey it is included in the group "other", which is calculated as a residual.

euro area residents and non-residents rose again in 2009. Specifically, as a result of both reduced investment and a reduction in prices, holdings of foreign equity instruments by euro area residents (assets) were reduced from 22% of euro area GDP in 2007 to 12% in 2008, before increasing again to 17% in 2009. Similarly, euro area equity instrument holdings by non-residents (liabilities) were significantly reduced from 37% of GDP in 2007 to 24% in 2008, before increasing again to 31% in 2009.<sup>3</sup> In addition, the financial crisis led to a shift from investment in equity instruments towards investment in debt instruments. Accordingly, the large drop in euro area equity instrument investment by non-residents was mitigated to some extent by a marked increase in investment in euro area debt instruments in 2008 and 2009. Investment in euro area debt instruments by non-residents rose by almost 9 percentage points of GDP over the course of these two years.<sup>4</sup>

A geographical breakdown of the assets and liabilities of equity instrument investment shows that the reduction in foreign assets held by euro area residents in 2008 was broadly based, while the reduction in liabilities was mainly driven by North America (i.e. the United States and Canada) and “other countries”.<sup>5</sup> The subsequent increase in equity assets and liabilities in 2009 shows a similar geographical pattern. As regards debt instruments, the assets of euro area residents were mostly invested in North America (predominantly the United States) and the United Kingdom, and show very small changes in 2008 and 2009. By contrast, the liability side of euro area debt instrument investment (investment in euro area debt instruments by non-residents) was dominated by “other countries”, with North America and the United Kingdom playing a more limited role. Even so, while the increase in euro area debt liabilities in 2008 was mainly driven by “other countries”, the 2009 increase was driven mainly by the United Kingdom. On balance, the importance of “other countries” as investors in the euro area increased markedly during the period 2008-09, with this group accounting for more than half of the total portfolio investment in the euro area at the end of 2009. This may indicate that, while the financial crisis was a global phenomenon, it affected countries to varying degrees. By contrast, the geographical breakdown of portfolio investment by euro area residents does not show such shifts in relative importance between country groups.

Preliminary data on the euro area i.i.p. position, for the third quarter of 2010, show that total assets and total liabilities have both recovered fully and are above pre-crisis levels. While investment in equity instruments by both residents and non-residents remains somewhat muted, investment in debt instruments – in particular investment in the euro area by non-residents – increased further.<sup>6</sup>

3 The reduction in the market value of equity instrument investment in 2008 was approximately €800 billion for the asset side and €1.1 trillion for the liability side.

4 Euro area debt securities held by euro area residents increased by roughly 6 percentage points of euro area GDP during the same period.

5 The country-specific data on assets and liabilities of equity and debt investment are from the IMF Coordinated Portfolio Investment Survey (CPIS), while data on the total extra-euro area assets and liabilities are from the ECB. The countries/country groups that are included in the calculations are: the euro area (excluding Estonia), offshore financial centres, Denmark, Sweden, the United Kingdom, countries that joined the EU in 2004 and 2007 (EU8), Switzerland, Canada, the United States, Japan, Brazil, India and Russia. The country group “other” includes, apart from China, all the main oil-exporting countries – except for Russia – and is calculated as a residual from the total extra-euro area data. Interestingly, offshore financial centres seem to play a fairly limited role in the liabilities of euro area portfolio investment. Finally, a country breakdown of FDI and other investment positions does not show any marked changes during the period under review.

6 Preliminary quarterly data do not include a geographical breakdown, nor do they include a breakdown of changes between exchange rate valuation, price valuation and other adjustments.