

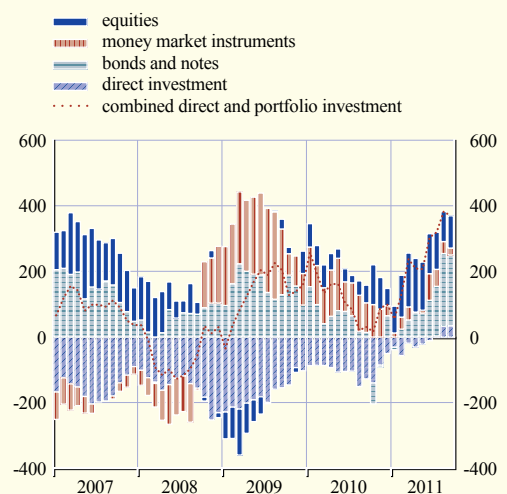
Box 3

RECENT DEVELOPMENTS IN THE FINANCIAL ACCOUNT OF THE EURO AREA BALANCE OF PAYMENTS

This box analyses recent developments in the financial account of the euro area balance of payments. Net inflows in the euro area financial account increased in the 12-month period to September. These were driven mainly by larger inflows in combined net direct and portfolio investment, which increased considerably to reach an all-time high of €369.4 billion in the 12-month period to September, up from €30.6 billion in the previous year, and were only partially offset by larger net outflows in other investment (see table and chart). However, in the third quarter of 2011 the renewed intensification of financial market tensions appears to have led to changes in investment patterns. There was a significant reduction in the size of net capital flows and, most noticeably, both euro area and foreign investors reduced their cross-border financial exposures.

Main items in the financial account

(EUR billions; 12-month cumulated net flows; monthly data)



Source: ECB.

The larger inflows in combined net direct and portfolio investment in the 12-month period to September were supported mainly by larger net inflows in portfolio investment, but also reduced outflows in foreign direct investment. The larger net inflows in portfolio investment mainly concerned debt securities, reflecting foreign investors' substantial purchases of euro area securities issued by the MFI and non-MFI sectors in the first half of 2011, as well as the moderation of euro area investment in foreign securities. In particular, foreign demand for more liquid and highly rated debt securities issued by the non-MFI sectors of core euro area countries was particularly strong in the second quarter of 2011, probably reflecting safe-haven flows in the context of the downward revision of growth expectations for major developed economies. Moreover, these portfolio investment inflows in the euro area non-MFI sector have contributed positively to the liquidity available in the euro area and are partly reflected in the evolution of the broad monetary aggregate M3. In fact, as can be seen from the monetary presentation of

Financial account of the euro area balance of payments

(EUR billions; non-seasonally adjusted data)

| | 2011 | | Three-month cumulated figures | | | | 12-month cumulated figures | |
|--|-------|-------|-------------------------------|-------|-----------|-------|----------------------------|-----------|
| | Aug. | Sep. | 2010 Dec. | Mar. | 2011 June | Sep. | 2010 Sep. | 2011 Sep. |
| Financial account¹⁾ | 6.8 | 2.8 | 9.5 | 15.7 | 20.6 | 12.2 | 20.0 | 58.0 |
| Combined net direct and portfolio investment | 31.7 | 13.5 | 99.0 | 118.7 | 127.1 | 24.7 | 30.6 | 369.4 |
| Net direct investment | -0.3 | -7.2 | 79.5 | -9.9 | -28.5 | -6.8 | -127.3 | 34.3 |
| Net portfolio investment | 31.9 | 20.7 | 19.5 | 128.5 | 155.6 | 31.5 | 157.9 | 335.1 |
| Equities | 19.1 | 5.8 | 6.7 | 89.2 | -29.3 | 31.8 | 54.0 | 98.4 |
| Debt instruments | 12.8 | 14.9 | 12.8 | 39.3 | 184.9 | -0.3 | 103.9 | 236.7 |
| Bonds and notes | 19.2 | 17.9 | 42.1 | 16.8 | 145.4 | 11.2 | 13.6 | 215.5 |
| Money market instruments | -6.4 | -3.0 | -29.3 | 22.5 | 39.5 | -11.5 | 90.2 | 21.2 |
| Net other investment | -27.4 | -14.1 | -96.8 | -89.1 | -114.3 | -13.0 | -9.1 | -313.3 |
| <i>Of which: money-holding sector²⁾</i> | | | | | | | | |
| Net direct investment | 0.8 | -8.0 | 83.5 | -5.3 | -22.3 | -8.7 | -114.7 | 47.1 |
| Net portfolio investment | -22.8 | 22.4 | -103.1 | 61.5 | 79.4 | -18.7 | -13.3 | 19.0 |
| Equities | -10.6 | 2.9 | 17.0 | 82.3 | -20.9 | 16.3 | 69.8 | 94.8 |
| Debt instruments | -12.2 | 19.5 | -120.1 | -20.8 | 100.2 | -35.0 | -83.2 | -75.8 |
| Net other investment | 16.8 | -0.5 | -36.4 | 31.1 | -37.8 | 35.4 | 30.8 | -7.7 |

Source: ECB.

Note: Figures may not add up, owing to rounding.

1) Figures refer to balances (net flows). A positive (negative) sign indicates a net inflow (outflow).

2) General government and other sectors of the balance of payments.

the balance of payments, these transactions involving the money-holding sector are a mirror image of the gradual increase observed in MFIs' net external asset position since the beginning of 2011.¹

More recently, however, there have been significant changes in the patterns of portfolio investment flows. Specifically, in the third quarter of 2011 net inflows in debt securities declined considerably, while at the same time there was a shift from net outflows to net inflows in equity securities. This masked a liquidation process, whereby euro area investors repatriated funds previously invested in foreign securities and non-resident investors disinvested in euro area securities. Whereas in the euro area, both the MFI and non-MFI sectors liquidated foreign securities, foreign investors' disinvestment focused mainly on securities issued by the euro area non-MFI sector, particularly the general government sector. By contrast, non-residents' demand for euro area securities issued by the private non-MFI sector remained robust, as reflected in MFIs' net external assets in the third quarter of 2011. These developments should be seen against the backdrop of the further intensification of financial market tensions, as well as volatile and declining stock market prices at the global level. Increased concerns regarding the sovereign debt crisis and uncertainty regarding the global economic outlook weighed on market sentiment and altered the behaviour of investors. A heightened degree of risk aversion, together with an apparent increase in home bias on the part of investors, appears to have triggered flight-to-safety flows.

1 To the extent that they are settled via resident banks, transactions carried out by the money-holding sector have an impact on the external assets and liabilities of the banking sector, which is one of the counterparts of M3. The money-holding sector comprises households, non-financial corporations, non-monetary financial intermediaries, and general government other than central government. For more information on the monetary presentation of the balance of payments, see Duc, L.B., Mayerlen, F. and Sola, P., "The monetary presentation of the euro area balance of payments", *Occasional Paper Series*, No 96, ECB, 2008. See also the article entitled "The external dimension of monetary analysis", *Monthly Bulletin*, ECB, August 2008.

Turning to the MFI sector, inflows in euro area debt securities issued by MFIs moderated in the third quarter of 2011, both for bonds and notes and for money market instruments. This moderation was particularly strong for money market instruments, indicating a reversal of previous investment patterns on the part of foreign money market investors. At the same time, euro area MFIs' ongoing liquidation of foreign debt securities – which is in line with the restructuring of balance sheets – increased. Euro area MFIs may also have stepped up their liquidation of foreign securities in order to mobilise funds, given reduced inflows owing to the retrenchment by foreign investors.