

Box 2

RECENT DEVELOPMENTS IN MFI NET EXTERNAL ASSETS

Since early 2005, there has been some divergence between the developments in M3 and those in MFI net external assets – one of the counterparts of M3. This divergence follows a protracted period of close co-movement that emphasised the international dimension of monetary developments. However, even within this period of co-movement, the magnitude of the contribution from net external assets to monetary dynamics and the broad forces and players behind international capital flows have been changing over time. Against this background, this box identifies four different periods between 2001 and 2005 that allow the recent developments in net external assets to be put into perspective.

Net external assets and their link to money

When the euro area money-holding sector (mainly households and non-financial corporations) purchases an asset from the rest of the world and the transaction is settled through a euro area MFI, the transaction is simultaneously recorded as a decline in the net external assets of the MFI sector and a decrease in the money holdings of the households and/or non-financial corporations making the purchase. By recording such transactions, the MFI balance sheet accounting framework relates developments in the money stock to changes in the net external assets of the MFI sector.

It should be emphasised, however, that this accounting relationship does not imply any necessary causal link between money and net external assets. For instance, in the previous example, the same external transactions might be financed through loans or may reflect the desire of the euro area money-holding sector to trade euro area longer-term financial liabilities against foreign assets. Therefore, a priori, the final impact of movements in MFI net external assets on money holdings may vary and certainly does not have to be one-for-one.

Four periods of capital flows since 2001

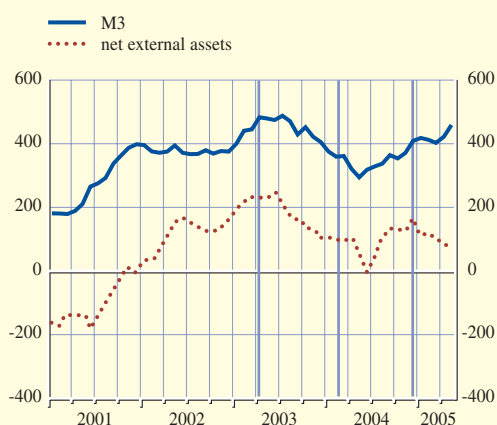
Over recent years, the international dimension of monetary developments (associated with transactions such as that described in the preceding paragraphs) has come to the fore in the analysis of euro area M3 (see Chart A). Between 2001 and early 2005, four separate periods can be identified, each characterised by a distinct impact on monetary dynamics and different patterns of investment by euro area residents and non-residents underlying the capital flows.

During the first period between 2001 and mid-2003 characterised by high geopolitical and financial market uncertainty, high monetary growth was mirrored by a strong increase in the net external assets of the MFI sector, in the context of large net capital inflows into the euro area. During the second episode between mid-2003 and early 2004 characterised by the normalisation of the money-holding sector's portfolio allocation behaviour, the gradual decline of annual net capital inflows and the associated decrease in net external assets helped dampen M3 growth. In the third period from early 2004 to the end of 2004, the resumption of the net inflow of funds into the euro area and the rebound in net external assets, along with the prevailing low level of interest rates, led to a renewed strengthening of M3 growth. Finally, during the fourth episode since early 2005, developments in M3 and net external assets have diverged. Annual flows into M3, after levelling off briefly, have continued to strengthen due to the stimulative impact of the low level of interest rates, while the annual flow of net external assets has moderated and therefore did not contribute in accounting terms to a strengthening of M3 growth.

To highlight the main driving forces behind these four periods, this box presents an analysis of the asset classes and the groups of investors involved. A natural tool to support this analysis is the monetary presentation of the balance of payments, which links MFI net external assets to the balance of payments statistics. The monetary presentation framework allows, first, developments in net external assets to be linked to specific asset classes (debt securities, equity, etc.) and, second, a distinction to be drawn between transactions made by euro area investors and non-resident investors.

Chart A M3 and net external assets of the MFI sector

(annual flows; end of period; EUR billions; adjusted for seasonal and calendar effects)



Source: ECB.

Note: Vertical lines separate the four periods described in this box.

Net external assets and international investment

Chart B distinguishes the major forms of international investment that lead to changes in the net external assets of the MFI sector: flows into debt securities (bonds) and flows into equity and direct investment.

Other than for very short and exceptional periods, the euro area has experienced a net inflow into debt securities (portfolio investment) since 2001. Over this period, the average 12-month net inflow into debt securities has amounted to €95 billion.

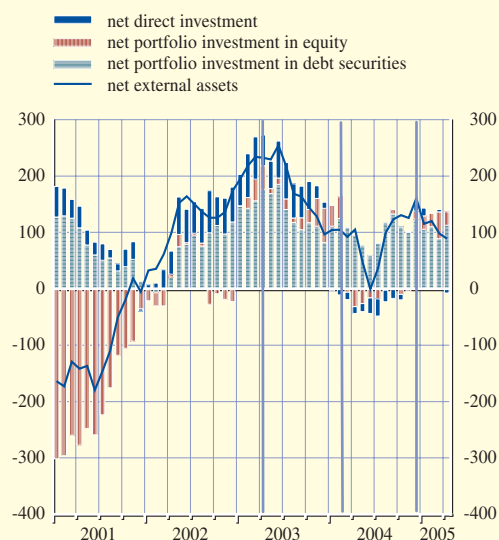
The sum of net direct investment and the net portfolio investment in equity has been substantially lower. Moreover, it has displayed considerably stronger cyclicalities than the net inflow into bonds. For instance, as the global economy strengthened between mid-2003 and mid-2004, net portfolio investment in equity and direct investment in the euro area diminished, even becoming negative in March 2004. Since mid-2004, net inflows into equity portfolio investment have resumed, as euro area equity securities were perceived to be attractively priced relative to foreign equities.

In general, international portfolio asset allocation is driven by the expected risk/return profile of the spectrum of available assets. In this context, exchange rate dynamics are likely to play a significant role in explaining the incentive to invest in domestic rather than foreign assets. For example, equity flows may be caused by expectations of an appreciation of the currency the investor purchases. At the same time, by influencing the relative demand for currencies, the relative performance of asset markets in different currency areas will affect the exchange rate. Thus, net equity flows may affect the exchange rate.

Whichever of these causal channels predominates – and in practice it is likely that both will play some role with time-varying weight – the implied correlation between exchange rates and cross-border capital flows as well as that between exchange rate expectations and cross-border capital flows are confirmed by the stylised facts. Chart C shows the link between the changes in the US dollar/euro exchange rate, revisions in three-month-ahead US dollar/euro exchange rate expectations (as measured by Consensus Economics forecasts) and the three-month flows in the net external assets of MFIs. The exchange rate and exchange rate expectations are chosen here as summary indicators that reflect a number of underlying fundamental factors, such as interest rate differentials or expected growth differentials between the United States and the euro area. The close link observed between developments in the exchange rate, exchange rate expectations and net external assets suggests that an appreciation and/or an expected

Chart B Net portfolio and direct investment (external counterpart of M3)

(annual flows; end of period; EUR billions)



Source: ECB.

Notes: Net external assets are shown for reference only. For a full list of balance of payments items reflected in net external assets, see Section 7.2 of the "Euro area statistics" section of the Monthly Bulletin. Vertical lines separate the four periods described in this box.

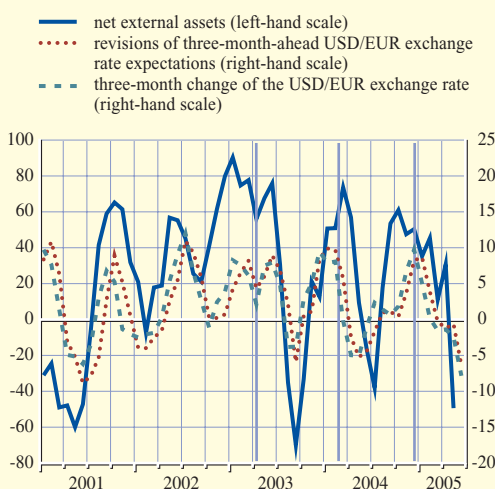
appreciation of the euro against the US dollar goes in parallel with a rise in MFI net external assets.

Differing investment patterns of non-residents and the euro area money-holding sector

The overall correlation shown in Chart C conceals, however, the different investment patterns of non-residents and the euro area money-holding sector over the past few years. In order to highlight this, Chart D plots the annual flows of portfolio and direct investment of non-residents into the euro area (settled through euro area MFIs) against portfolio and direct investment of the euro area money-holding sector abroad (again settled through euro area MFIs). While the demand and supply effects influencing these statistics cannot be distinguished, Chart D nevertheless reveals a number of interesting points. In the first two periods (i.e. between 2001 and early 2004), the strong dynamics in the net external asset position of euro area MFIs reflect the behaviour of euro area residents: first, until mid-2003, the repatriation of funds to the euro area and, second, between mid-2003 and early 2004, the subsequent normalisation of portfolio allocation behaviour as the heightened geopolitical and financial uncertainty which prompted the initial repatriation receded. During these two periods, the pattern of non-resident investment in the euro area was relatively stable and thus had little role in explaining the sharply different evolution of net external assets. By contrast, in the subsequent two periods (i.e. since early 2004), the dynamics of net external assets have been driven to an important extent by the portfolio and direct investment in the euro area by non-residents. The investment pattern of non-residents changed in mid-2004, when international investors felt that euro area assets were probably rather undervalued and expectations of a significant euro appreciation prevailed. This led to inflows that, other things

Chart C Net external assets and exchange rate expectations

(right-hand scale: three-month flows; EUR billions; adjusted for seasonal and calendar effects; left-hand scale: percentages)

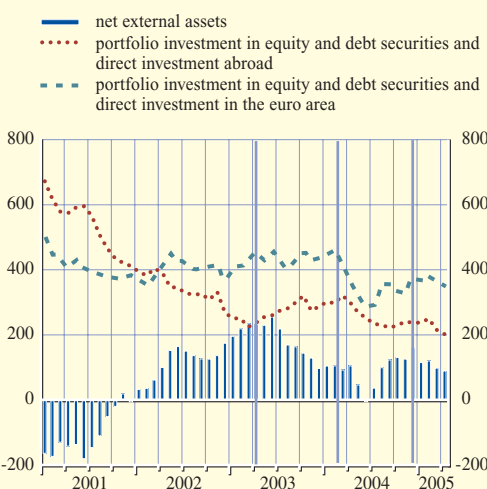


Sources: ECB, Consensus Economics.

Notes: Revisions are calculated as the three-month change in the exchange rate forecast. Vertical lines separate the four periods described in this box. A positive value of the three-month change in the USD/EUR exchange rate corresponds to an appreciation of the euro over this time span.

Chart D Capital flows into and out of the euro area

(annual flows; end of period; EUR billions)



Source: ECB.

Notes: Net external assets are shown for reference only. Vertical lines separate the four periods described in this box.

being equal, can partly explain the pick-up in monetary dynamics in the euro area observed in the second half of 2004. In the most recent period (i.e. since early 2005), market expectations of a further appreciation of the euro exchange rate have diminished and the inflow into net external assets has moderated.

In conclusion, the analysis presented in this box illustrates the important role played by international capital flows in the determination of monetary dynamics. As international financial markets become more integrated, such effects are likely to become even more important over time. In particular, it is likely that the impact on capital flows of exchange rate dynamics and expectations will play a larger role in the overall monetary analysis.