

Box 7

THE IMPACT OF THE FINANCIAL TURMOIL ON EURO AREA CROSS-BORDER FINANCIAL FLOWS

The financial turmoil that started in early August 2007 as a result of the US subprime mortgage crisis has led to uncertainty in financial markets and to diminished liquidity in key market segments. Over the last year, global economic activity has been dampened by the economic weakness in the United States, by the global repercussions of the financial turmoil and, increasingly, by high prices for oil and other commodities. The resulting global portfolio allocation decisions have affected euro area cross-border portfolio flows. This box suggests that the repatriation of portfolio funds by both euro area residents and foreign investors may simply reflect heightened investor risk aversion, as the fundamentals of the euro area economy remain sound. It is worth noting that euro area foreign direct investment activity, which is driven by longer-term considerations, does not seem to have been particularly affected by the financial turmoil over the last year.

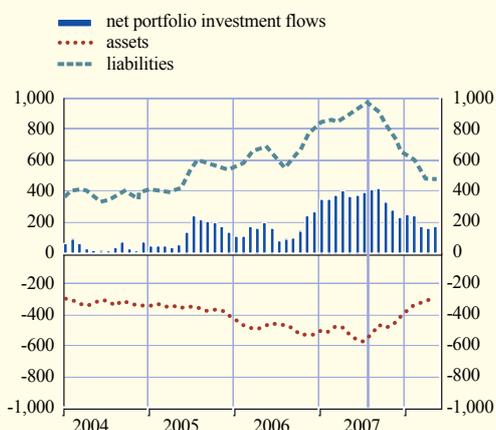
Starting with portfolio investment, both euro area investment abroad (asset flows) and foreign investment in the euro area (liability flows) followed an upward trend until July 2007 (see Chart A). The outbreak of the financial turmoil interrupted these trends. From July 2007 to May 2008, both assets and liabilities declined by around half on a 12-month cumulated basis. By the same token, net portfolio inflows declined from around €390 billion to around €170 billion by May 2008, owing to the reduction in net flows of both equities and long-term bonds and notes.¹

Specifically, the financial turmoil has severely affected inflows and outflows of both equity and fixed income securities. Since the beginning of 2008, euro area residents, particularly euro area MFIs, have been net sellers of equity assets (see Chart B) owing to a combination of several

¹ The cross-border financial flows analysed in this box are all 12-month cumulated data.

Chart A Euro area portfolio investment flows

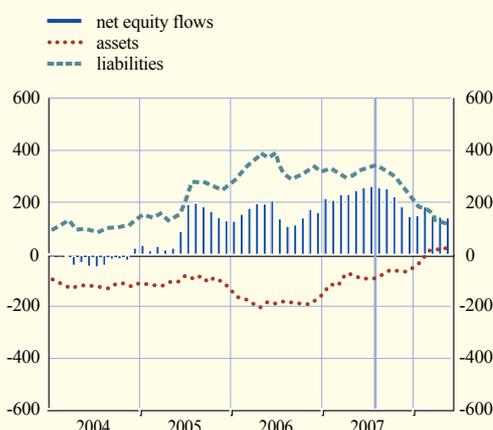
(EUR billions; monthly data; 12-month cumulated flows)



Source: ECB.
Note: The vertical line represents the beginning of the financial turmoil.

Chart B Euro area equity portfolio flows

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



Source: ECB.
Note: The vertical line represents the beginning of the financial turmoil.

factors such as expectations of a decline in asset returns in euro terms, an increased need for liquidity and greater risk aversion.² Repatriations of equity funds by euro area residents have been particularly large from Japan, the United Kingdom and Switzerland, while net investment in the United States continued to flow but on a very small scale. The decline in equity flows was larger on the liabilities side than on the assets side, but there remains a net inflow to the euro area.

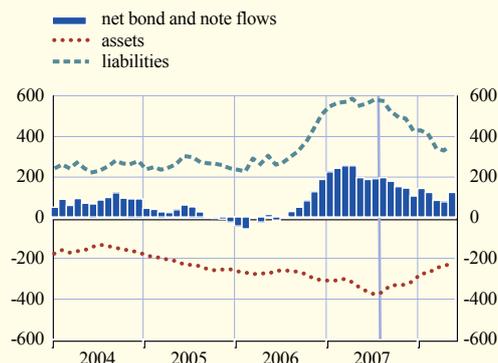
The reduction of cross-border investment in long-term fixed income instruments (see Chart C) mirrors the subdued activity in international debt markets, with low issuance of bonds and notes amid continued financial market turmoil. By contrast, cross-border money market instrument outflows initially slowed significantly, but have rebounded in 2008 (see Chart D). In particular, net issuance of commercial paper by European financial institutions increased significantly. This development is broadly in line with the market observation that commercial paper investors might favour euro-denominated assets issued by financial institutions with relatively high credit ratings.

Turning to foreign direct investment (FDI), since 2005 FDI outflows emanating from euro area residents to the rest of the world have been considerably larger than FDI inflows to the euro area (see Chart E). The financial market turbulence did not change this pattern and does so far not

2 See also the article entitled "The external dimension of monetary analysis" in this issue of the Monthly Bulletin, and R. A. De Santis, C. A. Favero and B. Roffia, "Euro area money demand and international portfolio allocation: a contribution to assessing risks to price stability", ECB Working Paper No 926, presented at the ECB workshop on "The external dimension of monetary analysis", Frankfurt am Main, 12-13 December 2007.

Chart C Euro area bond and note flows

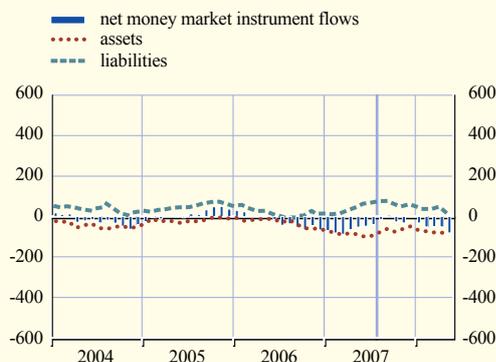
(EUR billions; monthly data; 12-month cumulated flows)



Source: ECB.
Note: The vertical line represents the beginning of the financial turmoil.

Chart D Euro area money market instrument flows

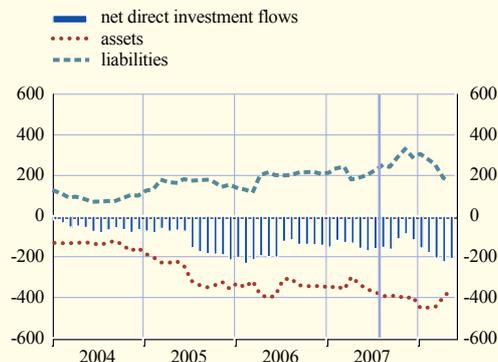
(EUR billions; monthly data; 12-month cumulated flows)



Source: ECB.
Note: The vertical line represents the beginning of the financial turmoil.

Chart E Euro area direct investment flows

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



Source: ECB.
Note: The vertical line represents the beginning of the financial turmoil.

seem to have affected euro area residents' FDI activity in a particular manner. On the contrary, the latter has fluctuated between €370 billion and €460 billion (12-month cumulated flows) since summer 2007, with a recent decline in equity capital flows while other capital flows (mostly inter-company loans) have increased. Euro area FDI inflows, which had increased until the end of 2007, declined markedly in the spring of 2008, however.

Overall, the financial turmoil that began in August 2007 has significantly affected euro area cross-border portfolio flows. These developments seemed mainly to be related to heightened risk aversion by global investors.