Box 3

RECENT IMPROVEMENT IN THE EURO AREA'S INTERNATIONAL INVESTMENT POSITION

The international investment position (i.i.p.) shows the stock of both total holdings of foreign assets by euro area residents (assets) and total holdings of euro area assets by foreign residents (liabilities). This box reviews the main developments in the euro area i.i.p. in recent years.

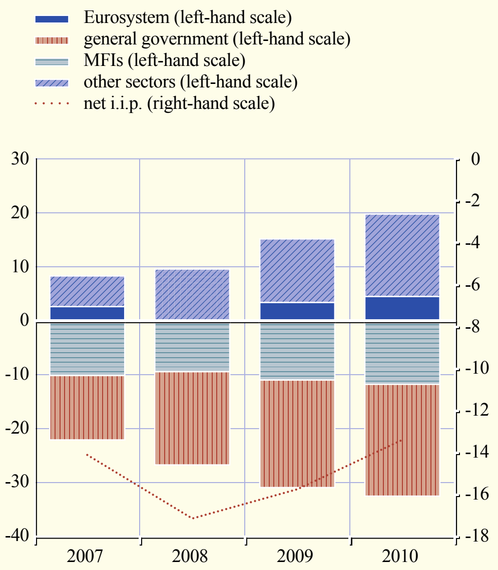
The net euro area i.i.p. has improved in recent years, following the significant deterioration in 2008, which had been triggered by an expansion of the net liabilities of the general government sector. Since 2009, the euro area's i.i.p. has moved closer to its pre-crisis levels. The reduction of the net liability position was due mainly to significant favourable changes in prices[1] and exchange rates that more than compensated for the continued net borrowing of the euro area, particularly by the general government, on account of automatic stabilisers and the fiscal stimulus packages that were implemented in response to the financial crisis. This led to an increase in the order of almost 10% of GDP in the general government sector's net liability position, which was only partly offset by an increase in the net asset position of "other sectors"[2] (see Chart A).

In order to gain a better understanding of the impact of changes in financial stocks not accounted for by financial transactions, Chart B plots the i.i.p. against an external position calculated on the basis of unchanged returns (i.e. without price and exchange rate changes and other adjustments[3]). In particular, it shows that, in the latter circumstances, the net liability position at the end of 2010 would have been more than 4% of GDP higher than it actually was.

1 Price changes in the i.i.p. refer to changes in the prices of external assets and liabilities.
2 "Other sectors" include non-financial corporations, financial corporations other than MFIs – i.e. investment funds, insurance corporations, pension funds and other financial corporations – and households.
3 "Other adjustments" include, for example, reclassifications, company write-downs, changes in the survey coverage and changes in the residency of companies.

Chart A Net international investment position of the euro area, by institutional sector

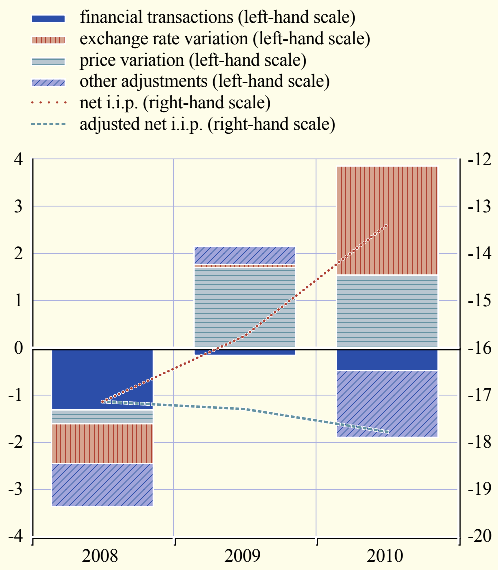
(percentages of euro area GDP)



Sources: ECB and ECB staff calculations.
Note: Financial derivatives not included.

Chart B Breakdown of changes in the net international investment position of the euro area

(percentages of euro area GDP)



Sources: ECB and ECB staff calculations.
Note: The "adjusted i.i.p." is the net position obtained if it is assumed that there were no price and exchange rate variations, nor other adjustments.

There are three explanations for the fact that the return recently observed on euro area residents' external assets was higher than that on the respective liabilities: the first relates to the composition of the euro area's external balance sheet, the second to intra-asset-class return differentials and the third to the exchange rate. First, the main source of funding for the euro area has typically been portfolio investment, and at the same time, it has been a net exporter of foreign direct investment. By financing itself in highly rated and more liquid instruments and, at the same time, holding riskier assets, the asymmetric distribution of instruments in both assets and liabilities is one of the reasons for the euro area's favourable return differential. Second, euro area investors' holdings of some types of instruments yielded, on average, a higher return than the foreign holdings of the same instrument issued by euro area residents. This is manifested in the relatively weaker equity market performance of the euro area in comparison with the rest of the world in the period under review, as well as in the reduction of the market value of the euro area debt securities held by foreign investors in 2010, which may to some extent have reflected the decrease in prices of government bonds issued by some euro area countries. Third, the depreciation of the euro vis-à-vis other major currencies in 2010 – to the extent that this raised the value of assets not denominated in euro – led to a sizeable increase in the value of euro area investor's assets.