2 Analysing euro area net portfolio investment outflows

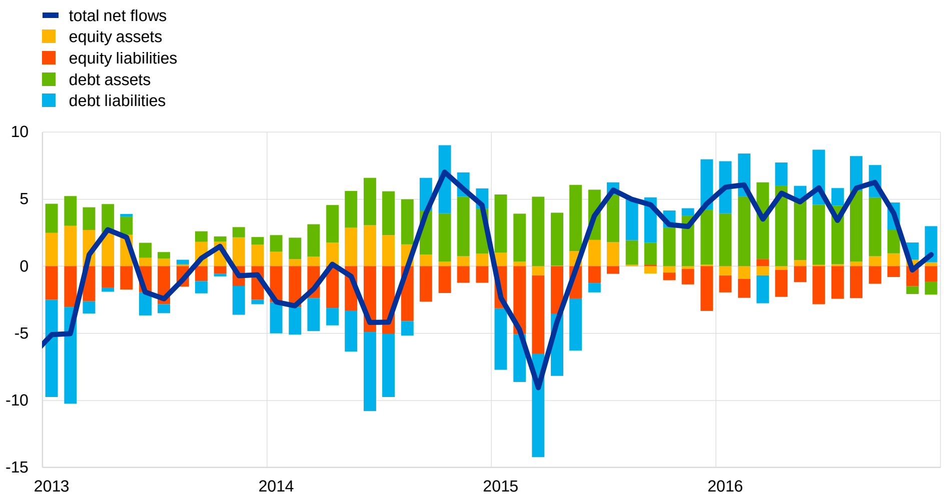
This box analyses recent developments in portfolio investment flows in the euro area financial account. In 2016 the euro area's current account surplus was mainly mirrored in the financial account of the balance of payments by net outflows for portfolio investment and – to a lesser extent – direct investment.

In 2016 the euro area recorded net outflows for portfolio investment, owing to rebalancing towards non-euro area debt securities on the part of both euro area and non-euro area investors (see Chart A). In the case of euro area residents, that represented a continuation of the pronounced shift towards non-euro area debt securities that had been observed since the second half of 2014. Annual net purchases of non-euro area debt securities by euro area investors totalled €364 billion in 2016, only slightly below the all-time high of €382 billion that was recorded in 2015. However, this masks the fact that the fourth quarter of 2016 saw euro area investors become net sellers of non-euro area debt securities, the first time this had happened since the second quarter of 2012. Net sales of non-euro area debt securities totalled €26 billion in that quarter. Euro area residents' net investment in non-euro area equities remained subdued in 2016, totalling €12 billion.

Chart A

Breakdown of euro area portfolio investment flows

(as a percentage of GDP; three-month moving averages)



Sources: ECB and Eurostat.
Notes: For assets, a positive (negative) number indicates net purchases (sales) of non-euro area securities by euro area investors. For liabilities, a positive (negative) number indicates net sales (purchases) of euro area securities by non-euro area investors. For net flows, a positive (negative) number indicates net outflows (inflows) from (into) the euro area. Equity includes investment fund shares. The latest observation is for December 2016.

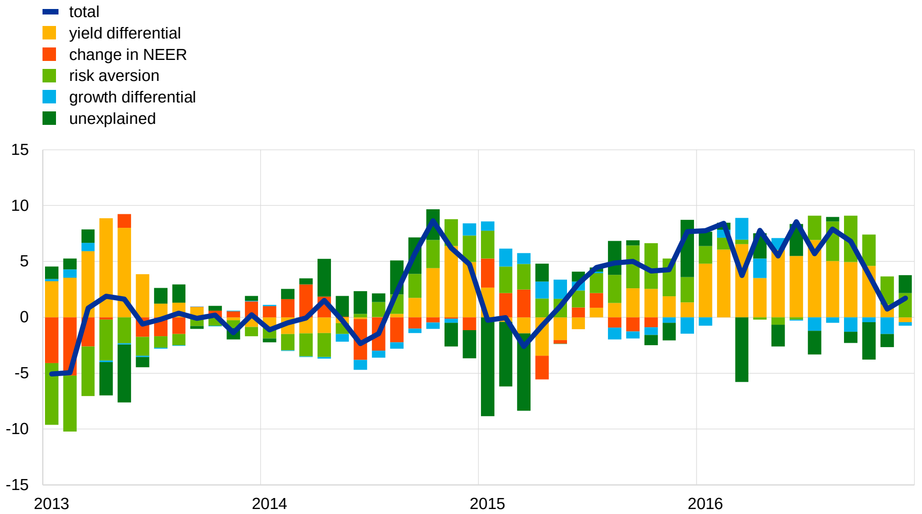
Non-euro area investors were net sellers of euro area debt securities in 2016 – the first time that had happened since the introduction of the euro. Their net sales of euro area debt securities totalled €192 billion in 2016, compared with net purchases of €30 billion in 2015. This was largely a result of net sales of government debt securities (which totalled €116 billion and were, to a significant extent, a reflection of PSPP-related sales) and net sales of debt securities issued by euro area MFIs (which totalled €63 billion). On the other hand, non-euro area investors remained net purchasers of euro area equities, albeit their net purchases declined to €126 billion in 2016, down from €268 billion in 2015.

The persistently negative interest rate differentials vis-à-vis other advanced economies were an important determinant of net portfolio debt outflows in 2016 (see Chart B). An empirical exercise estimating the time-varying contributions that selected economic and financial variables make to the evolution of euro area net portfolio debt flows suggests that interest rate differentials played a significant role in 2016.[1] For instance, the average yield differential between GDP-weighted euro area government bonds and US government bonds was around -1.0 percentage point for ten-year bonds and -1.4 percentage points for five-year bonds in 2016. Moreover, these estimates suggest that investors' risk aversion contributed somewhat to net portfolio debt outflows in the second half of 2016, which may be linked to the temporary increases seen in financial stress indicators following the United Kingdom's referendum on EU membership in June 2016.

Chart B

Model-based estimates of drivers of net portfolio debt outflows

(as a percentage of GDP; three-month moving averages; contributions of variables)



Sources: ECB and Eurostat.
Notes: A positive (negative) number indicates net outflows (inflows) from (into) the euro area. For details of variables, see footnote 1 of this box. The latest observation is for December 2016.

1 These estimates of the time-varying drivers of euro area net portfolio flows are based on a reduced-form model with time-varying regression coefficients which captures both changes in market sentiment and changes in the conditional correlations between fundamentals and financial flows. These fundamentals include (i) the ECB's composite indicator of systemic stress (CISS) as a proxy for the degree of risk aversion among investors, (ii) the nominal effective exchange rate (NEER) of the euro against the currencies of 38 of the euro area's most important trading partners, (iii) the difference between the euro area and non-euro area advanced economies in terms of growth in industrial production, and (iv) the yield differential between euro area government bonds and non-euro area advanced economies' government bonds. The model is estimated at a monthly frequency on the basis of Kalman filtering with maximum likelihood. For more details, see Box 4 in the article entitled "Euro area cross-border financial flows", *Monthly Bulletin*, ECB, February 2012.

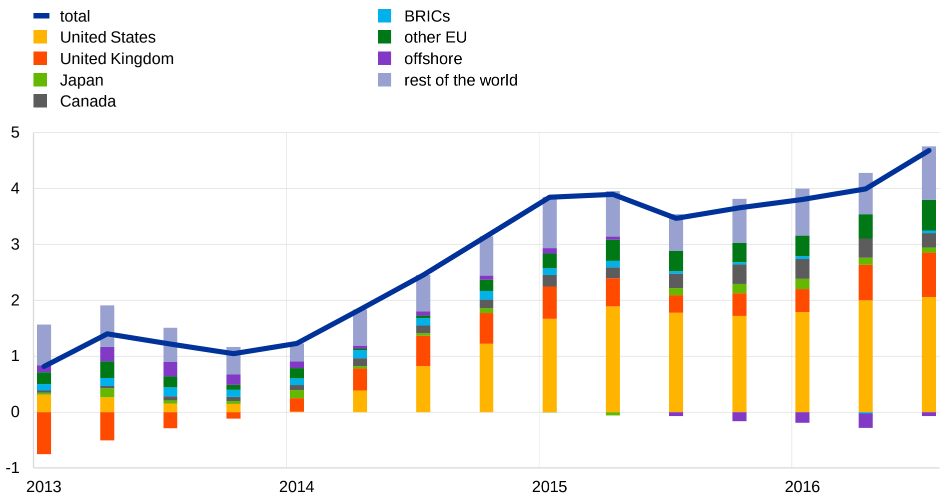
According to data available for the first three quarters of 2016, euro area residents' net purchases of non-euro area debt securities in that period consisted almost exclusively of long-term debt instruments and largely reflected transactions by "other financial corporations". This group of corporations – which includes investment and pension funds, as well as insurance companies – accounted for around 74% of the euro area's net purchases of non-euro area debt instruments in that period, with "other private entities"[2] and MFIs excluding the Eurosystem accounting for 14% and 7% respectively. Around 40% of the non-euro area debt securities that were purchased by euro area residents were issued by non-euro area governments, with securities issued by non-euro area MFIs, other financial corporations and other private entities accounting for the remainder (around 20% each).

Euro area investors' portfolio debt investment outside the euro area remained concentrated in other advanced economies in 2016 (see Chart C). According to evidence available for the first three quarters of 2016, 46% of euro area investors' net purchases of non-euro area debt securities in that period involved securities issued by the United States, followed by the United Kingdom (17%), other EU Member States (13%) and Canada (4%). Aggregate net purchases of debt securities issued by Brazil, China, India and Russia continued to account for less than 1% of total net purchases.

Chart C

Geographical breakdown of euro area investors' net purchases of non-euro area portfolio debt securities

(as a percentage of euro area GDP; four-quarter moving averages)



Sources: ECB and Eurostat.
Notes: "BRICs" comprises Brazil, Russia, India and China; "other EU" comprises EU Member States outside the euro area, excluding the United Kingdom. The latest observation is for the third quarter of 2016.

Country-level data show net portfolio investment outflows for the largest euro area countries, driven by foreign investors' net sales of domestic debt

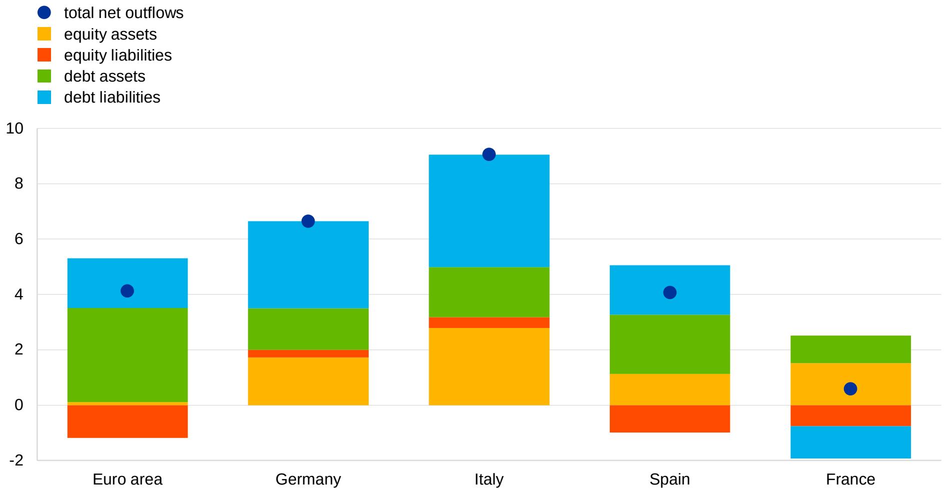
2 These comprise non-financial corporations, households and non-profit institutions serving households (NPISHs).

securities and domestic investors' net purchases of foreign assets (see Chart D). The largest net sales of debt securities by non-domestic investors were recorded in Italy (4.1% of GDP), followed by Germany (3.1% of GDP) and Spain (1.8% of GDP), while non-domestic investors were net purchasers of French debt securities (with net purchases totalling 1.2% of GDP). Spain and France also saw net portfolio equity inflows from foreign investors. In contrast to the euro area financial account, pronounced net cross-border portfolio equity flows have been observed at the country level. These can be explained by strong intra-euro area cross-border flows into investment funds – which are mainly based in euro area financial centres. In 2016, net cross-border flows into investment funds accounted for most of the portfolio equity flows observed for individual euro area countries, with Italy having the largest flows. Moreover, investors in France, Germany, Italy and Spain were net purchasers of non-domestic debt securities in 2016, with those net purchases totalling between 1% and 2% of GDP.

Chart D

Breakdown of net portfolio investment flows in 2016

(as a percentage of GDP)



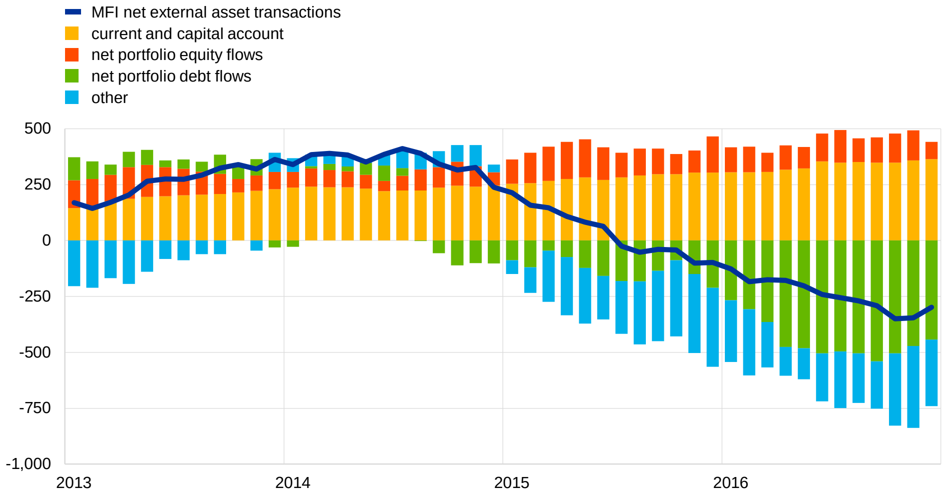
Source: ECB.
Notes: For assets, a positive (negative) number indicates net purchases (sales) of foreign securities by domestic investors. For liabilities, a positive (negative) number indicates net sales (purchases) of domestic securities by foreign investors. For net flows, a positive (negative) number indicates net outflows (inflows) from (into) the relevant country/the euro area. Equity includes investment fund shares.

In the non-MFI sector, portfolio shifts away from euro area debt securities continued to weigh on euro area MFIs' net external asset position in 2016 (see Chart E). Euro area portfolio investment flows excluding the MFI sector closely followed the pattern for the economy as a whole as shown in Chart A. MFIs' net external asset position mirrors transactions resulting from the trade and financial flows of the non-MFI sector. As can be seen from the monetary presentation of the balance of payments, the net portfolio debt outflows in the non-MFI sector had an increasingly negative impact on annual M3 growth in the euro area in 2016 via MFIs' net external asset position. Conversely, MFIs' net external assets continued to be supported by non-MFI transactions related to the euro area's current account surplus and, to a lesser extent, net equity inflows.

Chart E

Monetary presentation of the balance of payments

(EUR billions; 12-month moving sums of monthly flows)



Source: ECB.
Notes: A positive (negative) number refers to a net inflow (outflow)/increase (decrease) in MFIs' net external assets. All b.o.p. transactions relate to the non-MFI sector. "Other" includes net FDI flows, other investments and financial derivatives, and discrepancies between balance of payments and monetary statistics, as well as errors and omissions. The latest observation is for December 2016.