Capital Flows in the Euro Area: Some lessons from the last *boom-bust* cycle

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The last *boom* in capital flows was largely a global phenomenon ...

**Sum of current account deficits and surpluses (USDbn)**

- World (ex. EA-12) deficits
- World (ex. EA-12) surpluses
- EA-12 deficits (rhs)
- EA-12 surpluses (rhs)

**Standard deviation of current account balances as % GDP**

The size of current account imbalances and their dispersion sharply widened globally and in the EA during the *boom*.
... while the *bust* was particularly intense in the euro area ...

**Sum of current account deficits and surpluses (USDbn)**

<table>
<thead>
<tr>
<th>Year</th>
<th>World (ex. EA-12) deficits</th>
<th>World (ex. EA-12) surpluses</th>
<th>EA-12 deficits (rhs)</th>
<th>EA-12 surpluses (rhs)</th>
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<td>13,000</td>
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</table>

**Standard deviation of current account balances as % GDP**

<table>
<thead>
<tr>
<th>Year</th>
<th>World (ex. EA-12)</th>
<th>EA-12 (rhs)</th>
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<td>1997</td>
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<td>2005</td>
<td>14</td>
<td>11</td>
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</table>

*Source: ESM based on IMF WEO*
... for various reasons

**Euro area exports: Intra- and extra-EA** (% of GDP)

- Intra-EA exports
- Extra-EA exports

**Cross-border bank claims vs. banks by region** (1999=1)

- Euro area
- US
- Japan

**Source:** ESM based on Eurostat

**Source:** ESM based on BIS

**Different degrees of economic adjustment required**

**Different roles of the banking sector**
Lesson #1: Aggregate/average dynamics may be highly misleading

Current account balance in 2007 (% GDP)

Source: ESM based on Bloomberg
Lesson #1: Aggregate/average dynamics may be highly misleading

Current account balance in 2007 (% GDP)

... but masking large outliers and without immediate adjustment mechanisms

Source: ESM based on Bloomberg
Lesson #2: The size of the flows matters, but also their resilience

Spain: Breakdown of financial account flows (% GDP)

Foreign direct investment moves around, but it is always an inflow

Source: ESM based on Banco de España
Lesson #2: The size of the flows matters, but also their resilience

Spain: Breakdown of financial account flows (% GDP)

Even at the peak of the EA debt crisis, equity investment meant foreign inflows to Spain.

Source: ESM based on Banco de España
Lesson #2: The size of the flows matters, but also their resilience

Spain: Breakdown of financial account flows (% GDP)

Large swings in the debt liabilities explain most of the *boom-bust* dynamics in Spain ...

Source: ESM based on Banco de España
Lesson #2: The size of the flows matters, but also their resilience

Spain: Breakdown of financial account flows (% GDP)

Inflows

Outflows

... together with the expansion and collapse of bank-related liabilities

Source: ESM based on Banco de España
Lesson #2: The size of the flows matters, but also their resilience

Spain: Breakdown of financial account flows (% GDP)

- FDI liab.
- PI: Equity liab.
- PI: Debt liab.
- OI: OMFI liab.
- OI: BdE liab.

Target 2-channeled inflows helped to avoid a complete *sudden stop*

Source: ESM based on Banco de España
Lesson #2: The size of the flows matters, but also their resilience

Breakdown of net foreign assets: debt vs. equity in 1997 (% GDP)

The debt/equity split of net foreign assets has largely changed over time & across countries

Source: ESM based on IMF
Lesson #2: The size of the flows matters, but also their resilience

**Breakdown of net foreign assets: debt vs. equity in 2008 (% GDP)**

The debt/equity split of net foreign assets has largely changed over time & across countries.

Source: ESM based on IMF
Lesson #2: The size of the flows matters, but also their resilience

The debt/equity split of net foreign assets has largely changed over time & across countries.

Source: ESM based on IMF
Lesson #3: One monetary union, but *one* financial sector?

**Banking sector’s holdings of debt securities issued by domestic General Gov.** (% total holdings of EA debt securities)

- **Source:** ESM based on ECB

**Banking sector’s holdings of debt securities issued by domestic General Gov.** (% total assets)

- **Source:** ESM based on ECB

*Increased diversification in banks’ portfolios was an illusion*

*Bank-sovereign link especially intense in the periphery*
Lesson #4: Even if the *move* makes sense, be mindful of over-reactions

10-year sovereign bond yield spread vs. Germany (basis points)

Source: ESM based on Bloomberg

The *great compression* made sense ...
Lesson #4: Even if the move makes sense, be mindful of over-reactions

10-year sovereign bond yield spread vs. Germany (basis points)

... up to a point. What is the new normal?

Source: ESM based on Bloomberg
Lesson #4: Even if the move makes sense, be mindful of over-reactions

10-year sovereign bond yield spread vs. Germany (basis points)


... up to a point. What is the new normal?

Need to make the financial sector more growth enhancing
Markets have become more resilient ...

Case Study Brexit: markets normalise after one week

The week before Brexit:
Investors fly to the save haven

The Brexit week:
Turbulence in the markets

The week after Brexit:
Markets are re-connecting

Source: ESM, FIRAMIS

The financial networks can also be seen as a video under: https://apps.firamis.de/sample-apps/FiramisApp-CRM_plain/

- Looking at bond market microstructure: Filtered correlation influences of hourly 10yr bond yield changes
- Blue arrows show reinforcing movements, red arrows show diverging forces between bond markets
- Past experience shows a predictive power of 1 week
- Networks can be used for hedging strategies
- Collaboration with Frankfurt based Fintec Company FIRAMIS
... which is also reflected in the secondary flows ...

Case Study: **Trump election**

- Trump’s election caused the highest weekly turnover since beginning 2014
- The solid home investor base absorbed net sell from UK/Switzerland investors
Case Study: French election

- In view of the French elections, pension funds and insurances were reducing spread risk by net selling long maturities (yellow line)

- Two days after the first round of the French election, we tapped a 26yr EFSF bond

- With a solid 18% share, pensions funds and insurances came back through the primary market.