

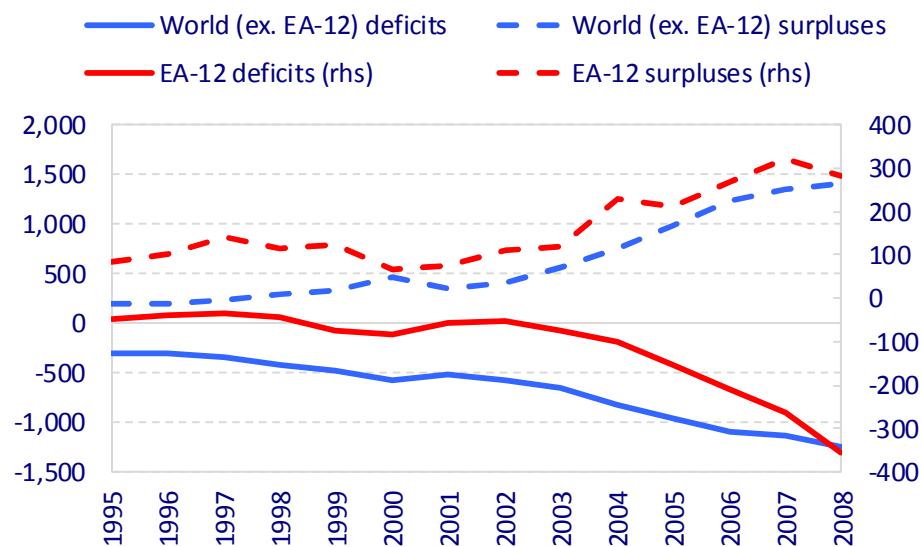
Capital Flows in the Euro Area: Some lessons from the last *boom-bust* cycle

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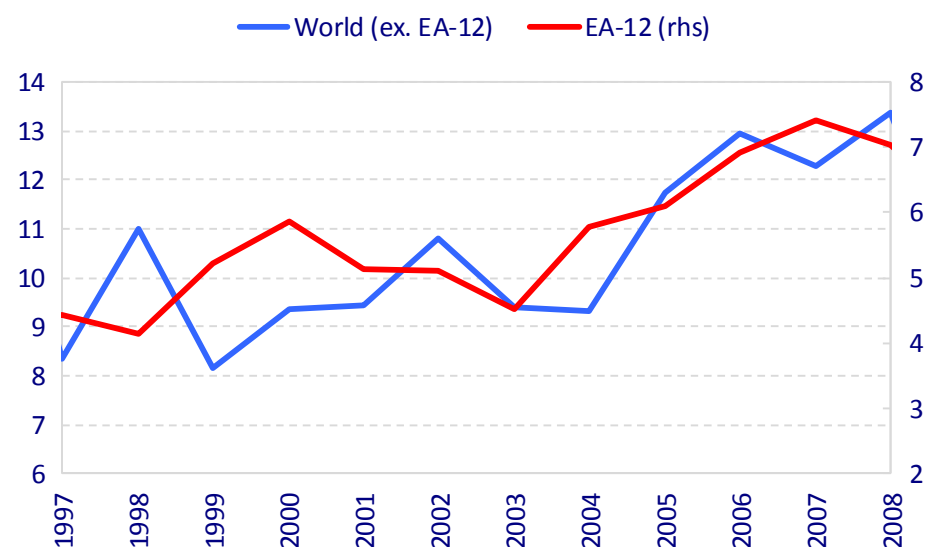
The last *boom* in capital flows was largely a global phenomenon ...

Sum of current account deficits and surpluses (USDbn)



Source: ESM based on IMF WEO

Standard deviation of current account balances as % GDP

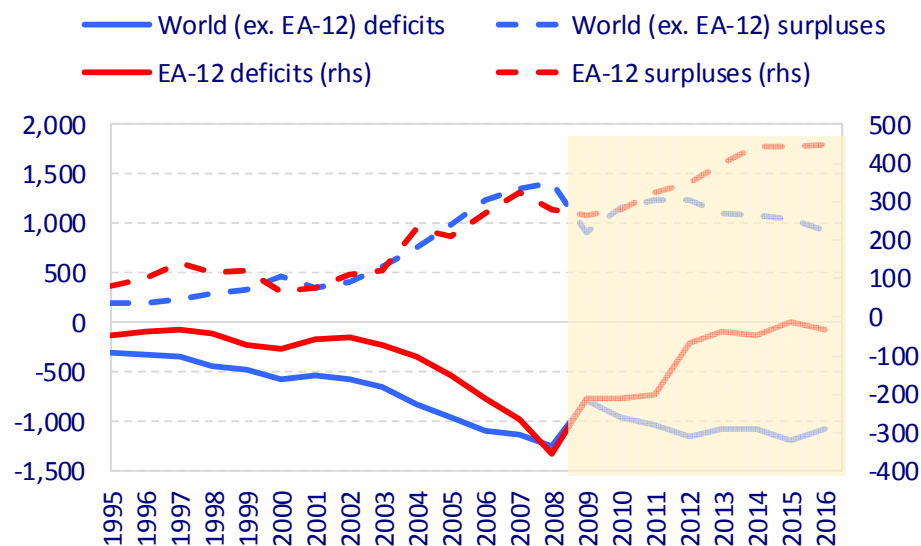


Source: ESM based on IMF WEO

The size of current account imbalances and their dispersion sharply widened globally and in the EA during the *boom*

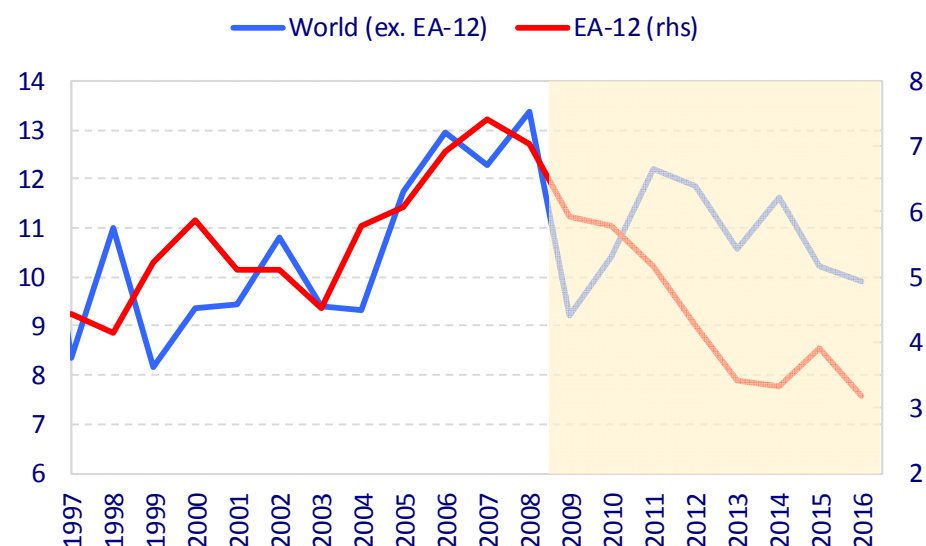
... while the *bust* was particularly intense in the euro area ...

Sum of current account deficits and surpluses (USDbn)



Source: ESM based on IMF WEO

Standard deviation of current account balances as % GDP

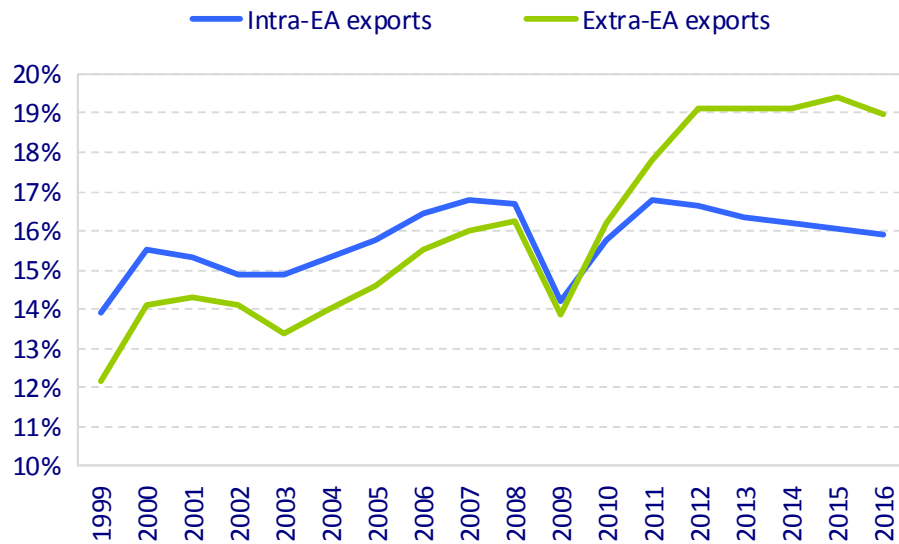


Source: ESM based on IMF WEO

Since the *bust*, current account balances have improved more and become less dispersed in the EA than in the rest of the world

... for various reasons

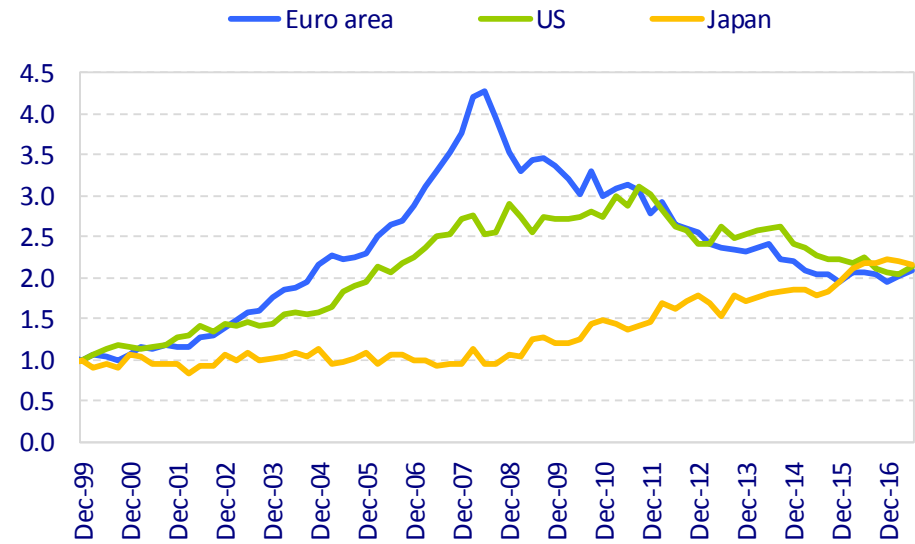
Euro area exports: Intra- and extra-EA (% of GDP)



Source: ESM based on Eurostat

Different degrees of *economic* adjustment required

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

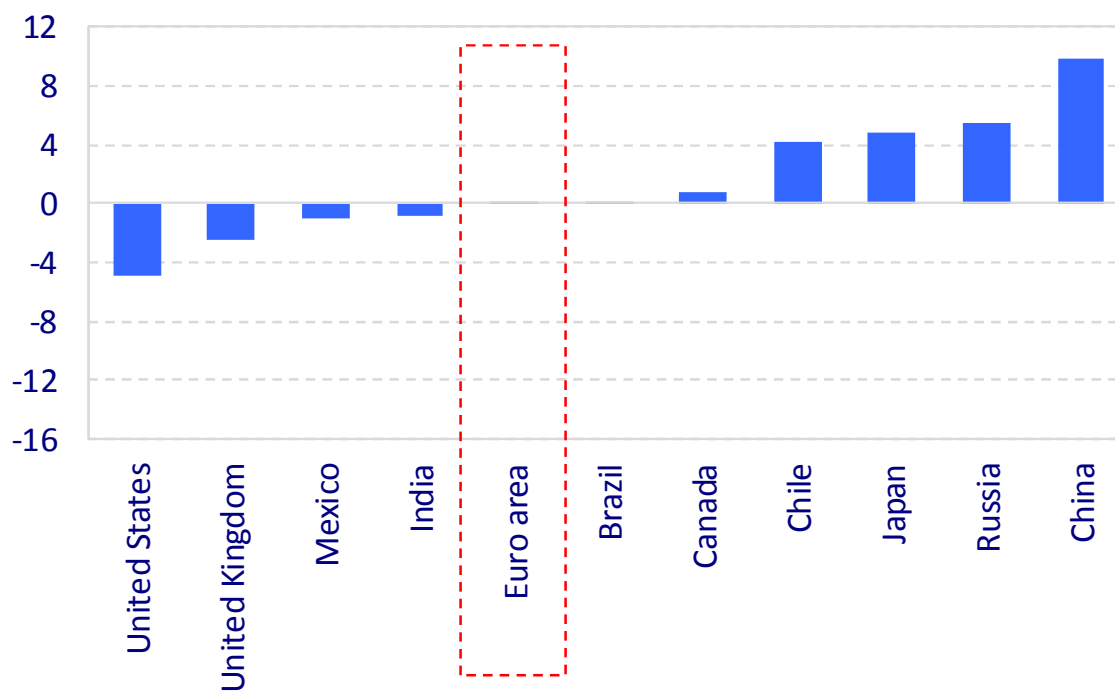


Source: ESM based on BIS

Different roles of the banking sector

Lesson #1: Aggregate/average dynamics may be highly misleading

Current account balance in 2007 (% GDP)

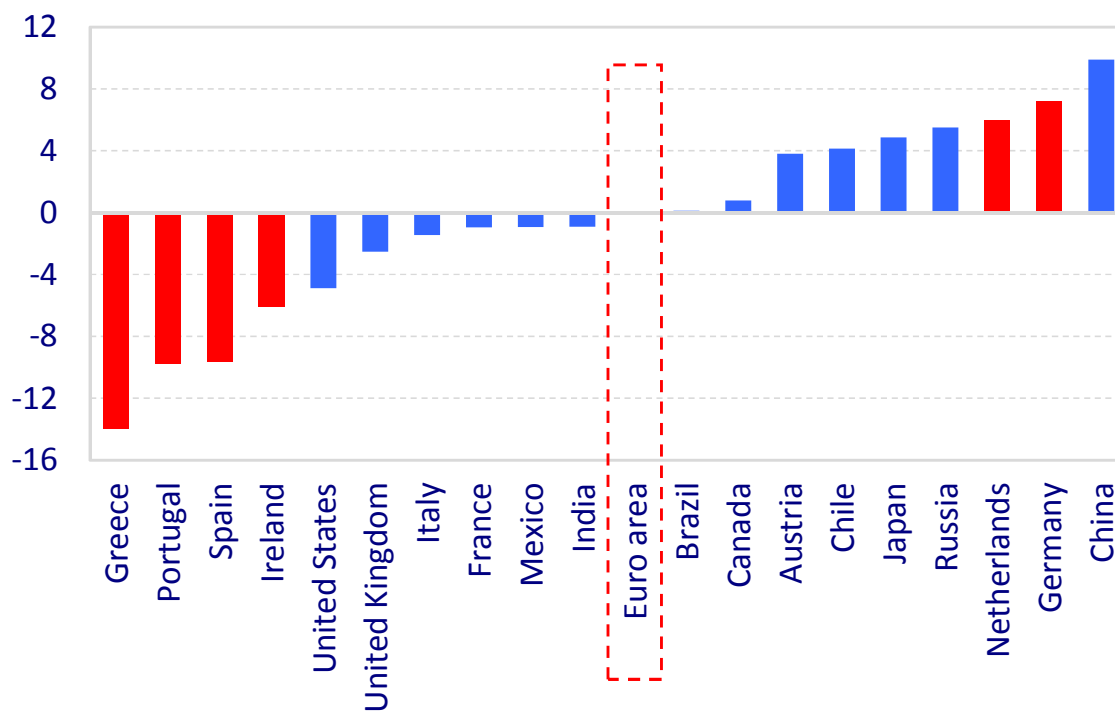


Perfectly balanced external position at the EA aggregate in 2007 ...

Source: ESM based on Bloomberg

Lesson #1: Aggregate/average dynamics may be highly misleading

Current account balance in 2007 (% GDP)

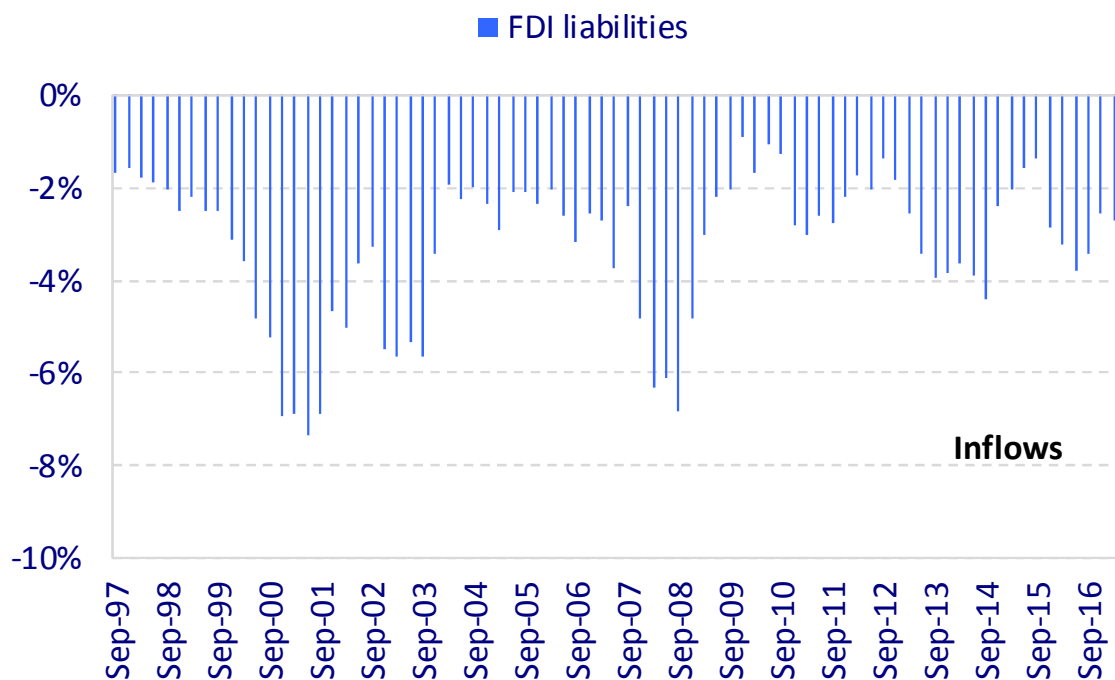


... but masking large outliers and without immediate adjustment mechanisms

Source: ESM based on Bloomberg

Lesson #2: The size of the flows matters, but also their resilience

Spain: Breakdown of financial account flows (% GDP)

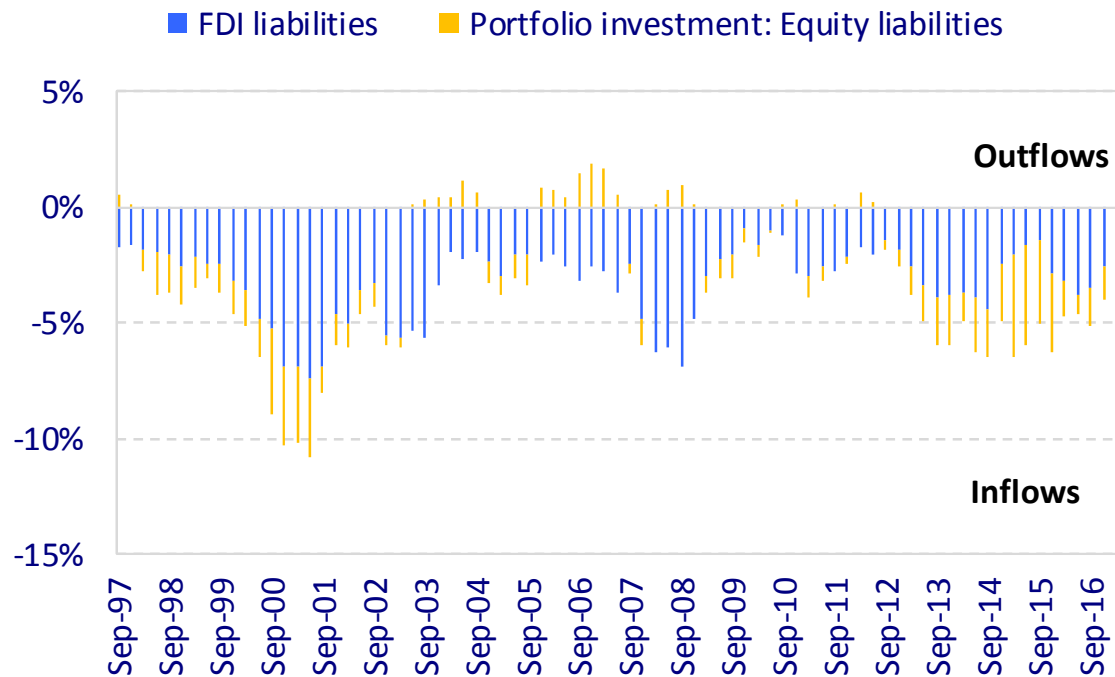


Foreign direct investment moves around, but it is *always an inflow*

Source: ESM based on Banco de España

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Spain: Breakdown of financial account flows (% GDP)

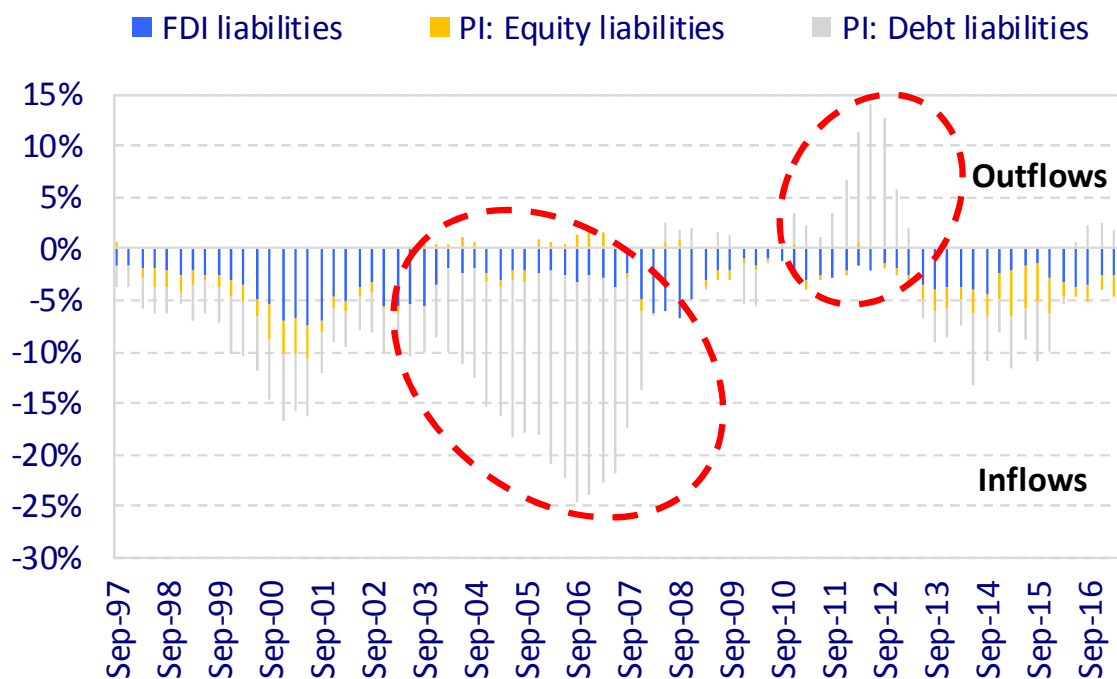


Even at the peak of the EA debt crisis, equity investment meant foreign inflows to Spain

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)

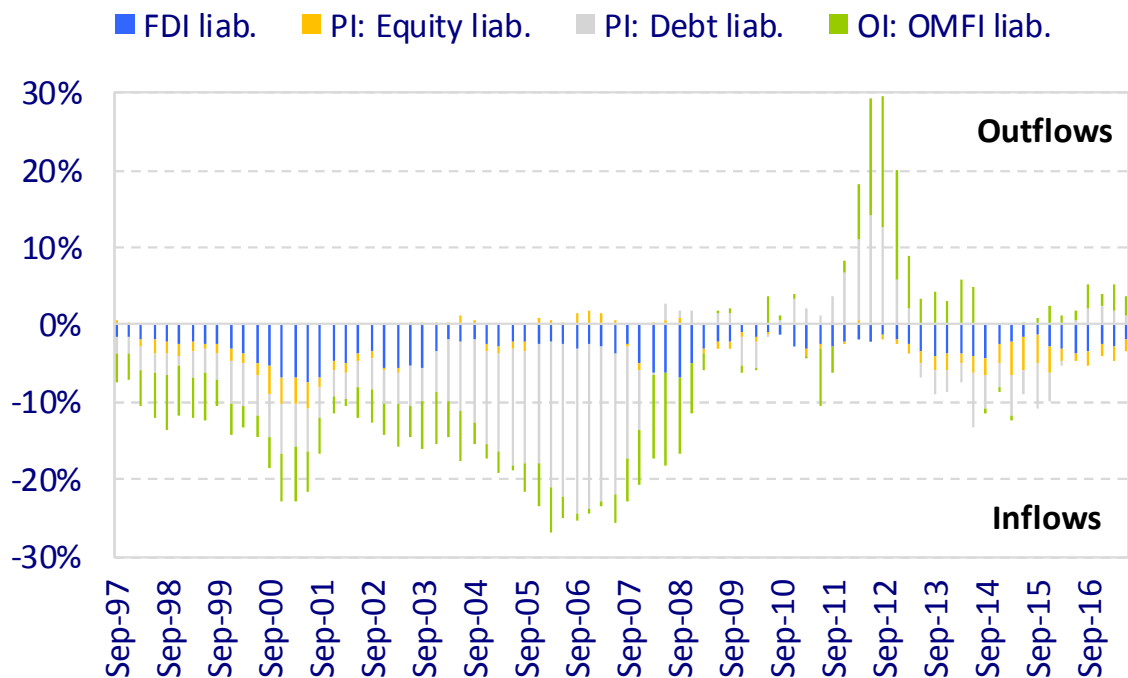


Large swings in the debt liabilities explain most of the *boom-bust* dynamics in Spain ...

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)

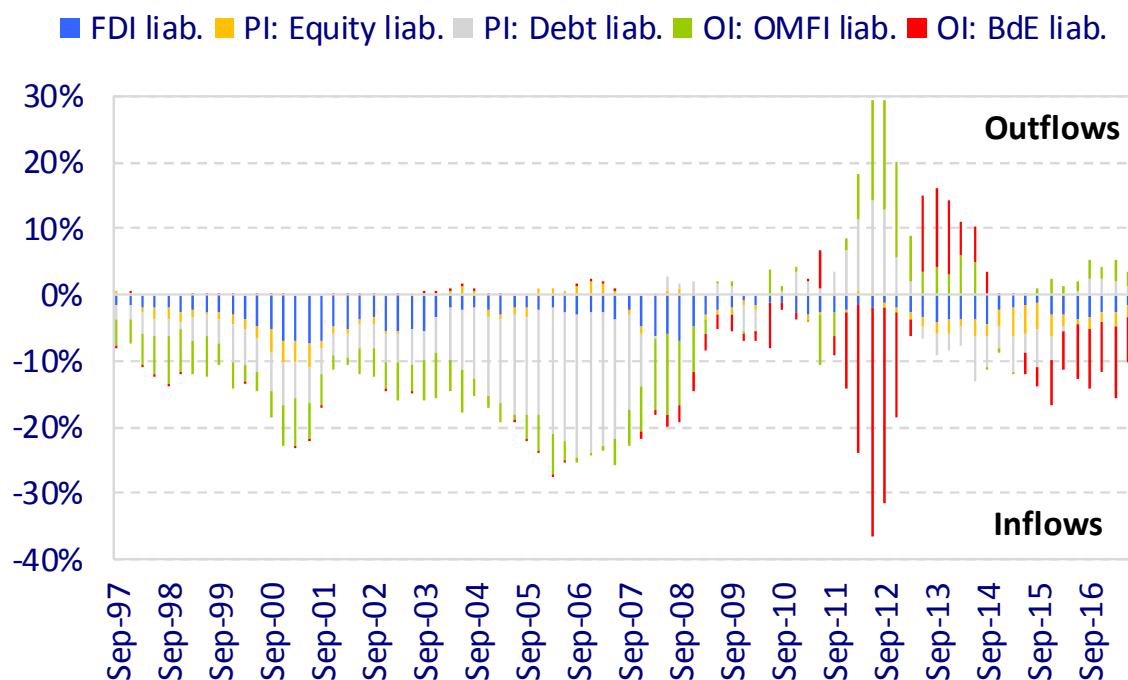


... together with the expansion and collapse of bank-related liabilities

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)

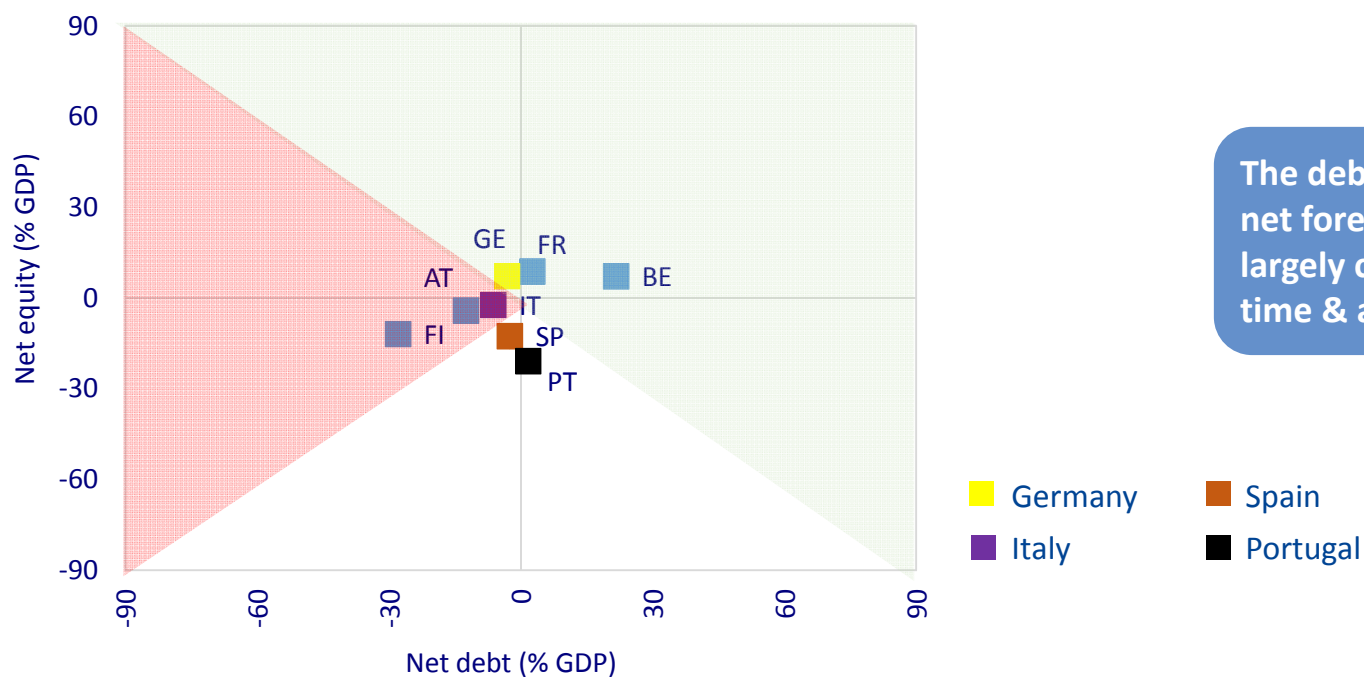


Target 2-channelled inflows helped to avoid a complete *sudden stop*

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)

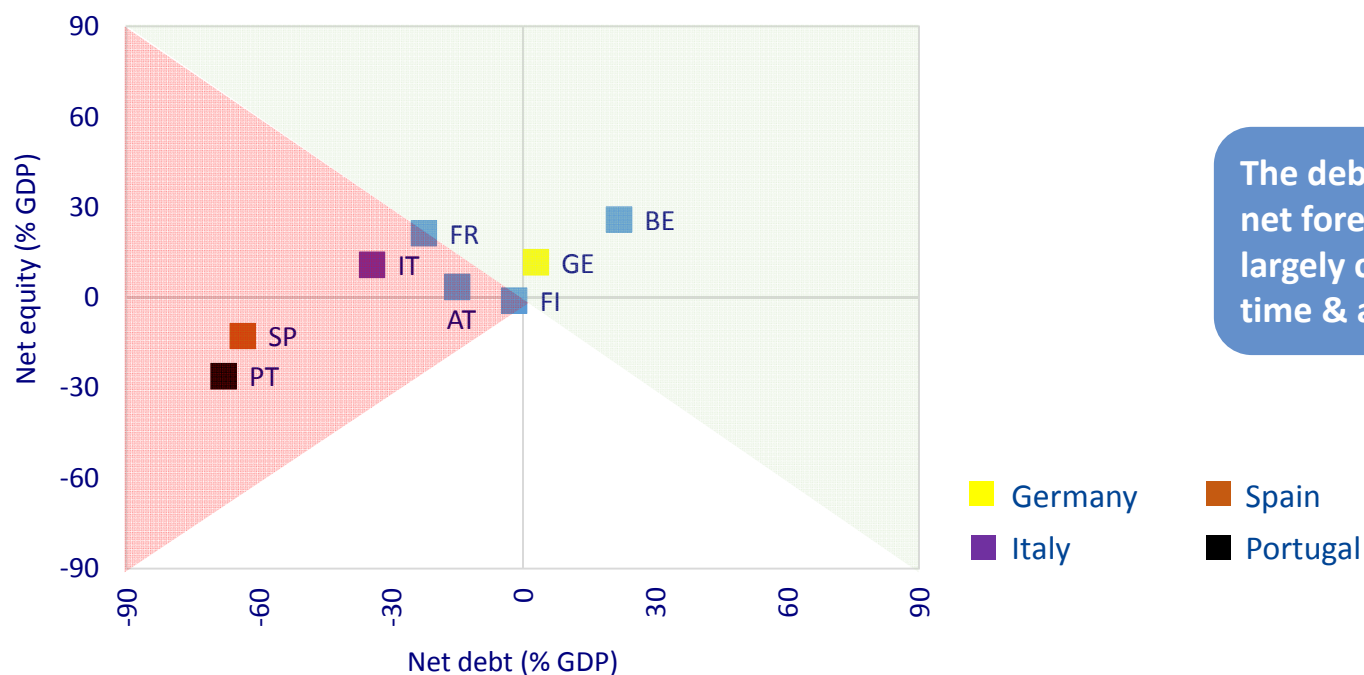


The debt/equity split of net foreign assets has largely changed over time & across countries

Source: ESM based on IMF

Lesson #2: The size of the flows matters, but also their resilience

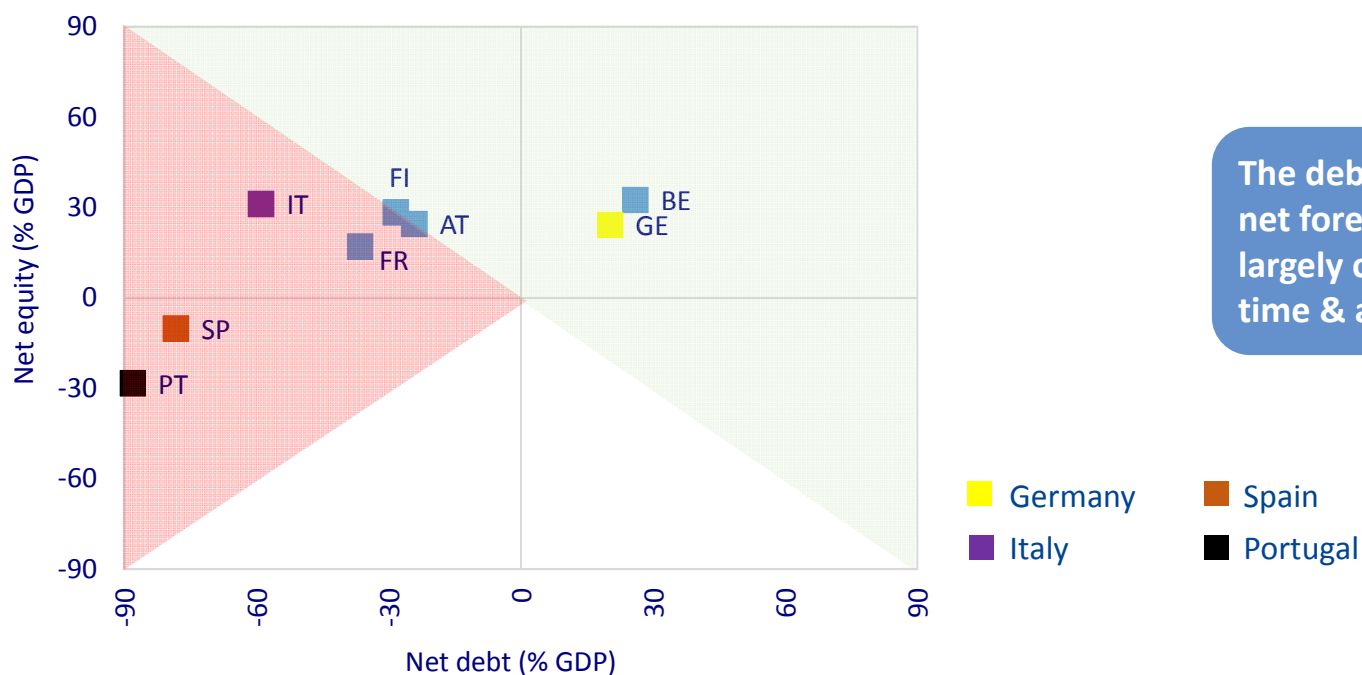
Breakdown of net foreign assets: debt vs. equity in 2008 (% GDP)



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 2015 (% GDP)

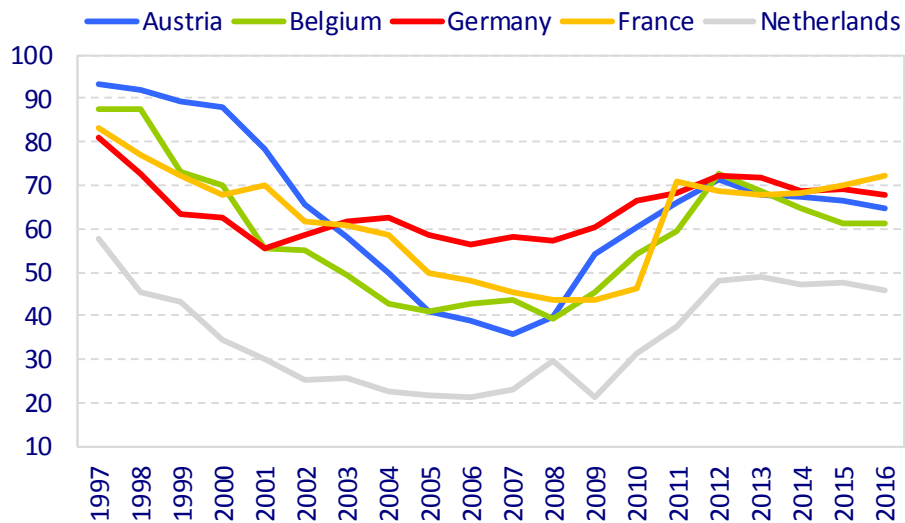


The debt/equity split of net foreign assets has largely changed over time & across countries

Source: ESM based on IMF

Lesson #3: One monetary union, but *one* financial sector?

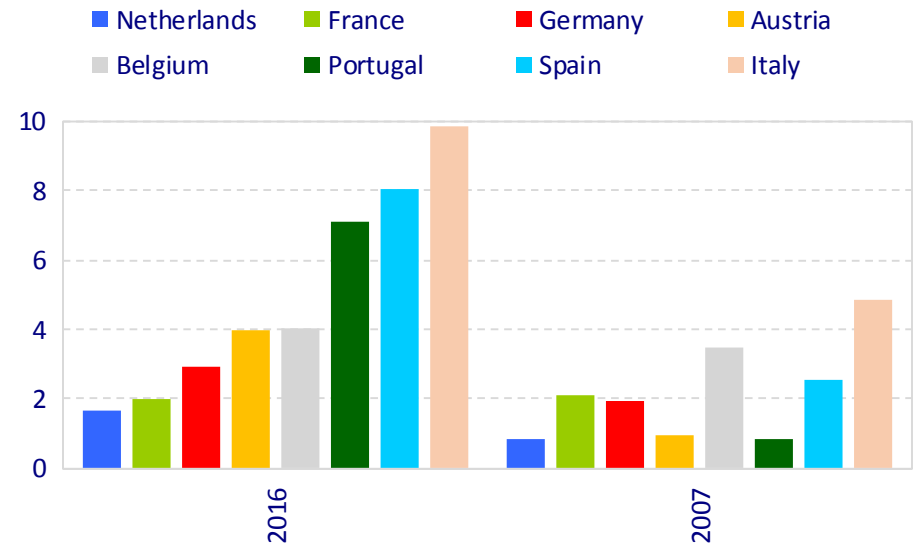
Banking sector's holdings of debt securities issued by domestic General Gov. (% total holdings of EA debt securities)



Source: ESM based on ECB

Increased diversification in banks' portfolios was an illusion

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

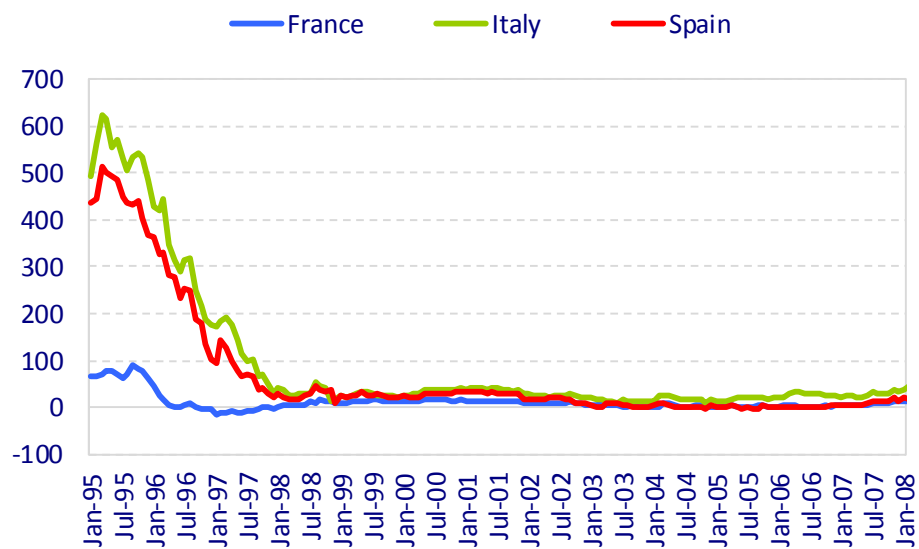


Source: ESM based on ECB

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)

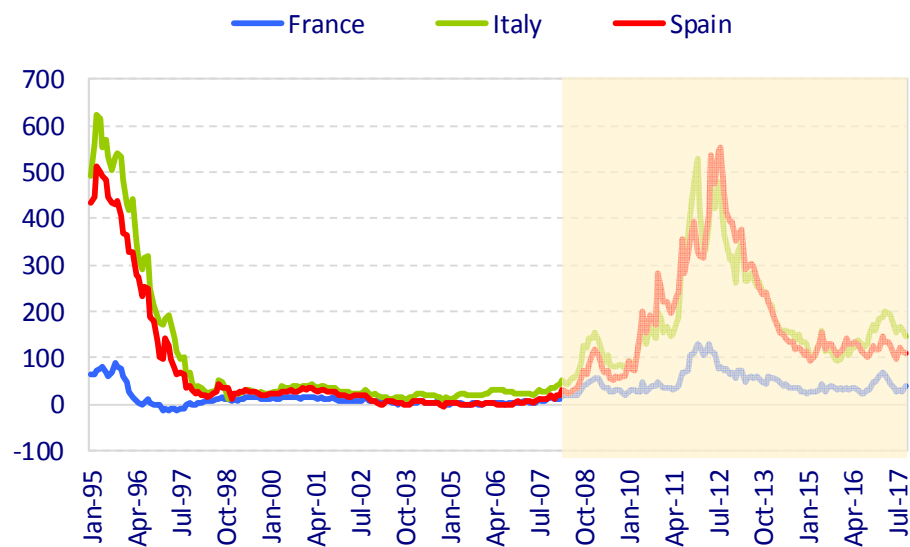


Source: ESM based on Bloomberg

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)

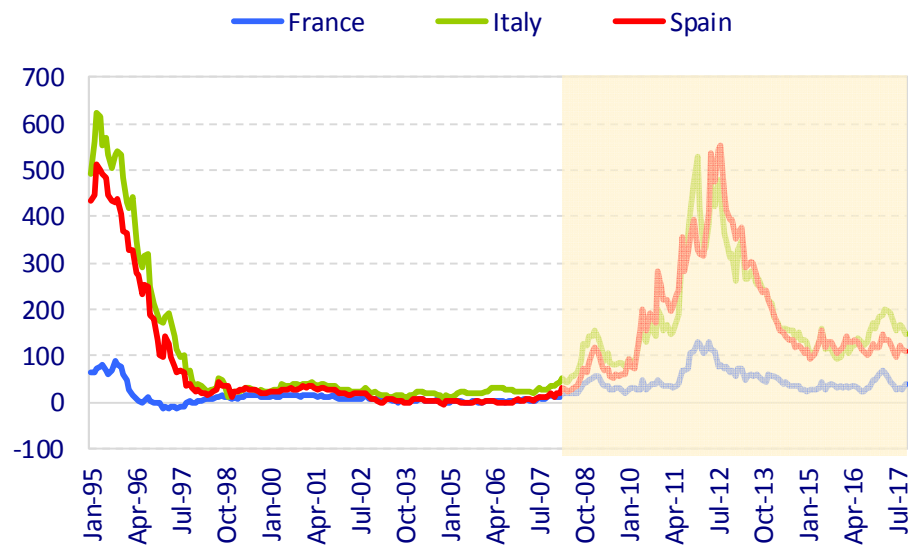


Source: ESM based on Bloomberg

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

Lesson #4: Even if the *move* makes sense, be mindful of over-reactions

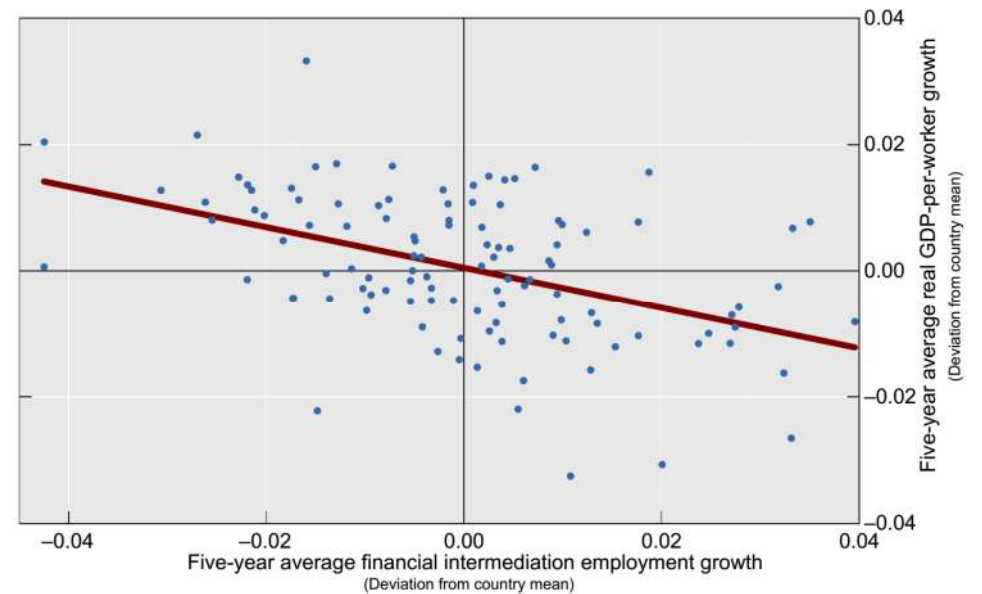
10-year sovereign bond yield spread vs. Germany (basis points)



Source: ESM based on Bloomberg

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

Financial sector growth and productivity growth (1980–2009)



Source: Cecchetti and Kharroubi (2012)

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 safe haven



The Brexit week:
Turbulence in the markets



The week after Brexit:
Markets are re-connecting

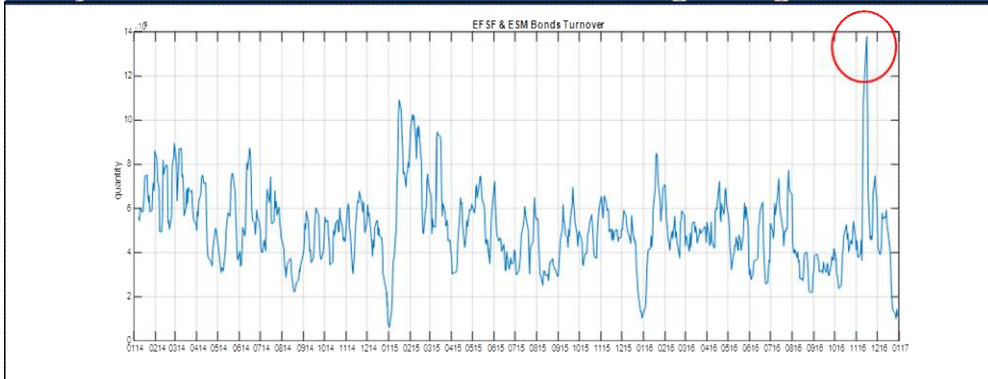
Source: ESM, FIRAMIS The financial networks can also be seen as a video under: https://apps.firamis.de/sample-apps/FiramisApp-CRM_plain/
ESM working paper: <https://www.esm.europa.eu/publications/european-government-bond-dynamics-and-stability-policies-taming-contagion-risks>

- 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 ...

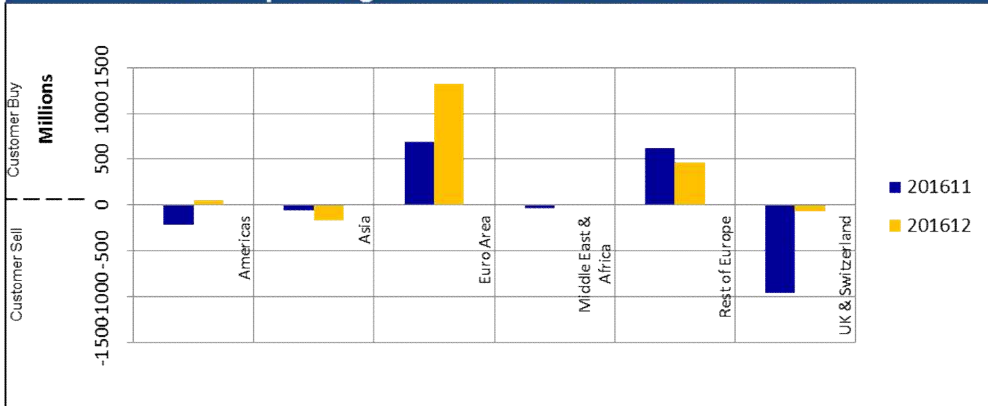
Case Study: Trump election

Daily turnover volumes 2014-2016 – 5d moving averages



- Trump's election caused the highest weekly turnover since beginning 2014

Net Flow per Region – November vs December 2016

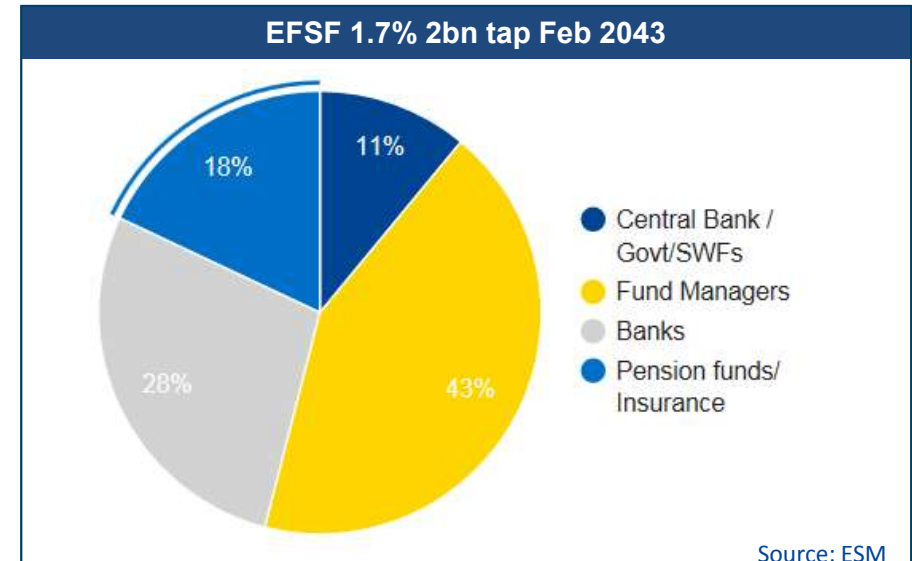
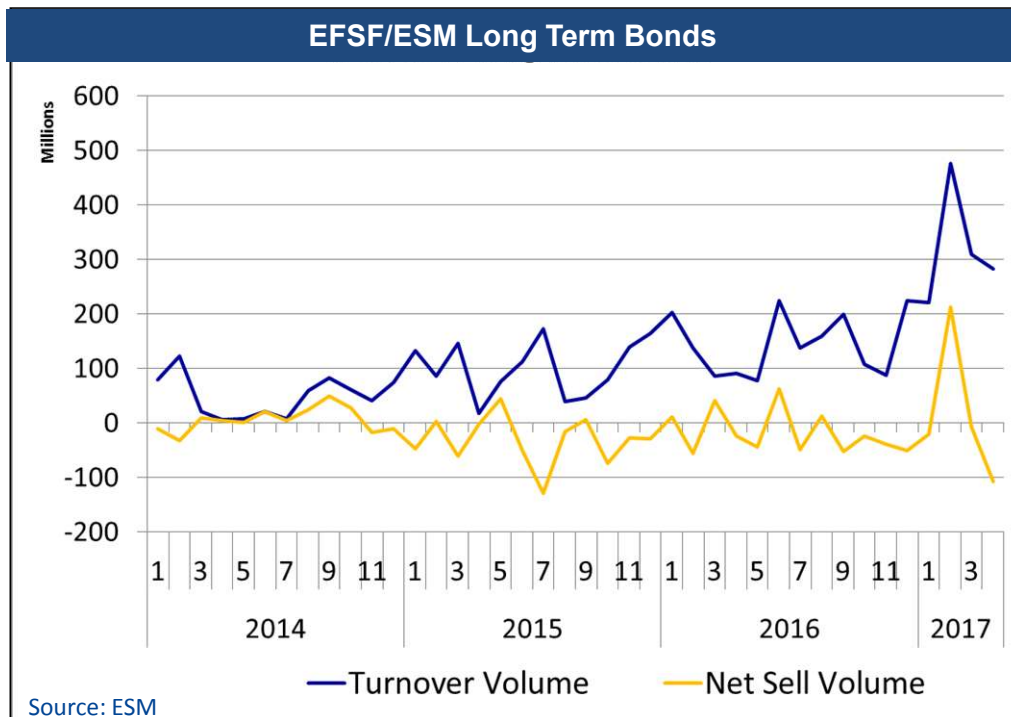


- The solid home investor base absorbed net sell from UK/Switzerland investors

... and primary market activity

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.