

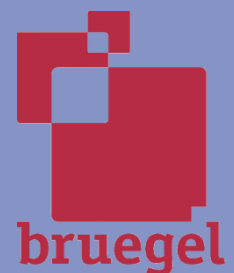


Executive Summary
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Analysis of developments in EU capital flows in the global context

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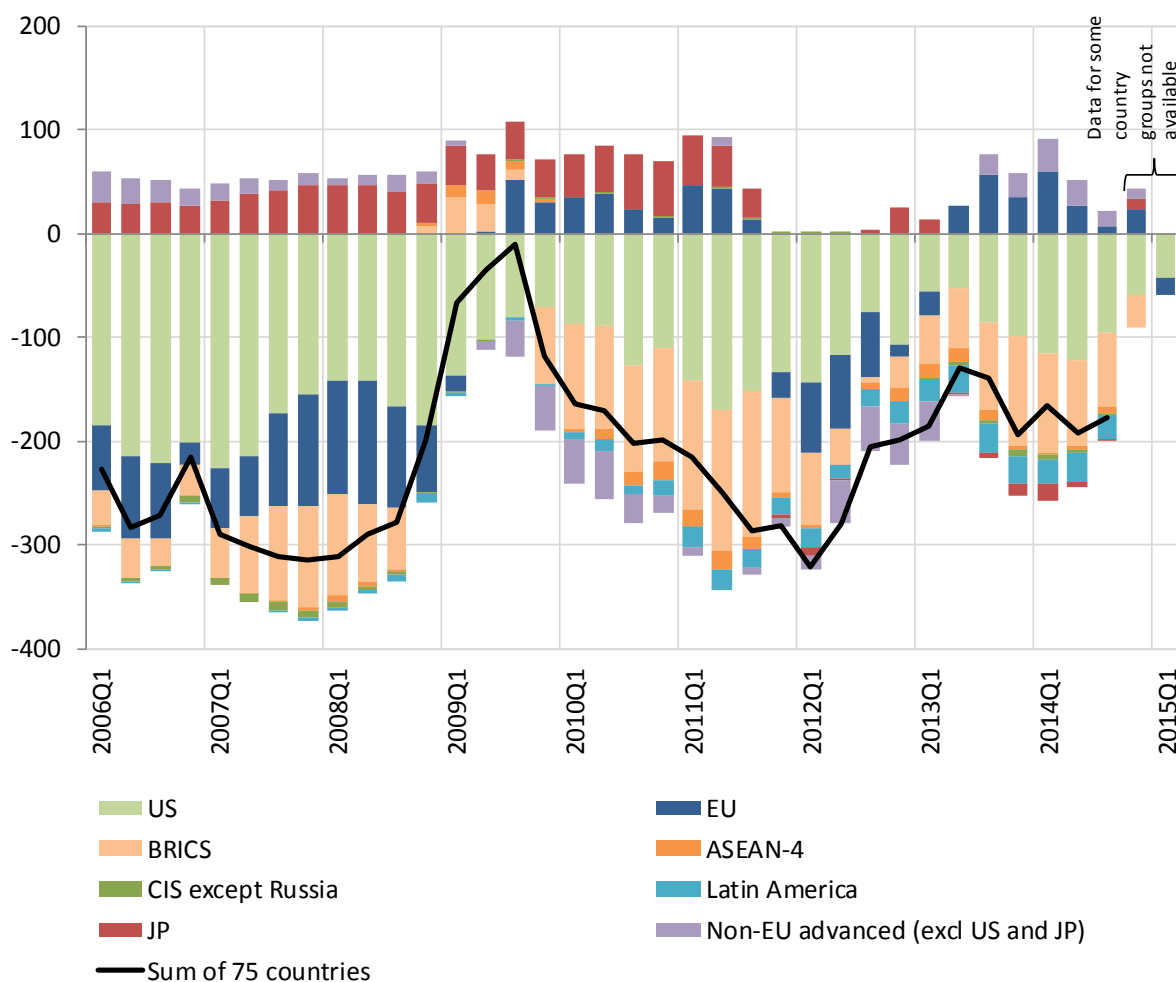
Executive summary*

The purpose of our report is to provide a comprehensive overview of capital movements in Europe in a global context. Free movement of capital, which is one of the four fundamental economic freedoms of the European Union, can enhance welfare if it leads to better allocation of financial and productive resources. However, it can also be a source of vulnerability, with far-reaching spillovers. Monitoring and assessing capital flows is therefore crucial for policymakers, market participants and analysts.

Chapter one introduces the topic and presents the outline of our report.

Chapter two analyses global capital flows. **Error! Reference source not found.** gives an overview of the development in net financial accounts across the world.

Figure 1 Net financial account for different country aggregates (in USD billions, four-quarter moving average)



Source: Bruegel calculations using IMF Balance of Payments Statistics and Eurostat for the EU28 (EU-28 vis-à-vis extra-EU-28, excluding intra-EU flows). Note: The sum of 75 countries is the balance of net assets minus net liabilities, where a positive sign is interpreted as net lending to the rest of the world and a negative sign as net borrowing. We report four-quarter moving averages. The 75 countries included in our country groups account for around 90 percent of GDP of the

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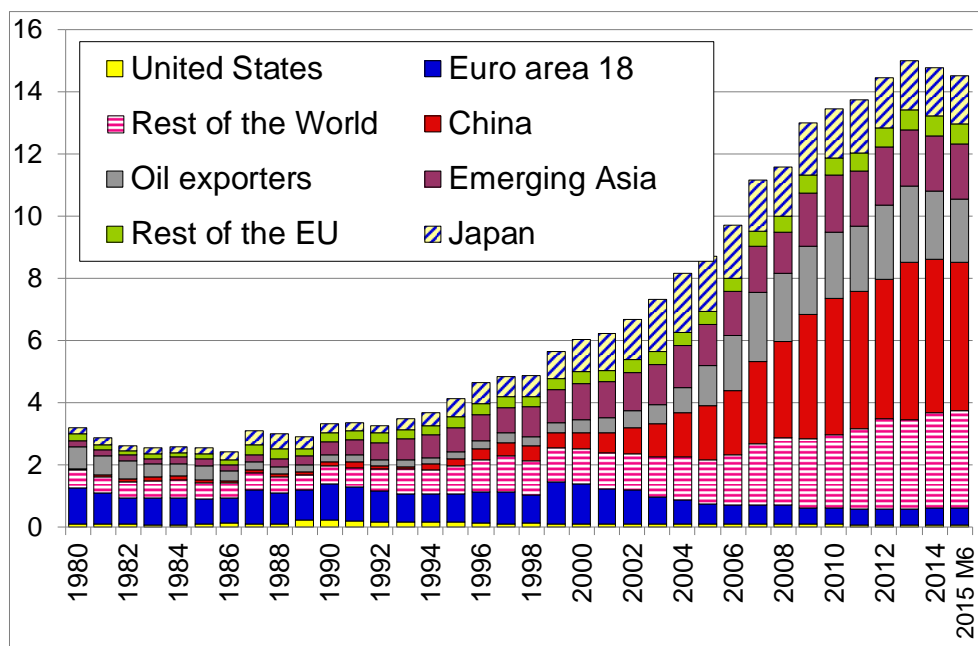
countries included in the IMF World Economic Outlook. Data is complete for all country groups up to 2014Q3, while data is available only for 5 groups for 2014Q4 and only for the EU and US for 2015Q1.

- Considering **the EU** as a whole, capital outflows, which characterised the EU in 2009-2011 and again from early 2013, have gradually been reduced since early 2014, and in the first quarter of 2015 there was even an inflow of 155 bn USD (note that Figure 1 reports 4-quarter moving averages and thereby the figure indicates 17 bn USD for 2015Q1).
- The **euro area** stands out as being an increasing net capital exporter since the end of 2010, on the back of net outflows of banking related investment (mainly deposits and loans), but this trend has declined over 2014. Euro area banks slowed the pace of their expansion of holdings and FDI abroad increased again, contributing to a reduction in net capital outflows in Q1 2015. At the same time, portfolio investment in the euro area became less attractive for foreign investors, possibly due to the European Central Bank's large-scale asset purchases, which compressed government and corporate bond yields in the euro area.
- **The UK, Sweden and Denmark** experienced increasing net capital inflows in 2014, on the back of strong portfolio and FDI inflows, while net capital inflows decreased somewhat during 2014 in **non EU-advanced countries**.
- The **Central Eastern European Countries'** net financial account did not return to pre-crisis levels, and net capital inflows started receding in 2011Q4 amid an outright reduction of cross-border lending on the part of foreign banks operating in the region. This trend seems to have lessened by the end of 2013/beginning of 2014. Moreover, outflows seem to be more than offset by domestic deposit growth in most countries, pointing towards a more balanced post-crisis economic model in the region.
- Globally, both the **ASEAN-5** and the **BRICS** have been subject to increased capital inflows since the global financial crisis due to accommodative monetary policy in advanced economies and the resulting global search for yields. For **Latin America**, a similar portfolio-based recovery can be observed. However, since May 2013, when the Federal Reserve discussed for the first time its plans for **tapering unconventional monetary policies**, these emerging markets have experienced receding or even reversing capital inflows at the same time that their domestic economic activity was slowing down.
- Analysing the **underlying drivers of capital flows to emerging economies** with vector-autoregressive models (VARs), we find that global factors are important. Capital inflows to emerging countries increase when advanced country GDP is higher and when the VIX index (a widely-used measure of risk aversion of financial investors) is lower. We also find that monetary policy of the Federal Reserve and the ECB influence economic developments in the US and euro area, respectively, and thereby monetary policies of advanced countries also influence capital flows to emerging economies. Further, we find that capital inflows to emerging economies are also higher when the GDP of emerging countries is higher and capital inflows increase the GDP of emerging countries. By assessing the three main types of capital flows, we find that FDI flows to emerging economies are not influenced by the VIX index (and consequently all factors that influence the VIX index), while portfolio and other investment flows to emerging economies do respond to changes in the VIX index.
- **Sub-Saharan Africa** has benefited from massive direct investment inflows since 2010, highlighting the attractiveness of this region in recent years. Between 2013Q1 and 2014Q1, FDI inflows continued while other investment inflows reversed, leading to a stronger financial account position. **The Middle East and North Africa** have experienced receding FDI inflows and other large investment outflows over the last three years.
- **CIS 9 (EXCL. RUSSIA)** experienced cross-border deleveraging of banks operating in the area between 2008 and 2013, a trend which seems to have

stopped in the last two quarters of 2013. At the same time, portfolio funding has been coming back to the region, contributing to increasing net financial inflows. In 2014Q1, capital flows reversed as the geopolitical tensions between Russia and Ukraine intensified.

- Available data on banks also suggest that the observable deleveraging process of **Euro area banks** since the financial crisis in 2008/09 seems to have reached a plateau at a lower level in mid-2012, a trend which continued throughout 2013 and into the second half of 2014. Three non-Euro area countries, **Denmark, Sweden and the United Kingdom**, report most claims on other non-EU advanced. Since 2012, a steady deleveraging process of banks in those three countries can be observed. By contrast, the banks located in the **six non-EU advanced economies** of Australia, Canada, Japan, South Korea, Switzerland, and the US continue to increase their exposure to foreign banks up to the end of 2013.
- The **net international investment positions (NIIP) of the Euro area and non-EU advanced economies** have been negative and stable for the past years, mainly on the back of negative portfolio investment and positive FDI stocks. However, academic research found that 8 percent of the global financial wealth of households is held in tax havens, three-quarters of which goes unrecorded. Accounting for unrecorded assets, the euro area becomes a net creditor instead of a net debtor to the rest of the world as indicated by official statistics.
- **In the CEE**, FDI liabilities are dominant and account for about the same as the sum of net portfolio and other investment liabilities while there was practically no change in NIIP/GDP position of this group of countries in 2010-14. **CIS 8 (excl. Russia)** and **Latin America** also have negative overall NIIP, but they have positive net portfolio and/or other investment positions.
- **Japan and Switzerland** exhibit strong positive NIIPs. Switzerland accumulated sizable positive reserve assets, stemming from interventions in the foreign exchange rate market by the Swiss National Bank during and after the peg of the Swiss Franc to the Euro (September 2011-January 2015). Other investment by foreign investors in Switzerland exceeds other investment abroad, suggesting an increasing importance of Switzerland as a safe haven, a trend which has been reverting over 2014.
- A rather marked trend-change can be observed for **foreign exchange reserves** held by central banks: following a period of more than two decades of large-scale foreign exchange reserve accumulation, reserves started to decline measured both in US dollars and as a share of world GDP in 2013 (**Error! Reference source not found.**). Capital outflow from emerging markets is likely linked to the rumours about monetary tightening in some advanced economies. The sell-off of reserves by emerging-country central banks aimed to dampen the impact of capital outflows on currency depreciation. It needs to be seen if the depletion of foreign exchange reserves is a temporary phenomenon or not. Yet in the short-run, reserve depletion can lead to interest rate increases in advanced countries and offset the impacts of quantitative easing policies.

Figure 2 Foreign exchange reserves (as share of world GDP)



Source: IMF IFS (foreign exchange reserves) and IMF WEO April 2015 (GDP).

- A **special focus on Ukraine and Russia** shows that both Ukraine and Russia have experienced capital outflows in the recent past due to geopolitical unrest, but to a smaller extent than during the turmoil of the financial crisis. While Russia continues to display persistent net capital outflows in 2015, Ukraine has managed to attract some capital in recent months. Despite this positive development, the country still faces major economic challenges.
- It is difficult to disentangle **the impact of sanctions and oil prices on the Russian economy**: the large drop in oil prices was immediately reflected in the deterioration of Russian economic outlook, yet the outlook also deteriorated when sanctions were imposed, suggesting that sanctions may have played an important role too.

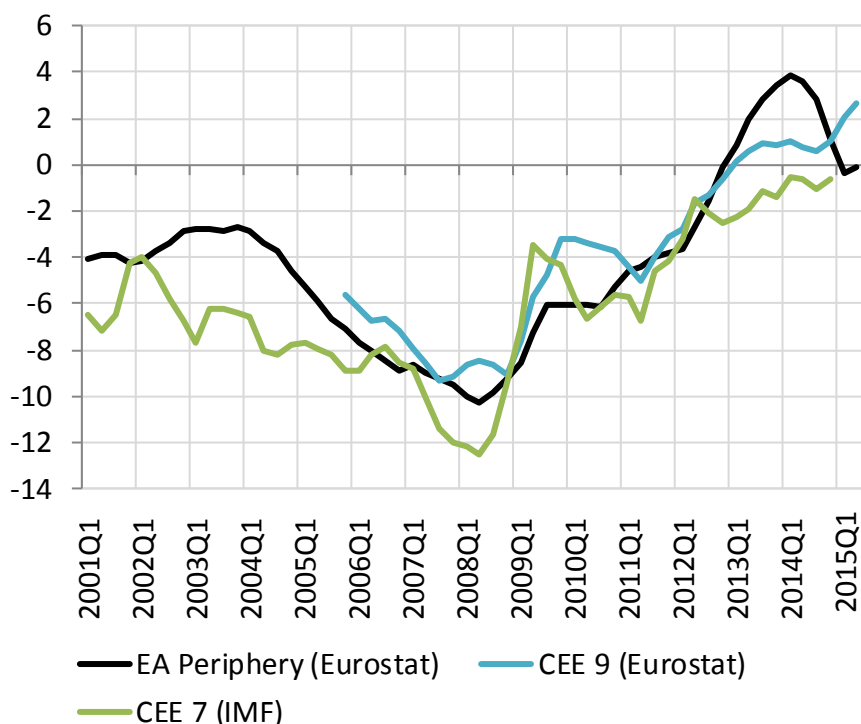
The third chapter focuses on capital flows in the European Union, with a special focus on Greece and Cyprus.

- The effect of the rise and contraction in **gross flows** is most evident in the **euro area centre and periphery** – where gross flows contracted both during the financial crisis in 2008Q3 and, after a short recovery phase, again in 2013Q1. By that time, the periphery had turned into a net exporter of capital, on the back of gross other investment outflows. By the end of 2014, the net outflows peaked and were slowing down, a trend which reverted in 2015Q1. In the euro area core, gross flows after the financial crisis have remained more stable, albeit at a significantly lower level compared to pre-crisis times. Since 2012Q1, the euro area core increased its position as net exporter of capital, a trend which reverted somewhat over 2014 before intensifying again in 2015Q1.
- This is confirmed by looking at **cross-border banking exposure**: In the post-crisis period, the banks in the euro-area core deleveraged significantly, reflected by the drop in net foreign claims from nearly 30% of group GDP to less than 10 % by end 2013. Over 2014 and 2015Q1, net foreign claims seem to have stabilized at that level. The euro-area centre banks' net foreign claims peaked at 10% of group GDP in 2012Q2 and have decreased steadily since then, only, beginning to increase their exposure abroad again in 2015Q1. Euro-area periphery banks were characterised by substantial inflows, which translated into a negative net foreign claim position. These inflows contracted massively during the financial crisis in

2007/2008 and again with the rise of the redenomination risk during the European debt crisis in 2011. Negative net foreign claims turned positive by mid-2012, reflecting massive deleveraging from the rest of the world. Since 2013, the euro-area periphery net foreign claims stayed in a balanced position, a trend which has continued in the latest quarters.

- The magnitude of gross flows in **Denmark and Sweden** as well as in the **CEE** tends to be smaller than in the euro area. As a share of GDP, **the UK**, which plays a special role as financial centre, experienced gross flows of up to 80% of GDP during the financial crisis. In terms of compositions, the three non-euro groups differ significantly from the euro area. For the UK, the banking-related component (loans and deposits) massively dominates capital flows, and portfolio investments (especially debt) play a certain role too. Flows to Northern Europe are characterized by portfolio equity and debt, as well as other investment. In the CEE, FDI constitutes the bulk of inflows before the crisis together with other investments (which includes bank loans). In the post-crisis period, the magnitudes held up well in Northern Europe, were volatile in the UK and declined dramatically in the CEE (and continue to stay at much lower levels compared to the pre-crisis period).
- In terms of **net flows**, the latest developments show a stabilization of net outflows over 2014, as rising net portfolio outflows are substituting receding other investment outflows. The **euro area centre** has been experiencing rising net outflows over 2014, which intensified by the end of the year on the back of increasing net portfolio investment outflows.
- **Denmark and Sweden** have been net exporters of capital up until the end of 2007 (reflecting current account surpluses). With the start of the financial crisis, capital in search of safety started pouring into these countries. This was particularly pressing for **Denmark**, which eventually adopted monetary policy measures such as the negative rate on central bank deposits to curb the inflows it was undergoing. Over the latest period, banking-related investment outflows are decreasing in importance while net portfolio investment turned from in- to outflows.
- A remarkable similarity can be observed when **comparing CEE countries with the euro area periphery countries** in terms of net flows (Figure 3). Both regions experienced large capital inflows before the crisis, which declined from late 2008. Over 2009-10, the initial adjustment was more gradual in the euro-area periphery most likely due to the provision of financial assistance and especially by ECB liquidity, which allowed a smoother adjustment on the external position than that which occurred in CEE countries, especially in the Baltics. Yet the trend remained broadly similar in both country groups, though in the past two years capital outflows from euro-area periphery countries were much larger than from CEE countries.

Figure 3 Net financial account of the euro-periphery and Central and Eastern Europe (percent of GDP)



Source: Eurostat, IMF and Bruegel calculations. Note: the EA periphery includes GR, PT, ES; the CEE 9 (Eurostat) includes CZ, HR, EE, HU, LV, LT, PL, RO, SI while the CEE7 (IMF) includes BL, CZ, LV, LT, HU, PL, RO; Data is available from 1999Q1 to 2015Q2.

- We included a special focus on **Greece and Cyprus**, two EU countries that introduced capital controls. Both countries experienced large capital inflows up to the financial crisis in 2008/09. With the start of the sovereign debt crisis in **Greece** in 2010, capital started leaving the country and Greece turned into a net exporter of capital by the end of 2012. In terms of net portfolio positions, France, Germany, and the rest of the euro area were the largest holders of portfolio before the crisis, a trend which reversed by December 2012. Beginning in 2010, Greece was also subject to substantial cross-border deleveraging, a trend which stabilized in 2013 at significantly lower levels. Bank exposure to Greece continued to decrease in 2015 amid renewed political and economic uncertainty. Capital controls were introduced in Greece in June 2015, but data is not yet available to assess its impact on capital flows.
- By contrast, **Cyprus** saw much slower and more gradual capital withdrawal even during the outbreak of the European debt crisis, which accelerated with the outbreak of the Cypriot crisis in winter 2012/spring 2013. On a bilateral basis, countries receiving the most portfolio outflows were Greece and the United Kingdom up to December 2012. In the midst of a 10 percent of quarterly GDP net capital outflow in 2013Q1, in March the Cypriot government established restrictive measures on capital movements. While capital outflow slowed down due to the controls, it did not stop but continued throughout 2013. In 2014, stabilization in portfolio, debt and other investment flows can be observed, reflecting the removal of uncertainty and the improved prospects of the country. Interestingly, exposure of Greek banks to Cyprus increased steadily, from 24% of Cypriot GDP in 2005 to 48% of Cypriot GDP in 2015, and banking exposure from the rest of the euro area picked up in the first half of 2015.

Chapter four presents the results of our in-depth study on financial cycles and macro-prudential policy.

- While price-based measures of financial integration signal a recovery of financial integration, various **quantity-based indicators suggest little change in intra-euro area financial integration**, which continues to be well below the pre-crisis level.
- **In the 1999-2007 period**, massive financial flows spurred by currency unification resulted into the **dis-anchoring of countries' domestic savings and investment**, as reflected also in the growing current account imbalances. Evidence of dis-anchoring is significantly weaker when all 27 EU countries are considered, although by 2007 non-euro area EU countries achieved the same level of dis-anchoring that persisted in the euro area for a decade.
- While the euro-area aggregate financial cycle fluctuated rather moderately, a **major divergence of domestic financial cycles** can be observed within the euro area, which was very much linked to capital flows, and especially to intra-euro area debt flows. The credit cycle for UK, Denmark and Sweden are found to have been close to the euro-area cycle.
- **The rationale for an effective macro-prudential policy is particularly strong** in the euro area going forward, especially in the current low rates environment. Since the financial cycles of individual euro-area countries will likely remain heterogeneous, macro-prudential policy in the euro area will face significant challenges. Financial integration and potential cross-country financial spillovers would favour strong macro-prudential power for the ECB, yet the euro area's macro-prudential system has become a two-tier system in which national authorities and the ECB each have certain tools to govern in a complex relationship. This system for macro-prudential policy in the euro area seems unfit to deal effectively with the special challenges. We suggest giving the ECB more power, which would require changes in the SSM legal framework.
- To the extent that capital flows are linked to underlying domestic macroeconomic imbalances, **there is synergy between the EU's Macroeconomic Imbalance Procedure (MIP) and macro-prudential policy**. Consistent and effective implementation of the MIP would facilitate the ECB's task to prevent the build-up of excessive financial risk at the country level.

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