Box 1

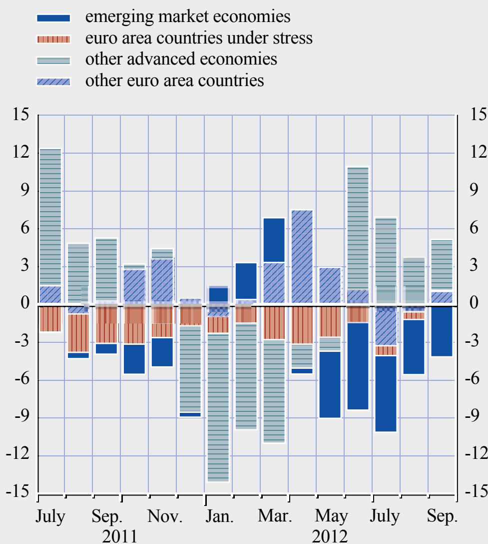
RECENT TRENDS IN GLOBAL PORTFOLIO FLOWS AMID SOVEREIGN TENSIONS IN THE EURO AREA

The rise of global tensions on account of the intensification of the sovereign debt crisis in the euro area since mid-2011 has led to distortions in capital flows and to a rebalancing of portfolio investment – both across asset classes and across borders. One aspect of these disrupted flows has been a hunt for safe and liquid assets in the context of heightened (and protracted) uncertainty. Indeed, an analysis of balance of payments data, complemented by high-frequency data on mutual fund portfolio decisions, suggests significant safe-haven flows.

Geographic flows have been severely affected. Within the euro area, there is clear evidence of flows toward highly rated euro area countries. At the global level, safe-haven flows suggest outflows from the euro area to the benefit of other advanced economies, along with rather volatile emerging market flows (see Charts A and B). US investors have exhibited particularly pronounced risk aversion, persistently repatriating foreign investments from all around the world, including other advanced economies, between November 2011 and early 2012. Some of the home bias inherent in these flows suggests that they have perceived their own market as the ultimate safe haven for piling up precautionary liquidity buffers in times of heightened financial market stress (see Chart A).

Chart A US investors' portfolio investment assets, by region

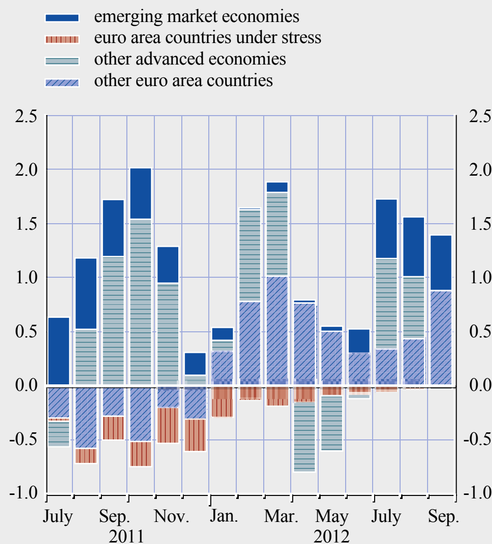
(July 2011 – Sep. 2012; USD billion; three-month moving average)



Source: US International Capital System.

Chart B Japanese investors' portfolio investment assets, by region

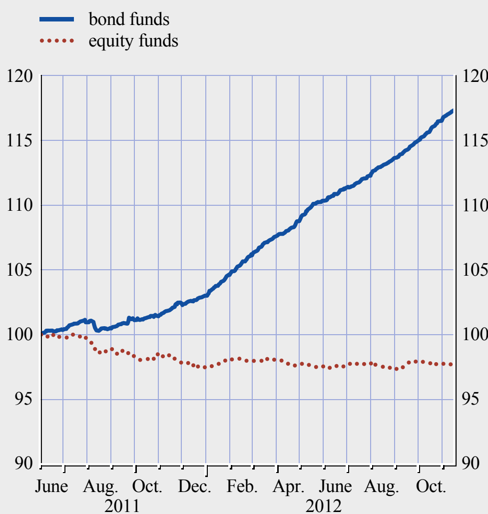
(July 2011 – Sep. 2012; JPY trillion; three-month moving average)



Source: Haver.

Chart C Cumulative gross flows into equity and bond funds

(June 2011 – Nov. 2012; index: June 2011 = 100)

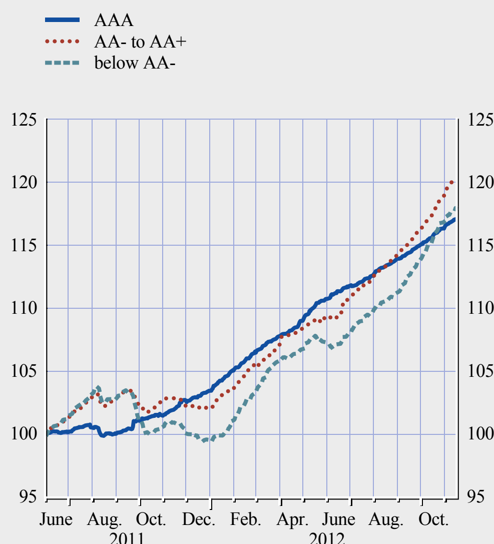


Source: EPFR.
Notes: EPFR data on flows reflect mainly investment decisions by funds domiciled in advanced economies, especially in the United States. As a consequence, EPFR flows can be considered gross flows from a balance of payments point of view. Cumulated inflows net of valuation effects are presented in the form of an index. For example, an increase in the index from 100 to 102 indicates net cumulated inflows equivalent to 2% of the assets invested in the region.

The manifestation of risk aversion that is revealed in geographic flows has been mirrored by asset class allocations. International investors have been reallocating investments in riskier assets, such as equities or lower-rated debt securities, to assets they perceive to be safer. Cumulating international flows into equity and bonds (see Chart C), as well as those into bonds, broken down by rating class (see Chart D), suggests persistent safe-haven flows that have been interrupted by policy interventions. The combination of inflows to AAA-rated countries and outflows from lower-rated countries was particularly strong between September and December 2011 (see Chart D). Since January 2012, flows into AAA-countries have continued, but flows into lower-rated countries resumed in the aftermath of the Eurosystem's three-year LTROs, subject to volatility, however, and with short-lived periods of outflows in spring this year. Since August 2012, expectations concerning market interventions by the ECB and the unveiling of the OMT programme in early September 2012 have boosted flows into lower-rated countries.

Chart D Cumulative gross flows into bond funds, by rating class

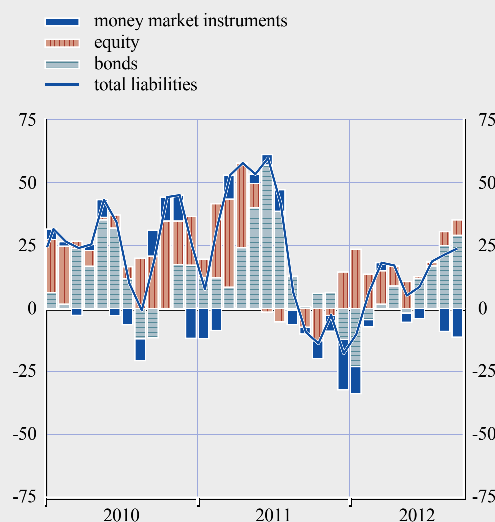
(June 2011 – Nov. 2012; index: June 2011 = 100)



Source: EPFR.

Chart E Euro area portfolio investment liability flows vis-à-vis non-residents, by instrument

(Jan. 2010 – Sep. 2012; EUR billions; three-month moving average)



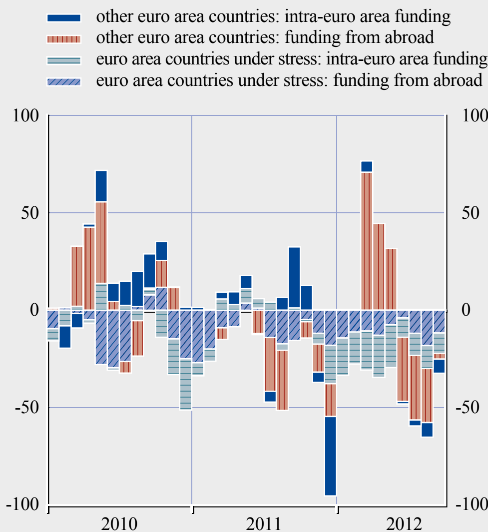
Source: ECB.

These aggregate developments in flows between geographical regions and across asset classes conceal certain differences. Clearly, portfolio flows in the euro area suggest an increased intra-regional fragmentation amid prevailing sovereign tensions. However, withdrawals of capital from the euro area by foreign investors have, on aggregate, remained limited. Instead, foreign investors have responded to elevated levels of financial stress by rebalancing their euro area securities portfolios both across instruments and across euro area countries. More specifically, foreign global investors have shifted portfolio investment away from euro area countries under stress to other euro area countries. Viewed in terms of instruments, foreign investors have sold debt instruments (bonds and money market instruments) and reinvested part of the proceeds in euro area equity markets (see Chart E). Residents in higher-rated euro area countries have also been rebalancing their portfolios, moving away from securities issued by sovereigns and companies in countries under stress towards other euro area securities. As a result, in contrast to the euro area aggregate, portfolio investment outflows from the euro area countries under stress increased sharply in the first half of 2012. However, these outflows moderated substantially in the third quarter of 2012.

Finally, looking at funding flows to euro area countries under stress, both foreign and other euro area investors have reduced their short-term exposures to these countries' banking sectors steadily over the last two and a half years (see Chart F). Since December 2011, however, these capital outflows from banking sectors in countries under stress have reflected withdrawals of deposits by other euro area residents. Given the intensification of the euro area sovereign debt crisis, foreign investors have also withdrawn short-term funding (mainly deposits) from the higher-rated euro area banking sector during the summer months of 2012, following a period of marked capital inflows in the first months of the year.

Chart F Euro area MFIs' short-term external funding

(Jan. 2010 – Sep. 2012; EUR billions; three-month moving average)



Source: ECB.
Notes: Short-term funding includes deposits and debt securities with a maturity of up to two years. Short-term intra-euro area funding includes only deposits.

Ultimately, these data clearly reveal that profound dislocations have occurred in international capital flows as a result of the sovereign debt strains in the euro area over the last few years. These dislocations were often based on, and provided evidence of, unfounded fears regarding the reversibility of the euro. The announcement of the OMTs helped to reduce risk premia related to the euro area sovereign debt crisis, thereby inducing investors to rebalance their portfolios in favour of securities issued by euro area countries under stress. From one perspective, the unwinding of dislocated capital flows should be the natural outcome of an eventual resolution of the financial crisis. A benign unwinding of these flows, however, is only one of several possible paths: the possibility of sudden stops or reversals of capital flows remains a risk. Indeed, a rapid and disorderly correction could occur upon a change in either risk perceptions or the perceived liquidity of current safe-haven flows.