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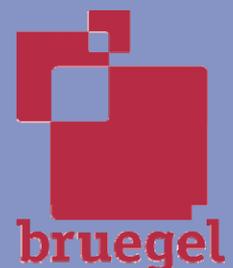
Executive Summary
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Analysis of developments in EU capital flows in the global context

*Taking the perspective of the Capital Markets
Union*

**Grégory Claeys, Maria Demertzis, Konstantinos
Efstathiou, Inês Gonçalves Raposo, Alexander
Lehmann, David Pichler**

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Executive Summary

- In 2017, the patterns of global imbalances (in terms of capital flows), which developed and became entrenched in 2013-16 (as identified in last year's edition of this report), continued to persist. In short, global imbalances have stopped shrinking and are now concentrated in advanced economies: the main current account surpluses are in the euro area and Japan (while they have decreased significantly in China and oil-exporting countries), whereas the main deficits are in the US, the UK, Canada and Australia. In last year's report, we already highlighted the reasons behind this pattern, chief among them being:
 - the differences between surplus and deficit advanced economies in recovery speed and the corresponding policy responses (in particular in terms of monetary policy);
 - structural changes to the Chinese economy
 - commodity prices, in particular low oil prices
- By 2017, some of these factors appeared to be less relevant as the recovery in the euro area finally accelerated and oil prices began to rise again. Despite these developments, the level and the distribution of imbalances remained broadly unchanged. There was only a slight decrease in surpluses relative to 2015-16, driven by China (and the UK on the deficit side). However, it is possible that the impact of the euro-area recovery and higher commodity prices could materialise with a lag in balance-of-payment statistics.
- The most important medium-term development in the US was that expectations of and then actual monetary policy diverged from the policies of other advanced economies, namely the euro area and Japan. Between 2013 and 2014, markets began to anticipate interest rate hikes in the US, while starting to expect the introduction of a large asset-purchase programme in the euro area. Both happened during the course of 2015. These developments increased domestic and foreign demand for US assets (as they became more attractive from the US and European perspectives). On the other hand, demand dropped for the assets of emerging market economies, into which capital was flowing when rates were at their lower bounds in advanced countries. Coincidentally, the effective exchange rate of the US dollar increased strongly.
- These interest rate differentials persist to date. Expectations about their future path will be a key variable looking forward. The market and US Federal Open Market Committee (FOMC) views are at the time of writing at odds, with the market expecting less tightening than the FOMC, although the former has repeatedly underestimated the pace and magnitude of US monetary policy measures in recent years. Moreover, the potentially stimulating effect of the tax cuts put in place by the current US administration could result in the overheating of a US economy already near full employment. This could thus lead to a quicker/stronger tightening of monetary policy by the Fed. As a result, the interest rate differential with other economies could increase. Finally, another interesting development visible in the recent data is the significant effect of the US Tax Cuts and Jobs Act's (TCJA) 'tax holiday' in relation to the repatriation of profits of US multinationals booked with subsidiaries abroad in the form of dividends.
- In China, there were significant changes in exchange rate policy in 2015 with the objective of internationalising the RMB. These steps coincided with the beginning of the US monetary policy tightening and a fall in the Chinese stock market. The result was a large depreciation of the RMB (both versus the US dollar and versus a basket of currencies), which went hand-in-hand with strong 'private' capital

outflows from China, and resulted in the selling of reserves and the tightening of capital controls by Chinese authorities.

- By 2017, 'private' capital outflows from China had stopped and the accumulation of reserves had resumed. Furthermore, the RMB (versus both the USD and a basket of currencies) appreciated until mid-2018, before its previous gains were wiped out in June and July 2018, mostly as a result of a strong fall in the bilateral exchange rate with the USD, and amid tensions between the two countries over trade policy.
- A sell-off of currencies affected emerging market economies in mid-2018, similar to the 2013 episode known as the 'taper tantrum'. Similarly to 2013, the currency depreciations of 2018 were synchronised across emerging markets. However, despite current account balances not deteriorating across the emerging market spectrum and fundamentals not being worse than in 2013, the magnitude of the depreciations was much larger across the board. Most affected were emerging markets with large current account deficits, financed by 'hot money' and with inadequate reserves.
- The euro area (excluding intra-euro area flows) has been since 2013 the world's leading net exporter of capital. Capital from the euro area has been invested heavily abroad in debt securities, especially in the US, taking advantage of the interest differential between the two jurisdictions. At the same time, foreign holdings of euro-area bonds fell as a result of the European Central Bank's Asset Purchase Programme.
- The combined effect has been a large net outflow from the euro area, and from the EU as a whole, in the portfolio investment category. Although this has continued in recent quarters, the most striking recent development has been related to foreign direct investment. Gross FDI flows, both into and out the euro area and, spiked in 2015, went down in 2016-17, and even became negative in the most recent quarters for which data is available. These fluctuations have been mainly driven by investment flows between the euro area and the US.
- As these outflows from the euro area mainly reflect flows to non-EU countries, they also drive patterns in the EU's consolidated financial account (as a single bloc versus the rest of the world and excluding intra-EU flows). The net financial account balance of the EU relative to the rest of the world remains in surplus. This is the result of a lopsided adjustment of pre-crisis imbalances, with the savings of the EU's surplus countries (e.g. Germany, the Netherlands, Sweden) being recycled into investment in EU deficit countries (e.g. Spain, Greece, Portugal, Ireland). Although the large financial flows to the euro-area periphery and central and eastern European countries have vanished, the capital exports of the 'surplus countries' have increased. Practically every EU country (except France, Romania, Slovakia and the UK) is now running a financial account in surplus or in balance.
- Gross flows from the EU to the rest of the world are relatively stable, but their composition has changed; in particular, the contribution of FDI has fallen because of the reduction in US-euro area FDI flows.
- Intra-EU gross flows picked up in late 2016 and early 2017, but appeared weaker in the second half of 2017 and first two quarters of 2018. In this case too, the fluctuations are a consequence of FDI movements. In general, intra-EU gross cross-border portfolio investment in securities is dominated by equity and, specifically, by investment fund shares. Portfolio debt securities transactions between EU jurisdictions are less important than transactions in other components of the financial account. Even gross flows of other investment are particularly

large and robust, but mainly reflect monetary policy operations in the euro area, rather than inter-bank flows.

- We now turn to the in-depth section of the report on equity financing. Facilitating the financing of European companies through external equity is a central ambition of EU financial regulation, including of the capital markets union. This is justified by macroeconomic vulnerability arising from persistently high corporate sector debt levels, which have not dropped significantly since the financial crisis. In addition, equity investors mobilise within the companies they invest in a number of operational and corporate governance reforms that lift firm productivity.
- The share of listed equity in total balance sheets of EU non-financial enterprises has expanded, though this is limited to the core euro area and to large companies. In terms of net funding flows, listed equity issuance by euro-area companies has dropped sharply in the past two years. By contrast, there has been a rapid expansion of private equity, and overall financing in 2017 was back at pre-crisis levels. A wider range of smaller companies access private equity than access listed shares, though these flows are still concentrated in a small number of EU countries.
- Firm-level data suggests that the use of external equity is still a relatively exceptional financing instrument, used by less than 4 percent of firms in any half year period. The share of firms using external equity has dropped since immediately after the financial crisis, when loan conditions tightened. It is lower for SMEs and in the EU countries in central and south-eastern Europe, and in those euro-area countries that recently experienced macroeconomic instability.
- Firm-level data suggests that EU companies seek to address diminished profitability and increased leverage through external equity, and in doing so they take advantage of improved investor appetite and their own firm's prospects. But perceived financing gaps suggest that availability of equity has not kept pace with growing financing needs. In particular for SMEs, this is a striking contrast to broader financing conditions that have improved amid monetary easing.
- Relative to the UK – as the most advanced equity market – other EU countries are considerably less attractive for private equity investors. There have been no broad improvements in two policy areas that underpin private equity activity: corporate governance and labour market flexibility. As the UK is home to nearly half of the European investor base, which will in the future be outside the single market, there is a clear need to further facilitate the cross-border integration of private equity funding within the EU27.
- Private equity activity in the EU still shows a strong home bias. Fundraising from outside the private equity firm's home base and eventual divestment outside national capital markets have become marginally more significant, but remain quite limited overall. Government agencies still play an important role in funding, and smaller countries remain particularly constrained by local capital markets.

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