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EUROPEAN ECONOMIC PERSPECTIVES

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European Economic Perspectives

Analyzing Europe's Trade and Capital Flows

In its latest Monthly Bulletin, the European Central Bank (ECB) published, for the first time, a country breakdown of the euro-area balance of payments. Although these data are available only for the last few quarters, they throw light on several key issues.

The euro-area current account returned to surplus in 2002 and has since been broadly stable at roughly €40 billion, or 0.5% of GDP, per annum. However, this modest overall position conceals an interesting geographic split.

The euro area has two large bilateral current account surpluses. The biggest is with the UK, where the surplus in the first three quarters of last year was €52 billion. This is followed by the US, with a surplus of €32 billion over the same period **(Display 1)**. It is worth noting that the bilateral surplus with the US is equal to just 10% of the overall US current account deficit, which means that a rising euro can only be of limited assistance in helping to correct global current account imbalances.

Equally interesting are the countries with which the euro area is running bilateral deficits. The biggest single deficit is with Japan, where it reached €27 billion in the first three quarters of 2004. In addition to this, the euro area had a combined current account deficit of €38 billion with the "Rest of the World"[1]. Merchandise trade data suggest that one-quarter of this is with OPEC and that the bulk of the remainder is with Asia ex Japan **(Display 2)**. This explains why European governments are concerned about the possibility of a further rise in the euro against Asian currencies tied to the dollar.

As well as current account data, the ECB now also provides a country breakdown of the capital account. Over the last year, the euro area has again become a net exporter of direct investment **(Display 3)**. There are several possible explanations for this. One is that the weak dollar and strong US growth are beginning to attract capital back across the Atlantic. Another is that the euro area's high labour costs are forcing companies to switch production to lower-cost production locations in central Europe and in Asia.

Some of these explanations are not supported by the data. The country which received the biggest net capital outflow from the euro area last year was the UK. ECB data show that, in the first three quarters of 2004, euro-area companies invested €20 billion more in the UK economy than British companies did in the euro area **(Display 4)**. By contrast, there was an overall inflow into the euro area from the US of €15 billion, and net outflows to central Europe were negligible. The ECB figures do include €30 billion of net outflows to unspecified countries, but it is not clear how much of this is to Asia.

The geographic split for portfolio investment is less comprehensive than for direct investment. However, in the first 11 months of 2004 the data show a net inflow into euro-area equities of €40 billion. Hence, in spite of weak growth in Europe, foreign investors found euro-area equities more attractive than euro-area investors found foreign equities. Indeed, the data show that euro-area investors currently have a much bigger appetite for foreign bonds than for foreign equities. In the first 11 months of 2004, euro-area investors bought €154 billion of foreign bonds and just €52 billion of foreign equities. Having flirted with foreign stock markets in the late 1990s, euro-area investors have again become much more risk-averse **(Display 5)**.

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[1] The ECB provides bilateral balance-of-payments data for the euro area with the other European Union countries, the US, Japan, Switzerland and Canada. The Rest of the World grouping, therefore, refers to all other countries.

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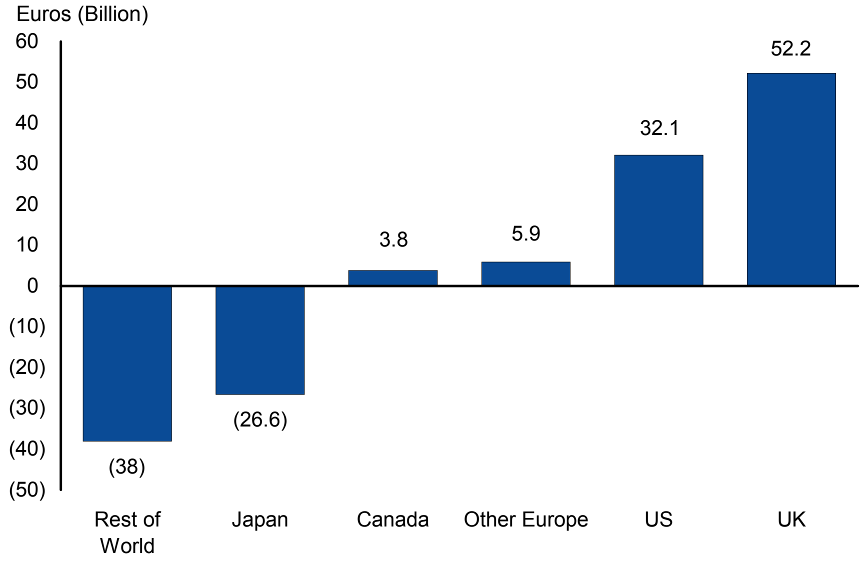
Display 1: The Euro Area Has Big Current Account Surpluses with UK And US, but Deficits with Asia

Breakdown of The Euro-Area Current Account, 1Q to 3Q:2004

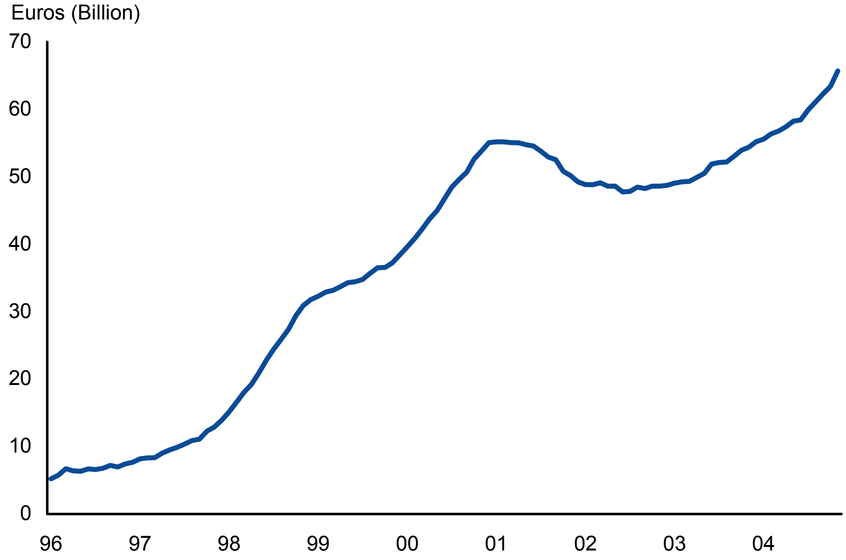


Source: European Central Bank and Alliance Capital Fixed Income, February 11, 2005

The euro area's biggest bilateral current account surplus is with the UK, closely followed by the US. The biggest bilateral deficit is with Japan, although there is also likely to be a sizeable deficit with the rest of Asia.

Display 2: Euro-Area Trade Deficit with Asia Is Large and Rising

Euro-Area Trade Deficit With Asia ex Japan, 12-Month Rolling Sum

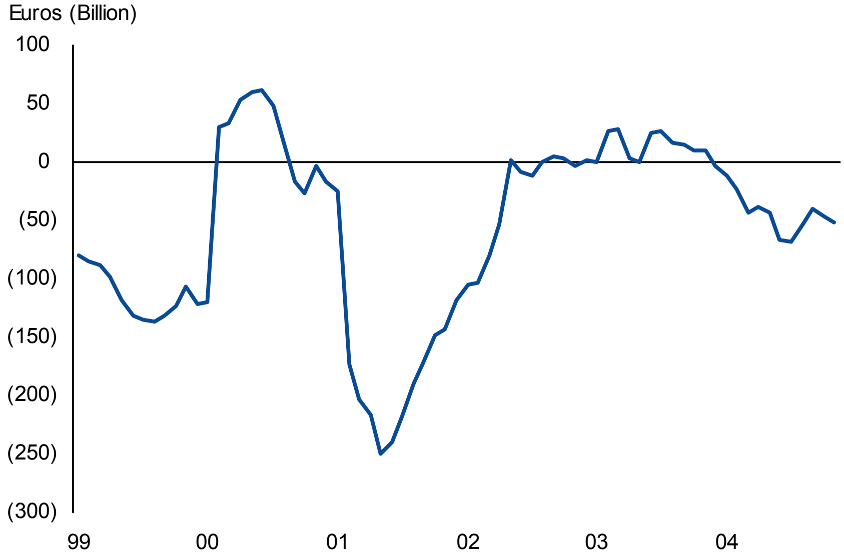


Source: Haver Analytics and Alliance Capital Fixed Income, February 11, 2005

The euro area's trade deficit with Asia ex Japan is running at €70 billion per annum, of which the deficit with China alone is running at €50 billion per annum. This helps explain the authorities' nervousness about a further appreciation of the euro against the Asian currencies tied to the dollar.

Display 3: The Euro Area Has Again Become a Net Capital Exporter

Euro-Area Net Foreign Direct Investment, 12-Month Rolling Sum

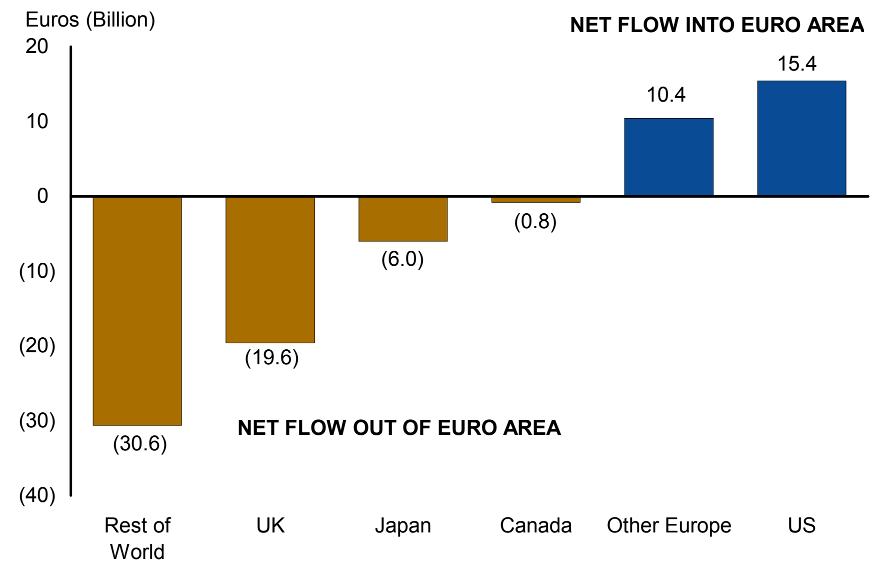


Source: European Central Bank and Alliance Capital Fixed Income, February 11, 2005

Net foreign direct investment in the euro area was close to zero in 2002 and for much of 2003. More recently, however, outflows have started to outstrip inflows, so that the euro area is again becoming a net capital exporter.

Display 4: The UK Was the Biggest Recipient of Net Direct Investment from the Euro Area in 2004

Breakdown of Euro-Area Net Foreign Direct Investment, 1Q to 3Q:2004

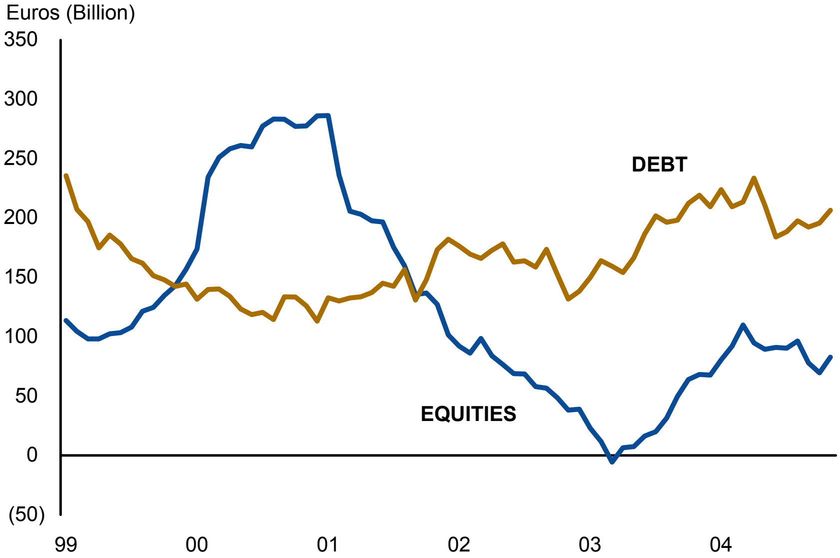


Source: European Central Bank and Alliance Capital Fixed Income, February 11, 2005

In 2004, the UK was the biggest recipient of euro-area capital outflows. However, in spite of strong US growth and a weak US dollar, US companies invested more in the euro area than euro-area companies did in the US.

Display 5: Euro-Area Investors Have a Marked Preference for Foreign Bonds over Equities

Net Overseas Portfolio Investment by Euro-Area Residents, 12-Month Rolling Sum



Source: European Central Bank and Alliance Capital Fixed Income, February 11, 2005

During the dot.com boom, euro-area investors stepped up their purchases of foreign equities. However, since the equity-market collapse, euro-area investors have started to show a marked preference for foreign bonds over equities.