

EUROPEAN ECONOMIC PERSPECTIVES



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European Economic Perspectives

Capital Flows Offering Less Support for the Euro

A few months ago, we argued that the basic balance of payments position in the euro area was not consistent with the consensus view that the euro would strengthen further against the dollar. More recently, a deterioration in the basic balance of payments has lent support to our view that the euro will move back towards fair value versus the US dollar, which we estimate is \$1.15.

The basic balance of payments is a key indicator of external sustainability. It is calculated by adding the current account deficit or surplus to the net long-term capital inflow. By definition, a current account deficit covered by long-term capital flows is likely to be more sustainable than a deficit covered by short-term flows, or “hot” money.

There are several definitions of the basic balance of payments. At the simplest level, it is calculated by adding net foreign direct investment to the current account balance. We prefer a wider measure which also includes net equity portfolio inflows. This allows for a deeper analysis of underlying investment trends.

There are two key questions to ask. First, does the basic balance of payments help explain movements in the euro’s exchange rate? Second, what can we conclude from recent trends?

Because the basic balance of payments excludes short-term capital flows, it is not a good indicator of short-term movements in exchange rates. However, **Display 1** suggests that the basic balance does do a good job of capturing longer-term trends in the euro. For example, the basic balance was in substantial deficit during 1999 and 2000, when the euro fell heavily. It then moved into surplus between mid-2001 and late 2003, a period during which the euro appreciated strongly.

This support for the euro has started to waver. In the first five months of the year, the basic balance of payments recorded a deficit of €48 billion compared with a deficit of €2 billion in the same period of 2003 and a surplus of €47 billion for the year as whole (**Display 2**). The deterioration has been driven by a rise in the net long-term capital outflow, which has swamped a modest improvement in the current account surplus. In the first five months of the year, net equity and direct investment outflows reached €64 billion. This represents a huge turnaround from the €4 billion net inflow registered during the same period of 2003.

The ECB suggests that that the sharp decline in foreign direct investment inflows into the euro area probably reflects the region’s relative unattractiveness as an investment location. Given that long-term growth prospects in the euro area are significantly weaker than in other countries, including the US, this net capital outflow might be a structural phenomenon. It is certainly consistent with the euro area’s rapidly ageing population.

Conclusions

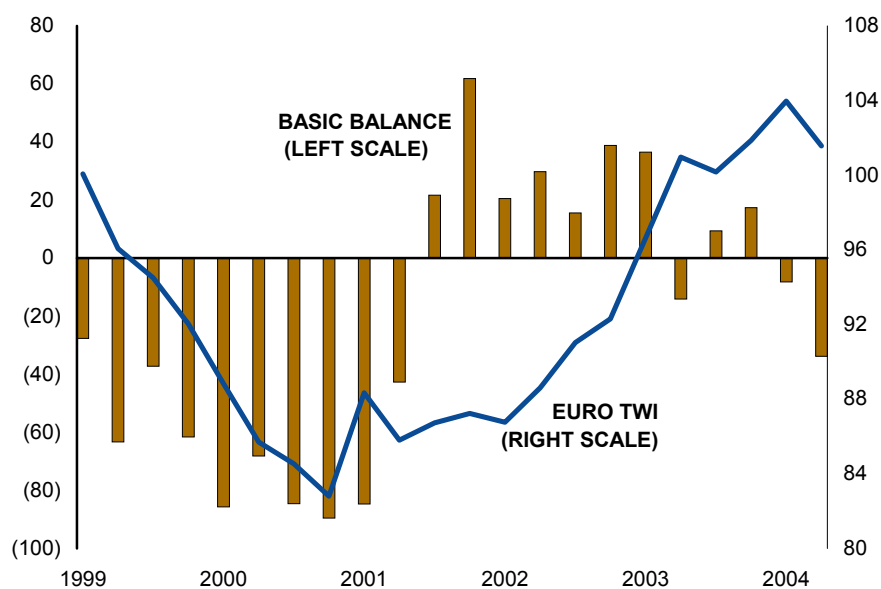
The basic balance of payments has been a good indicator of medium-term trends in the euro’s exchange rate. Recent data point to a deterioration in the basic balance, largely as a result of a pick-up in net equity and direct investment outflows. Although euro-area growth is starting to improve, it is likely to remain weak in a global context, suggesting that net capital outflows will probably continue. The recent trend in the basic balance of payments is therefore not consistent with an appreciating euro. Rather, it favours a modest easing back towards fair value against the dollar.

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Display 1: Euro-area Basic Balance of Payments and the Euro
 Basic Balance is Euros Billion, Euro Trade-weighted Index is Q1 1999=100



Basic balance = current account + net foreign direct investment + net equity portfolio capital inflows
 Source: European Central Bank and Alliance Fixed Income

The basic balance of payments has been a good guide to longer-term trends in the euro's exchange rate. Recent data suggest that the basic balance is offering much less underlying support for the euro.

Display 2: Euro-area Balance of Payments

Euros in Billions

	2003	Jan-May 2003	Jan-May 2004
Current account (1)	24.8	-6.1	16.7
Net foreign direct investment (2)	-13.2	1.9	-32.5
Net equity portfolio investment (3)	35.5	2.4	-31.8
Basic balance (1+2)	11.6	-4.2	-15.8
Basic balance (1+3)	47.1	-1.8	-47.6

Source: European Central Bank and Alliance Fixed Income

The turnaround in the basic balance is primarily due to deterioration in net long-term capital flows. In the early months of 2004, foreign direct investment and equity portfolio flows have both registered strong net outflows. This has swamped a modest improvement in the current account position.