



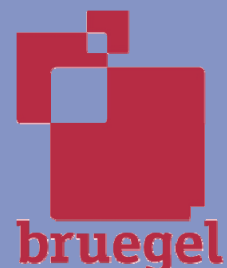
Executive Summary
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Analysis of developments in EU capital flows in the global context

*Taking the perspective of the Capital Markets
Union*

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Executive Summary

- Since the crisis, there have been major changes in current account imbalances: whereas the global surplus was concentrated in China and oil exporters in the pre-crisis period, capital is today mainly exported from the euro area, Japan and a few other advanced economies. Moreover, although in the aftermath of the financial crisis imbalances shrank rapidly and then remained contained for a few years thereafter, since 2014 they are on the rise once again.
- In absolute terms, the euro area is now the world's largest exporter of capital. The euro area plus China and Japan – two countries that have consistently generated current account (CA) surpluses – now represent 75 percent of global net savings.
- On the flip side, in the last two years, the US, together with the UK and some other advanced economies (Canada, Australia), have absorbed the vast majority of these savings. Inflows to emerging market economies, which attracted a high share of global surpluses up to 2012-13, have receded without resulting in major turbulence. Finally, since oil prices plummeted, oil-exporting economies have decreased their external supply of capital.
- Firstly, this rotation of current account imbalances reflects in part differences in the paths of recovery and the corresponding policy responses in surplus and deficit economies. Between 2015 and November 2017, there were four rate hikes in the US on the back of the US recovery, while the UK saw its first rate hike since 2007. On the other hand, with the economic recovery of the euro area lagging that of the US, monetary policy in the euro area has become more accommodating. In particular, the introduction of the public sector asset purchase programme (PSPP) by the European Central Bank in early 2015 has had an impact on the overall capital flows in and out of the euro area. Monetary policy was also further eased in Japan during the same period.
- Secondly, the transition in China from an investment-driven growth model to a consumption-based model also accounts for the change in the global picture. Crucially, China has moved from being a net receiver of foreign direct investment to becoming a net exporter. Moreover, in 2015-16, China made extensive use of its vast foreign-exchange reserves to mitigate strong outflows and prevent depreciation of the yuan (which could have damaging consequences in terms of financial stability in case of currency mismatches in its banking and corporate sectors). This significant reversal in the balance of China's reserves has driven the trend of the overall reduction of the global stocks of foreign exchange reserves.
- Thirdly, the current situation also reflects sustained low commodity prices, in particular oil prices. Accentuating the decline in reserves, oil-exporting countries are no longer generating excess savings that are recycled through international investment.
- The concentration of imbalances in advanced economies has three main implications. First, global imbalances might be more sustainable than before because the advanced economies with CA deficits (mainly the US and the UK) can, in principle, finance their deficits more easily because their liabilities are mainly labelled in their own currencies, which are global reserve currencies. This was not the case when many emerging markets ran excessive CA deficits, which were generally financed in foreign currencies. Second, increased concentration and persisting deficits in a few economies could heighten the risk

of protectionist responses. Third, the persistence of large excess imbalances in several advanced economies (where market forces are dominant and there are no foreign exchange interventions and/or foreign exchange reserve accumulation) suggests that global adjustment mechanisms such as exchange rates are not that effective in the short term.

- Turning to stock positions, valuation effects arising from capital gains and exchange rate movements are making substantial contributions to the net international investment positions (NIIP), often exceeding those of the financial flows.
- In particular, owing to sterling's loss of value relative to major currencies in the aftermath of the UK's Brexit referendum, the UK's NIIP has markedly improved despite a high financial account deficit.
- Global imbalances in stocks (i.e. net international investment positions) have also grown in recent years, again among advanced economies, with Japanese and euro-area creditors increasing their net asset positions at the expense of US liabilities.
- In this year's report, we compare countries in terms of their openness to capital flows using established indicators of financial restrictions. In recent years, emerging market economies have either reversed the advances achieved in capital account liberalisation, or progress has stalled. Foreign exchange rate movements, concerns about overheating of the domestic economy and potential spill-overs from monetary policy shifts in advanced economies have been the three main motives for the (re-) introduction and persistence of capital controls. This shift has been further amplified by the growing role of emerging economies in the global economy. Thus, there is a risk of inefficient international capital allocation in a growing share of the global economy.
- In the banking sector, the process of down-sizing cross-border balance sheets has come to a halt with the exception of the euro area. In both euro-area creditor and debtor countries, cross-border positions are still shrinking. One exception is French banks, which have expanded exposures and funding from outside of Europe, in particular from the US and Japan. Among the largest economies, Japan is the only other major country where the banks have expanded their foreign exposures.
- Coming back to cross-border capital flows in general, recent trends in the euro area have become entrenched. Euro area debtor economies, which in the aftermath of the crisis transitioned from recipients to providers of capital to the rest of the world, continue to experience small net capital outflows in net terms. In addition, inflows of foreign direct investment (FDI), as well as the corresponding positions, remain low. At the same time, euro area creditor countries continue to generate persistently high capital exports. As a result, their net international investment position has reached a historical maximum.
- The countries of central and eastern Europe share many similarities with euro-area debtors: large net liability international positions and substantial capital inflows that dried up in the aftermath of the Great Financial Crisis. However, central and eastern European countries have seen a re-emergence of inflows in recent quarters, including in non-FDI flows. This has clashed to some extent with the objective of maintaining exchange rate stability with the euro, leading to an accumulation of reserves by central banks.
- Turning the in-depth section of the report, in Europe's emerging strategy to tackle the legacy of non-performing loans the market for distressed debt will

need to play a more prominent role. This market could speed up NPL resolution, and offer capital relief to European banks, but also allow greater flexibility in banks' balance sheet management, and efficiency in the workout of distressed loans.

- All but two of the euro area countries describe their NPL markets as underdeveloped. Market demand is not directed at the bulk of unsecured assets among SMEs and other corporate borrowers, at smaller banks with their higher NPL ratios, or at exposures to larger enterprises that could benefit from comprehensive debt restructuring and additional finance. Turnover remains limited relative to the total stock of EUR 870 billion in non-performing loans, and the additional stock of EUR 1.1 trillion of so-called non-core banking assets which banks also seek to divest in this market.
- Significant further supply may now come into the market as stricter supervisory guidelines are implemented, as improved national restructuring and insolvency regimes reassure potential investors, and as new accounting guidelines force higher provisioning levels.
- The loan sale process potentially suffers from three market imperfections: (i) the high fixed costs related to individual markets, banks and loan portfolios discourage investor entry and lead to a concentration on the buyer side; (ii) information asymmetry leads to sellers selecting inferior portfolios and failure of the market to clear; (iii) externalities once the investor begins to restructure or foreclose on the borrower. These market imperfections manifest themselves in high valuation gaps, and the market failing to clear in certain asset types.
- This study could not identify significant or widespread regulatory barriers to investors entering the distressed loan market. Licensing requirements still restrict transfers of title, and the ability of non-bank investors seeking to provide additional credit to companies undergoing restructuring appears to be restricted. The initiative of the EU Council to implement improved standards in banks' loan documentation and greater liquidity through transaction platforms may lower transaction-specific fixed costs somewhat, and most investors interviewed for this study welcomed this.
- As a significant share of Europe's banking assets may move into the hands of little known investors, the benefits of relationship banking are lost, and the conduct of the loan servicers as the main interface with borrowers becomes more difficult to assess. It is in the interest of both the investor community as well as the banking sector that investor and servicer conduct be circumscribed clearly, though such rules will inevitably be specific to national markets.

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