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Capital inflows and euro area long-term interest rates☆

Daniel Carvalho [a,*], Michael Fidora [b]

[a] Banco de Portugal, Rua Francisco Ribeiro 2, 1150-165 Lisboa, Portugal
[b] European Central Bank, Kaiserstrasse 29, 60311 Frankfurt am Main, Germany

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Capital flows into the euro area were particularly large in the mid-2000s and the share of foreign holdings of euro area securities increased substantially between the introduction of the euro and the outbreak of the global financial crisis. We show that the increase in foreign holdings of euro area bonds in this period is associated with a reduction of euro area long-term interest rates by about 1.55 percentage points, which is in line with previous studies that document a similar impact of foreign bond buying on US Treasury yields. These results are relevant both from a euro area and a global perspective, as they show that the phenomenon of lower long-term interest rates due to foreign bond buying is not exclusive to the United States and foreign inflows into euro area debt securities may have added to increased risk appetite and hunt-for-yield at the global level.

1. Introduction

There is by now a large literature that focuses on how international capital flows contributed to the unusually low levels of US long-term interest rates in the mid-2000s, which former Chairman of the Federal Reserve Board Alan Greenspan referred to as a “conundrum” (Greenspan, 2005). According to

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* Corresponding author.
E-mail addresses: daniel.sousa.carvalho@bportugal.pt (D. Carvalho), michael.fidora@ecb.europa.eu (M. Fidora).

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the "global savings glut" hypothesis (see Bernanke, 2005, 2007) large — and possibly excessive — net savings in some regions of the world — in particular in emerging economies in Asia but also in oil exporting countries — triggered large net capital inflows into US securities which ultimately exerted downward pressure on US long-term interest rates. Specifically, Warnock and Warnock (2009) estimate that foreign official inflows into US Treasuries lowered 10-year Treasury yields by about 80 basis points in the twelve months ending May 2005.

The coincidence of large capital inflows and low levels of long-term interest rates is however not a characteristic specific to the United States in the mid-2000s. Fig. 1 shows a strong comovement between euro area and US long-term interest rates with both series declining in the first half of the 2000s and up until end-2006. Over the same period, foreign purchases of both euro area and US securities were steadily increasing until end-2006 (see Fig. 2).

This evidence points to the possibility that the same mechanism that was behind the downward impact of foreign inflows into US securities might also have been at play in the euro area. Yet, to our knowledge there is so far no study which examines the impact that foreign bond buying in the first half of the 2000s had on long-term interest rates of the euro area or, more generally, of advanced economies other than the United States. This is striking for a number of reasons.

First, the question arises whether the results that have been found to hold for the United States can be generalised to other developed economies. This would further strengthen the evidence in favour of the hypothesis that there is a causal link going from foreign bond buying to long-term interest rates as it would show that the correlation that is documented for the United States is not due to characteristics which are specific to the United States and not easily controlled for in a single country framework, such as the role of US dollar reserve accumulation by Chinese authorities in the context of China's US-dollar pegged exchange rate regime.

In the pre-crisis period foreign acquisition of US debt securities was largely accounted for by Chinese residents and in particular the Chinese official sector. This reflects the accumulation of foreign exchange reserves by Chinese authorities under the US dollar-pegged exchange rate regime. The empirical literature on the link between foreign bond buying and long-term interest rates typically emphasises the usefulness of isolating purchases of the foreign official sector, as these are likely to be non-financially motivated and hence argued to be independent from yields. This in turn would allow for establishing a direction of causality from foreign bond buying to long-term interest rates. However, foreign official sector purchases might still respond to shocks which at the same time affect yields and hence the observed correlation may not reflect a causal link between the two variables. This is in particular the case for purchases of foreign official authorities that aim at maintaining a fixed bilateral exchange rate. For example, monetary policy shocks that negatively affect both interest rates and the exchange rate of the bond-issuing country may trigger bond purchases by the authorities of the pegging country in order to stem the appreciation pressure of the bilateral exchange rate vis-à-vis the

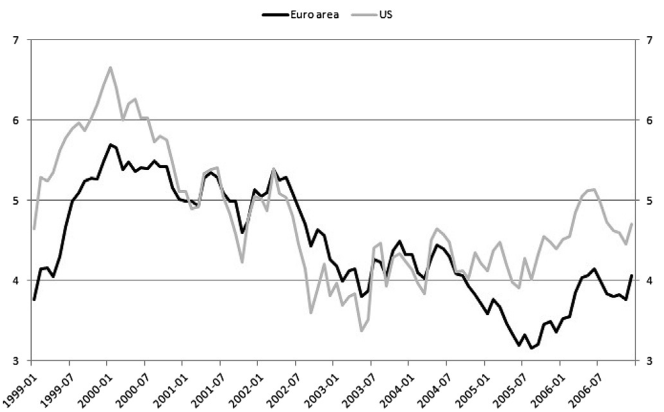

Fig. 1. Long-term interest rates (percent, January 1999–December 2006).
Source: ECB and Datastream.