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# Whither Macroeconomic Stability in Europe?

Will the eurozone turn into a collection of emerging markets? "Emerging markets" suffer chronically from elevated macroeconomic instability. In the good years of expanding global liquidity they attract large capital inflows at low real interest rates and enjoy a credit-funded boom. In the bad years, when creditors suddenly retract, they find themselves deprived of fiscal and monetary policy options to smooth the decline in output and subject to high sovereign country risk premia, which choke the economy.[1] These boom-bust cycles induced by international capital flows are the key reason why emerging markets have experienced periods of high growth over decades which then turned abruptly into crises followed by severe recessions. Only those economies which have sufficient domestic savings, and thus do not depend on foreign capital, have escaped this roller-coaster ride. China is of course the biggest example of how a large pool of domestic savings can insulate a country from the vagaries of international capital markets.

Europe was thought to consist only of "developed" economies (in the IMF classification at least) which were much more stable and had functioning financial systems which allowed them to finance themselves from domestic savings and in their own currency. Emerging market countries by contrast suffered from what economists called the "original sin", i.e. by and large they could not fund themselves in their own currency, certainly not with foreign investors. This meant that when they ran out of dollars they had no choice but to default. The countries which have adopted the euro have put themselves into the position of "emerging markets" issuers: they issue their debt in a currency which they cannot control and thus subject themselves to similar boom and bust cycles as emerging markets. Macroeconomic instability coupled with high debt levels naturally leads to default risk. It is thus not surprising that global investors treat Greece, and other peripheral euro area member countries, in much the same way as the Latin American countries which struggled during the 1980s with a large debt overhang.

The countries with excess savings cannot isolate themselves from the macroeconomic instability in the periphery of the eurozone. When the periphery booms the core stagnates as capital flows to the seemingly more dynamic economies whose debt accumulation seems sustainable because of their rapid growth. When the bust comes capital flows back to the core and stimulates domestic demand, especially via the housing market, which is always the most sensitive to financial conditions. Moreover, the excess savings of the core have been recycled to the periphery via the local banking systems. A default in the periphery thus also threatens the stability of the banking systems in the core, and indeed the entire area, given the high degree of integration of financial markets in the eurozone.

This implies that both core and periphery have a joint interest in finding ways to mitigate these threats to macroeconomic and financial stability.

At the global level the IMF deals with this issue. It seems to follow that the euro area needs to create a "European Monetary Fund" with tasks similar to those of the International Monetary Fund at the global level, namely to alleviate the stress created by volatile international capital flows. Europe has now created a structure, the European Financial Stability Facility (EFSF), to provide financing for governments which have been shut out of the market. Is this the solution?

1 Christian Kopf: Restoring financial stability in the euro area, 2011, http://www.ceps.eu/book/restoring-financial-stability-euro-area.

It does not seem so. A key difference is that the EFSF (and its permanent successor, the ESM) does not have the professional staff and operational independence enjoyed by the IMF.

That the EFSF has aroused even more controversy than the operations of the IMF is understandable given the huge difference in economic weight between the IMF and the EFSF rescue operations. The IMF has never disbursed more than US $40 billion (about €33 billion at today's exchange rates) in any one year, which never accounted for more than 0.1% (one tenth of one per cent) of global GDP. Moreover, the IMF has never made any losses; not only because its credits are treated as super senior, but also because the amounts it lends to any one country have usually been quite limited, never accounting for more than 10% of the GDP of the recipient.

By contrast, the credits granted to the Greek government by eurozone members (about €80 billion) alone weigh about ten times as heavily since they amount to about 1% of their collective GDP. The programmes for Ireland and Portugal combined will add about the same again. It is thus understandable that the resistance in the creditor countries against continuing massive financial support or "bail outs" is also much stronger. Given that the intra-euro area financial support also represents a much larger share of the recipients' GDP (and is subordinated in terms of seniority to the IMF) the risks are also much larger.

A further difference between an emerging country and the euro area sovereign debt crisis is that the problems of even the largest emerging markets could never endanger global financial stability, but a default by Greece is widely perceived as putting the financial system of the entire euro area at risk.

This leaves creditor countries in a quandary: their populations revolt against further bail outs but their bankers tell them that a default by Greece would constitute a second Lehman with enormous costs.

The obvious way out would be to strengthen the financial system of the euro area so that its stability would no longer be endangered by a default in the periphery. However, this would take time and money and a strong political will. Given the interconnectedness of financial markets in a common currency area, weakness in any one corner spills over into the entire system, which cannot be stabilised until all of its major components have been dealt with. But Europe lacks a common body that has the fiscal resources to stabilise the system as a whole. The required fiscal resources exist at the national level and their use is generally guided by purely national considerations and interests. In other words: Europe faces a fundamental collective action problem. Europe will not be able to resolve this crisis until this problem is resolved and the financial system as whole has been strengthened to the point that a sovereign default can be contemplated without a meltdown of the European banking system. There is no need to invent a new institution for this task. It could be performed either by a reinforced European Investment Bank or a revamped EFSF. The key in both cases would be to bundle the existing national resources for a common purpose.

In order to make future crises less likely and less virulent it would of course be important to lower the incentives for banks to hold government debt. This could be achieved if the EU recognised that lending to sovereign countries involves risks, against which banks should be forced to hold capital. At present EU regulations say that banks do not have to hold any capital against their lending to euro area sovereign states. This is clearly wrong and needs to be changed.

*Daniel Gros*
*Director, CEPS, Brussels, Belgium.*