Research Fellowship Programme - Future of the EMU

Essay on Cross-border capital flows within the euro area and risk allocation

Background:

The euro has fostered financial integration in the euro area and, in particular, cross-border capital flows.[1] The neoclassical growth model predicts that countries with comparatively lower income levels, in which the production process is less capital intensive, should attract foreign capital because of a higher marginal risk-adjusted return. Indeed, since the launch of the euro, capital has flown primarily from advanced to catching-up Member States and therefore in the decade preceding the economic crisis, the euro area emerged as the only significant exception to the "Lucas paradox"[2] – an empirical puzzle refuting the prediction of the neoclassical growth model.

However, in certain countries, financial integration has not only brought benefits. There is now substantial evidence that, in the pre-crisis years, some of the capital inflows in certain Member States, notably in the euro area periphery, were misallocated towards unproductive uses, for example to sustain private consumption and to finance excessive public deficits. In some of these countries capital inflows also resulted in an excessive investment in the non-tradable sector (and particularly in real estate). Demand pressures, fuelled by easier access to international capital markets, contributed to push up inflation and the real exchange rate. Persistent overheating pressures, reinforced by comparatively low real interest rates, led to the accumulation of large and persistent current account deficits, excessive credit and asset price distortions. In addition capital inflows in catching-up countries have predominantly been allocated to debt instruments (bank deposits, bonds and other money market instruments) rather than equity and FDI, suggesting that perceived corporate profitability was lower than predicted by the neoclassical growth model.

Aims of the essay and key questions to be tackled:

The objective of the essay is to provide analysis on the developments of capital flows in EMU. First, the study should review developments in cross-border capital flows in the first decade of EMU and during the recent crises with a view to documenting quantitatively the extent of the misallocation of capital flows into certain Member States. The presentation should rely on both balance of payments and financial sector data. Second the essay should

[1] See for instance 'EMU@10, Successes and challenges after 10 years of Economic and Monetary Union', European Economy, No. 2, 2008.

[2] According to the "Lucas paradox" capital does not flow from countries with high capital intensity towards countries with low capital intensity despite the higher returns on capital in the latter group of countries. The paradox was first formulated in Lucas, Robert (1990). "Why doesn't Capital Flow from Rich to Poor Countries?" American Economic Review 80 (2): 92–96.

contribute to a better understanding of the reasons behind the misallocation, focusing in particular on the possible roles of the financial system, financial integration and the euro. Finally, the essay should suggest possible policy changes aimed at preventing such misallocation in the future, while preserving the flow of capital towards Member States that are catching up.

Important questions to be addressed include:

- Which parts of the real and financial sector are the predominant providers and receivers of cross-border capital flows in the euro area? Did the structure of the financial sector in the receiving and sending countries contribute to the misallocation of capital? Did the organization of the financial market infrastructure play any part in the misallocation towards non-productive uses?

- The predominance of debt-type capital inflows at the expense of equity and FDI suggests that investors did not expect strong corporate profitability in the euro area countries that were catching up in the first ten years of the EMU. To what extend did the risk-return combination of equity in the catching-up countries contribute to the misallocation of capital? Is there a considerable risk perception associated with holding relatively less liquid assets such as equity and FDI over relatively more liquid bonds and money market instruments? Did risks and rewards related to direct corporate control through equity and FDI influence the choice of instruments?

- Did the interplay between financial integration and the functioning of EMU contribute to the misallocation of capital flows?

- To what extent did a similar misallocation of capital inflows take place in the Member States which adopted the euro more recently? On the other hand did some of the lower income non-euro Member States experience a similar misallocation of capital? If not are these countries potentially at risk of experiencing the misallocation of capital inflows as they are acceding to the euro area? If that is the case, what could be done to avoid the misallocation?

- Can changes in the governance and the supervisory framework of the financial sector in the EU or the euro area eliminate future misallocation of capital? Is there scope for changing EMU's policy framework so that such misallocation is prevented in the future, without hindering capital flows to countries that are catching up?