Summary for non-specialists
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Capital Flows in the Euro Area

by Philip R. Lane, Trinity College Dublin and CEPR

The goal of this paper is to understand the patterns of capital flows in the euro area, both during the pre-crisis period and during the crisis itself. We place heavy emphasis on the patterns in net capital flows, since the divergences between those countries running large current account deficits and those countries running large current account surpluses during 2003-2007 helped to sow the seeds of the crisis and helps to explain the macro-financial tensions that have plagued the euro area since 2008.

Moreover, we also highlight the importance of gross capital flows, since the spectacular increase in the scale of cross-border financial positions (even for countries running small net positions) has structurally changed the operation of national financial systems across the euro area and created a web of cross-border financial linkages that determines the transmission of financial shocks across the euro area and the wider global financial system.

In terms of our empirical analysis, a core finding is that gross and net capital flows grew rapidly during the 2003-2007 period relative to the 1998-2002 “euro entry” period. For this reason, it is insufficient to attribute the growth in capital flows across the euro area to the introduction of the single currency. Rather, the capital flow boom in the euro area during 2003-2007 was simultaneous with the wider boom across the advanced countries during this period. However, the scale of the boom was larger within the euro area, which can be partly attributed to the contribution of a common currency and a common central bank in the scaling up of cross-border capital flows. Importantly, this capital flow boom was concentrated in debt-creating instruments, such that the risk-absorbing capacity of national financial systems was compromised.

The subsequent reversal in capital flows during the crisis period has demonstrated that the prevalence of wage-price rigidities means that current account deficits cannot be rapidly closed in a pain-free manner. The importance of this finding for the future conduct of macro-financial policies is difficult to overstate: large and persistent current account deficits pose significant risks and preventive measures should be taken to counteract such imbalances. In similar vein, the crisis has also underlined the disruptions associated with damaged balance sheets, such that excessive debt levels at national and sectoral levels are to be avoided.

Accordingly, the final section of the paper describes the policy reforms at national, European and global levels that can help to improve macro-financial stability for members of the euro area. Although there is some substitutability across the different types and different levels of reform, the more powerful dynamic is of policy complementarity whereby the construction of more robust macro-financial frameworks at national levels can also foster the development of important area-wide initiatives, with a deep and comprehensive banking union the single most important guarantor of future stability for the euro area.

In summary, the scale of cross-border capital flows per se should not be considered a direct policy target. Rather, the general aim of policy reforms should be a new financial environment in which destabilising-type flows are reduced (such as excessive debt flows intermediated by non-diversified local banks) but stabilising-type flows are expanded (such as equity flows and debt flows intermediated through diversified banks that are embedded in an area-wide banking union).