COMMENTARY

Thinking ahead for Europe

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The eurozone as an island of stability

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After a decade of struggles, the eurozone is an island of relative stability in a turbulent sea. To ensure that it stays that way, its leaders must remember a fundamental truth: no predominantly domestic problem will ever be resolved by a loan or transfer of resources from abroad.

Market volatility has surged lately, apparently vindicating those who have warned of lofty equity valuations. But, even as the US stock market suffered one of its worst weeks since the financial crisis, the eurozone's public-debt market has remained relatively stable, with risk spreads – which have usually increased amid market volatility – scarcely changing, even for the peripheral eurozone countries.

The eurozone owes its ostensible immunity from financial-market gyrations to major improvements in the peripheral economies' fundamentals: growth has picked up, and unemployment, though still high, is declining rapidly. The question is whether these improvements are stable enough to ensure the eurozone's continued resilience.

Here, the key concern is that the current recovery is too dependent on low interest rates: if borrowing costs rise, the periphery's debtor countries would suffer. But it is no longer accurate to view the economies of the periphery as weak debtors. Indeed, with the exception of Greece, they are all now running current-account surpluses, meaning that far from depending on capital inflows, they are repaying their foreign debt.

And, yes, this includes Italy, which, despite its high public debt, is running a current-account surplus at the aggregate level. In the past, Italy's external deficits were never as large as those of the other peripheral countries. Moreover, the country also had periods of consistent surpluses, with the result that the country is not a net debtor today. Because its net international investment position is balanced, a generalised interest-rate hike would not necessarily be bad for Italy. The government would face higher debt servicing costs, but citizens would earn more on their savings.

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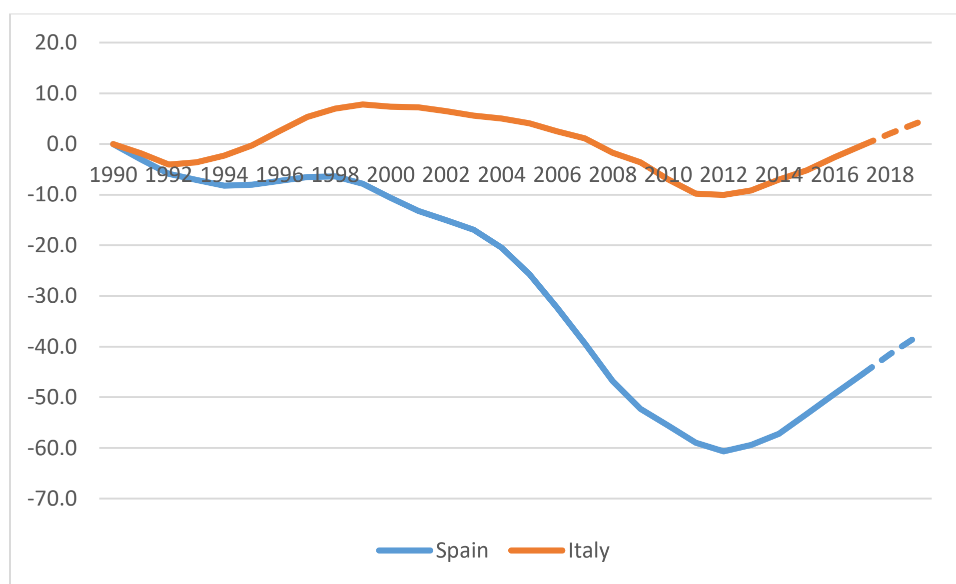
Spain and Portugal, by contrast, would probably be negatively affected by higher interest rates, owing to their still-considerable external debts. Nevertheless, if interest-rate hikes come along with accelerating global growth, even these countries might not be much worse off, because growth will help them to service their foreign debts.

But the implications of today's constellation of current-account balances extend beyond shorter-term interest-rate considerations. If the situation persists for a few more years, the eurozone might get to a point where it consists mainly of creditor countries, some with a large net foreign asset position (Germany and the Netherlands) and others, like Italy, with a small positive external position, and the debtor position of the remaining peripheral countries (e.g. Spain) in continuous improvement.

The figure below shows the evolution of the external position of the two largest peripheral countries, Italy and Spain. The net position of Italy is now clearly in positive territory and that of Spain has improved, within a span of a few years, from minus 60% of GDP to less than 40% today, with a clear trend upwards.

Figure 1. Cumulated current account balance in Spain and Italy, 1990-2018 (% of GDP)



Source: Author's own configuration based on European Commission data.

A continuation of this trend, which seems likely will have important political consequences. For starters, the conflicts of interests within such a eurozone might be much less acute than those that emerged during the crisis a decade ago, when creditor countries were obliged to bail out the debtors, which in turn felt squeezed by forced austerity.

More broadly, the relative power of the creditor countries – particularly Germany – will be diminished. The concerns expressed by some observers, such as George Soros, that the eurozone will remain a two-tier club, in which the creditors impose their conditions on the debtors, thus seem exaggerated.

But that does not mean that this new dynamic is risk-free. If former debtors, facing diminished pressure from major creditors or risk premia, adopted less prudent fiscal policies, their public debt would continue to accumulate. Against that background, the next crisis might be very different from the last one.

When the last eurozone crisis began, large capital flows into the periphery were generating inflationary pressures; resources were shifting away from exports; and government revenues appeared to be strong. Then the capital inflows abruptly reversed, which necessitated a decline in domestic wages and prices, relative to the eurozone average, in order to shift resources back toward exports. In most countries, government revenues fell, as domestic activities, such as construction, contracted much faster than exports increased. As a result, the peripheral economies fell into a deep recession.

Making matters worse, because an export-led recovery yields less revenue – value-added taxes are rebated on exports but collected on imports – seemingly strong government finances quickly turned into large deficits. In Greece's case, the problem was compounded by the fact that, during the boom years, the large fiscal deficits had been financed entirely by capital inflows. When these flows stopped, the bottom fell out of public finances.

Today, eurozone countries are not subject to large capital inflows, so a crisis would not cause them to face external disequilibrium. They would not need a large downward adjustment in wages and prices, and government revenues would remain relatively stable.

If risk premia increase, it would be a result of creditors' doubts about a government's ability to finance itself in the long run, owing to a downward revision of growth expectations or a domestic political stalemate in which taxpayers oppose bondholders. Domestic bondholders might be the first to recognise potential risks, spurring escalating capital flight.

In these circumstances, a loan from the European Stability Mechanism – the eurozone's bailout fund – would merely provide fuel for even higher outflows. Yet transforming the ESM into a "European Monetary Fund" is currently one of the main issues in the debate about eurozone governance reforms. The implicit role model is the International Monetary Fund, which has made its reputation by addressing the fallout from sudden capital-flow reversals. Again, however, that is not the type of crisis that today's less inflow-dependent eurozone is likely to experience.

Instead of trying to copy the IMF, Europe's leaders should focus on strengthening the resilience of the financial system, so that it can provide a safety valve for whatever pressures inevitably arise from the build-up of excessive public debt in some eurozone countries. If a crisis does occur, perhaps the ESM's resources could be used to prevent contagion within the eurozone financial system, rather than providing loans to countries with deep-seated domestic problems.

After a decade of struggles, the eurozone today is an island of relative stability in a turbulent sea. To ensure that it stays that way, its leaders must remember a fundamental truth: no predominantly domestic problem will ever be resolved by a loan or transfer of resources from abroad.

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