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# Macroprudential policy and imbalances in the euro area

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ABSTRACT

Since its creation the euro area suffered from imbalances between its core and peripheral members. This paper checks whether macroprudential policy applied to the peripheral countries could contribute to providing more macroeconomic stability in this region. To this end we build a two-economy macrofinancial model and simulate the effects of macroprudential policy (regulating the loan-to-value ratio) when the core and the periphery are exposed to asymmetric shocks. We find that macroprudential policy is able to substantially lower the amplitude of credit and output fluctuations in the periphery. However, for the policy to be effective, it should be decentralized. Very similar conclusions hold when welfare is considered as the optimality criterion.



## 1. Introduction

Since the euro area was created, large imbalances have built up in some of its member countries. These imbalances concerned in particular the housing market. As can be seen from Fig. 1, residential investment in Greece, Ireland, Portugal and Spain, a group of euro area members that we will refer to as the periphery, nearly doubled from 1999 to 2006, while it stagnated in the rest (core) of the currency union. A qualitatively similar picture can be observed for mortgage loans and real house prices: while their growth was moderate in the core, they were booming in the periphery. These developments

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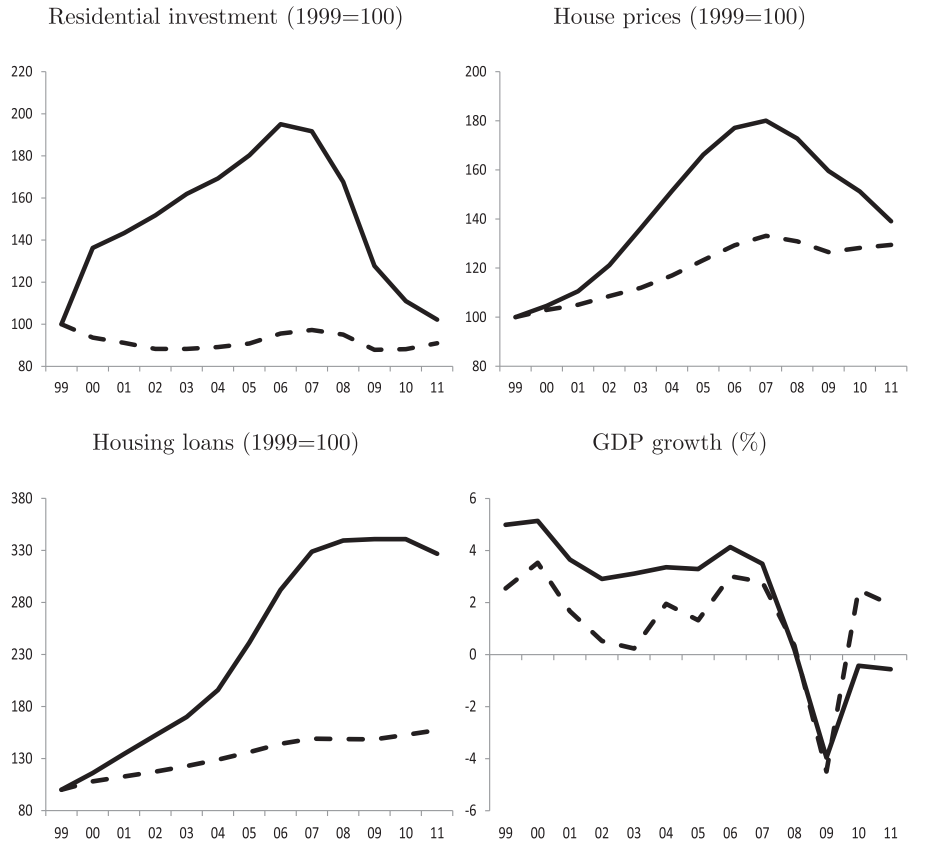
contributed to substantial GDP growth differentials within the euro area, i.e. countries experiencing housing booms were growing at a relatively high pace. These trends reversed when the housing market bubble burst, leading to a sharp slowdown in the peripheral economies. A subsequent deterioration of fiscal revenues sparked tensions in the financial markets that spread over the whole Europe, severely undermining the stability of the banking system and even threatening a break-up of the common currency area.

It has been established in the literature that the main source of these asymmetric developments was a sharp fall in the periphery's interest rates following their euro area accession, combined with an easy access to cross-border borrowing as well as asymmetric shocks to housing market prices (see e.g. ECB, 2003; Honohan and Leddin, 2006; Blanchard, 2007; Andrés et al., 2010).




Note: Dashed lines - core euro area members (Austria, Belgium, Finland, France, Germany, Italy, Luxembourg, Netherlands), solid lines - peripheral euro area members (Greece, Ireland, Portugal and Spain). For each country, GDP is real gross domestic product (source: Eurostat), residential investment is real gross fixed capital formation in dwellings (source: Eurostat), house prices are residential property prices of new and existing houses and flats (source: BIS), while housing loans are defined as outstanding amounts of lending for house purchase (source: ECB SDW). The last two series are deflated by HICP (source: Eurostat). The aggregates for both regions are calculated as sums (residential investment, loans and GDP) or GDP-weighted averages (house prices).

**Fig. 1.** Stylized facts on imbalances in the euro area.