Reforming the Architecture of EMU: Ensuring Stability in Europe

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Background

This paper is joint work with Jeroen Hessel and Niels Gilbert (DNB).

It is forthcoming in *Handbook of the Economics of European Integration (H. Badinger & V. Nitsch, eds)*.

The paper analyses the reforms in the architecture of EMU since the eruption of the euro crisis in 2010. We describe major weaknesses in the original set-up of EMU, such as lack of fiscal discipline, diverging financial cycles and competitiveness positions, and a lack of crisis instruments.

The paper is available on the website of DNB.

Focus presentation: financial cycles

Especially during its first stages, the euro crisis was often primarily attributed to a lack of budgetary discipline (see next slide).

Lack of budgetary discipline was not the only issue at play. Diverging financial cycles played a major role. In several Member States, macro-economic and financial imbalances built up in the years prior to the crisis were a major factor behind the deterioration of public finances. When the euro crisis erupted, problems were amplified by the fact that the architecture of EMU did not contain provisions for the resolution of a major sovereign debt crisis.

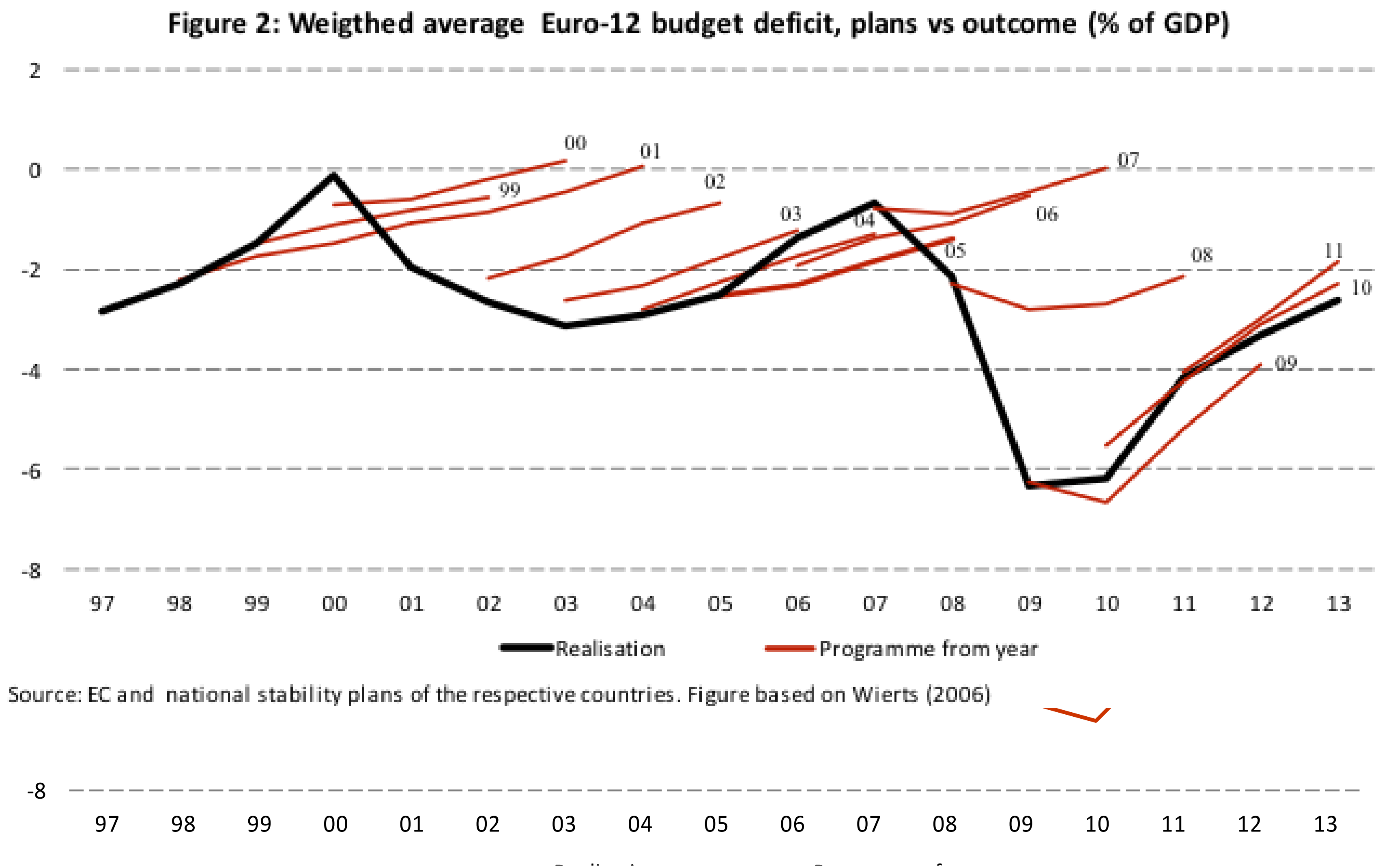
Figure 2: Weigthed average Euro-12 budget deficit, plans vs outcome (% of GDP)
2
0
-2
-4
-6
-8
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99
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07
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11
10
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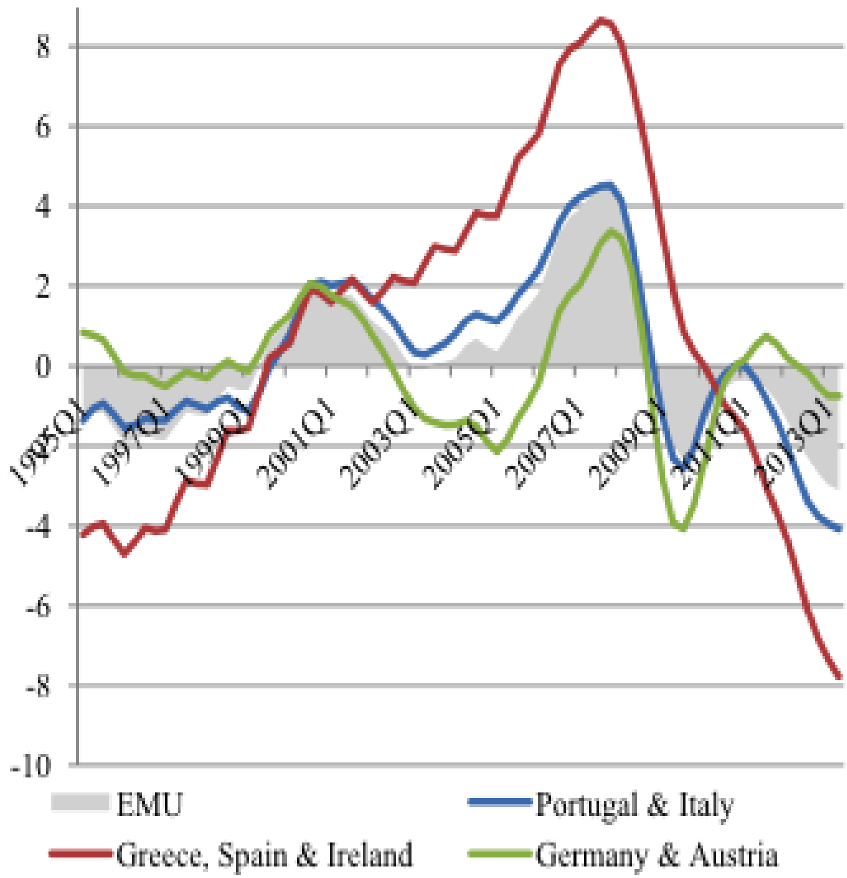
97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13
Realisation
Programme from year
Source: EC and national stability plans of the respective countries. Figure based on Wierts (2006)
-8
97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13

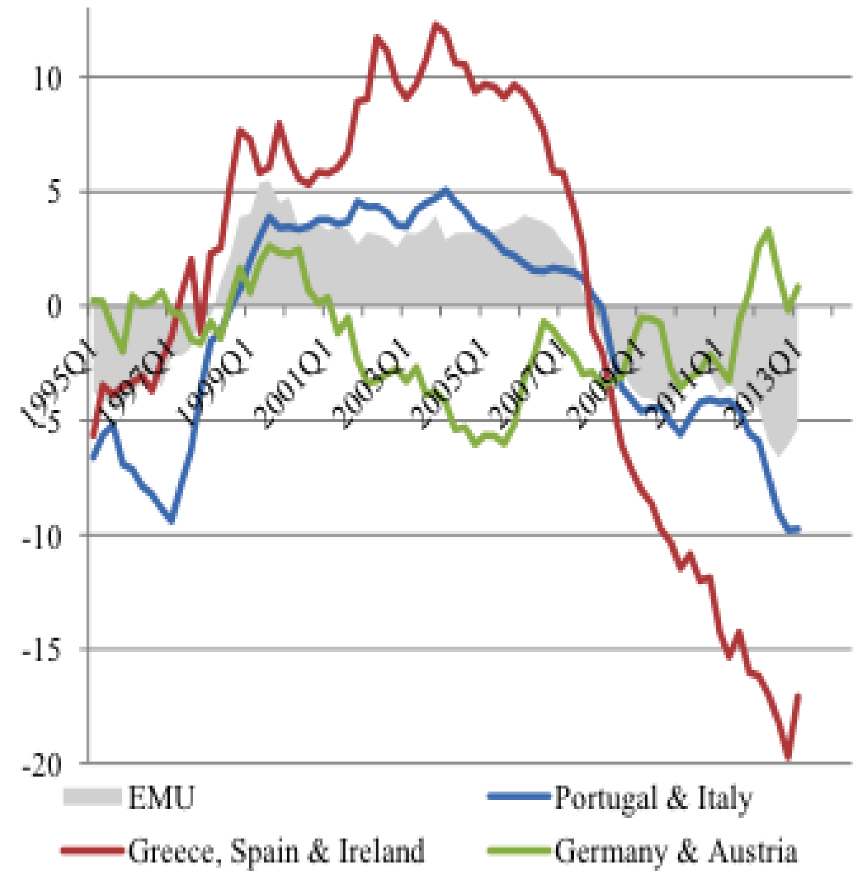
Diverging cycles

Divergences in the euro area were much more related to the financial cycle than to the normal business cycle.

Characteristics of the financial cycle are that i) it is driven by growth in credit and house prices, ii) it has a much longer duration than business cycles: 16-20 years instead of up to 8 years, and iii) it has a wider amplitude while the correction of the financial cycle is often accompanied by a financial crisis (Drehmann et al., 2012; Borio, 2012a,b).

Fnancial cycles diverged (see next slide).





Long-term output gap

Comovement of output, credit, house prices

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Impact on public finance

When the financial crisis triggered a correction of these macro-financial imbalances, the budgetary impact was much larger than expected. The average budget deficit in the euro area in 2009 was 5.2% of GDP larger than the European Commission had forecasted in March 2008, just months before the collapse of Lehman Brothers.

Recent research shows that a turn of the financial cycle has a much larger negative impact on public finances than a turn of the normal business cycle (Borio, 2012b, Bénétrix and Lane, 2013). This is mostly due to their effect on government revenues (Eschenbach and Schuknecht, 2004; Dobrescu and Salman, 2011; Lendvai et al., 2011).

Sufficient attention? (1)

MIP is based on a continuous monitoring of a 'scoreboard', consisting of a set of eleven indicators covering the major sources of macroeconomic imbalances. These include the current account balance, the growth of credit and house prices.

MIP has a preventive arm and a corrective arm. All decisions on sanctions are made in the Council via Reversed Qualified Majority Voting (RQMV) in order to increase automaticity. But…

MIP contains several potential weaknesses. First, the discretionary room of manoeuvre is relatively large. There are, for instance, no clear criteria to establish whether an imbalance exists and whether it is excessive or not.

Sufficient attention? (2)

Second, the decision in the Council on the existence of an excessive imbalance is not made with RQMV.

Third, there is a lot of discussion possible on the necessity and the effects of specific policy measures to contain the imbalances. Giavazzi and Spaventa (2010) point out that it is difficult to conceive of enforceable corrective actions. This increases the risk that recommendations are diluted in the Council.

Furthermore, the approach is of much less use for prevention, as the recommendations in the preventive stage of the procedure are non-binding. Recommendations only start to become binding when imbalances are excessive, which means that they are already pretty large and difficult to reverse quickly.

Conclusions

All major weaknesses in the set-up of the EMU have been addressed in some way or the other, which is a major achievement. However, the effectiveness of the new arrangements is not established yet, and will crucially depend on the implementation in practice.

Imbalance looms between the degree of risk sharing and the degree of national sovereignty (Weidmann, 2014). This is especially true if the current framework for policy coordination proves insufficiently effective, for instance, due to weak enforcement. If too much sovereignty is retained, this will also increase the risk of new budgetary, financial and economic imbalances and thereby the chance that risk sharing arrangements will be called upon.