

# Prevention and Correction of Macroeconomic Imbalances: the Excessive Imbalances Procedure

*Macroeconomic imbalances can lead to economic crises. This is especially true in a monetary union due to the restrictions it imposes on the tools available to economic policymakers. The years leading up to the outbreak of the global economic crisis were characterized by divergent macroeconomic developments within the euro area, which meant that the impact of the crisis varied from Member State to Member State and that, subsequently, unexpected challenges have arisen for the single monetary policy and coordinated fiscal and economic policy. In order to prevent such developments in future, a procedure for preventing and correcting macroeconomic imbalances, analogous to the Stability and Growth Pact, was created within the framework of the European semester. The preventive arm of the procedure is designed to detect and analyze potential macroeconomic problems. If the procedure flags up “excessive” imbalances for a Member State, the corrective arm will come into effect, under which the relevant Member States will be required to submit plans for corrective measures. If Member States then fail to comply with the recommended corrective actions, sanctions may be imposed. The new procedure constitutes a considerable boost to economic policy coordination within the EU and the euro area. Nonetheless, it has yet to prove itself in practice.*

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Macroeconomic imbalances, in particular the U.S. current account deficit and China’s current account surplus, are considered to be one of the prime driving factors behind the emergence of the global financial and economic crisis (The Economist, 2009). They have therefore become more and more central to the analyses of international organizations such as the IMF and OECD (Padoan, 2010) and to economic policy coordination at global level: thus, in spring 2011 the finance ministers and central bank governors of the G-20 states agreed on guidelines for the measurement of potentially destabilizing global imbalances (IMF, 2011). Serious macroeconomic imbalances also built up between the euro area countries during the precrisis years, caused in part by divergent developments in their competitiveness position and an absence

of adequate structural reforms; however, these attracted virtually no attention until the onset of the crisis.

A discussion of the causes behind these global macro imbalances would go far beyond the scope of the present study, which will address only the macroeconomic imbalances present at EU level, and in particular within the euro area. After this problem was highlighted due to the global economic crisis, the EU Member States agreed to implement a new framework – as a complement to the Stability and Growth Pact (SGP) – for the early identification and elimination of macroeconomic imbalances (the excessive imbalances procedure, or EIP), which will come into effect at the beginning of 2012. For the purposes of the EIP, “macroeconomic imbalances” shall mean “any trend giving rise to macroeconomic developments which are

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adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of economic and monetary union, or of the Union as a whole” (Council of the European Union, 2011a).

In principle, the EIP shall apply to all EU Member States. In a monetary union such as the euro area, the fact that both key decisions on economic and structural policy and responsibility for fiscal policy remain with the individual nations means that there is a greater need for economic policy coordination in order to prevent diverging economic developments which make it more difficult to conduct a single monetary policy. This article thus focuses exclusively on the euro area economies.

As the euro area countries no longer have the option of using exchange rate policy to address losses of competitiveness, wage policies need to be aligned across borders. Especially in the years leading up to the crisis, the euro area economies were shaped by increasingly divergent developments in the following respects: soaring public and private debt levels in Greece, real estate price bubbles in Spain and Ireland, an increasing loss of competitiveness in the Italian, Spanish, Portuguese, and Greek economies, etc. These problems were taken into account within the context of the governance reform carried out by the EU, which introduced a more effective macroeconomic coordination framework and tighter and more extensive surveillance – not only in the area of fiscal policy, but also with respect to the potential build-up of macroeco-

nomic imbalances – to help prevent deeply divergent economic developments in future.

This article is structured as follows: section 1 describes the emergence of macroeconomic imbalances within the euro area and discusses some of the theoretical economic background aspects. Section 2 describes how the EIP will work. Section 3 offers a discussion of some of the issues involved, and section 4 concludes.

## **1 The Problem: Macroeconomic Imbalances in the Euro Area**

### **1.1 Imbalances within a Monetary Union**

In a monetary union, the Member States relinquish both their right to conduct an autonomous monetary policy and the option to use exchange rates as a policy tool. In the event that asymmetric shocks occur, the Member States must either fall back on fiscal policy, responsibility for which remains fundamentally with each nation state, or use flexible labor markets (wage flexibility, worker mobility) to bring about the necessary adjustment.<sup>2</sup> As free movement of labor in the EU is limited in comparison with other major currency areas (e.g. the U.S.A.), flexible wages are a key requisite for the functioning of the euro area. However, there is a limit to how much wage developments can be influenced by public policy measures.

Thus, essentially the only option left to individual Member States is that of fiscal policy measures. Having said that, however, fiscal policy options can also be limited if, for example, high levels of government debt have left no

<sup>2</sup> This is the essence of the “theory of optimum currency areas” (De Grauwe, 2009). It should be stressed here that the scope of the discussion in this paper is of necessity limited to the “cost side” of a monetary union; in other words, to the restrictions it places on the use of economic policy instruments. However, it should not be forgotten that a monetary union also offers considerable benefits to its members (Beer, 2011, for an overview of the current literature).

room for expansive fiscal policy measures, or – in the somewhat longer term – for dealing with the increasing burden on the budget caused by an ageing population. And indeed, if the occurrence of asymmetric shocks is attributable to differences in structural developments across the Member States of a monetary union, even fiscal policy measures (to stimulate the economy) will not be able to help.

In principle, there is another possible way to absorb asymmetric shocks; that is, via transfers within a (partially) centralized EU budget (“transfer union,” De Grauwe, 2009). Politically, this is – at least for now – not a realistic option. In view of the limited scope for economic policy intervention, policymakers must therefore strive to identify macro imbalances as potential sources of asymmetric shocks *directly*, and to initiate countermeasures accordingly.

## 1.2 What Forms Do Macro Imbalances Take?

What do we mean by macroeconomic imbalances?<sup>3</sup> A definition given by Thomas Wieser, former President of the EU’s Economic and Financial Committee (EFC) would seem to offer a sufficiently tangible explanation of the term (Wieser, 2011): “A macroeconomic imbalance is the (negative or positive) position of a domestic, external or financial variable... [which] may – if uncorrected over time – make the national savings/investment balance so untenable that it self-corrects abruptly, thereby causing significant adjustment shocks [...]”

Thus, imbalances ultimately take the familiar guise whereby the current account balance of a country is equal to

the domestic savings/investment balance.<sup>4</sup> Current account balances, in turn, have their counterpart in the balance of payments; i.e. current account deficits go hand in hand with capital inflows, current account surpluses with capital outflows.

It stands to reason, then, that to detect imbalances one should cast a comprehensive eye over both national (i.e. public and private) savings and investment balances and the balance of payments. However, as these represent purely book-keeping identities and thus do not permit any conclusions to be drawn on the causal connection, it is also advisable to look at factors with a direct influence on the above-mentioned aggregates; e.g. determining factors of the current account balance, such as indicators of price competitiveness<sup>5</sup>: real effective exchange rates and their determining factors, or unit labor costs (within a monetary union). One can also consider complementary indicators, such as the development of export market shares, and supplement flow values with stock values (e.g. using net international investment position data to supplement current account balance or debt figures). Finally, early warning indicators can be derived directly from the experience gained in past crises, for example through attempts to identify “unusual” financial sector developments (i.e. any developments which cannot be squared with empirical experiences and theoretical knowledge), such as extreme credit developments accompanied by strong gains in real estate or asset prices (speculative bubbles).

The academic literature has tried to identify suitable leading indicators for

<sup>3</sup> See Ederer (2010) for an earlier overview study.

<sup>4</sup> See e.g. Blanchard and Illing (2009), chapter 19.

<sup>5</sup> See Ragacs and Vondra (2011) for a discussion of price and nonprice competitiveness.

the crisis risk to countries by making ex post forecasts. In view of the different economic policy frameworks (e.g. exchange rate regimes) in place in different countries, and due to the idiosyncratic causes of crises in individual countries or groups of countries (e.g. the Asian crisis), a certain heterogeneity in the results of these studies is unavoidable.<sup>6</sup>

Imbalances and macroeconomic crises can easily change their form – as also became apparent during the most recent global crisis, which developed from a banking and financial crisis into a crisis in the real economy and, subsequently, a sovereign debt crisis in some countries. Accordingly, when assessing a country's vulnerability to crisis, a thorough scrutiny of economic indicators is indispensable.

### 1.3 Macroeconomic Developments in the Euro Area

Chart 1 shows the development of a number of macroeconomic variables for selected Member States. In order to maintain a certain level of clarity here, on the one hand the chart is limited to a group of countries which have been left comparatively unscathed by the financial, economic and sovereign debt crisis: Germany, the Netherlands, and Austria. Juxtaposed with these are those countries which have been particularly hard hit by the crisis and, subsequently, have required varying degrees of support from the other Member States, the IMF or the ECB: Greece, Ireland, Portugal, and – with a few qualifications – Spain and Italy.

In Greece and Italy, public debt levels were already well above the debt

ceiling specified by the SGP even before the onset of the crisis (see chart 1(a)). The crisis then resulted in a rise in public debt levels in all euro area countries; however, this rise was most significant in relative terms in a few countries with low levels of debt (Ireland and Spain).<sup>7</sup> Both Spain and Ireland are examples of how strongly ultimately unsustainable developments in specific areas of the economy, such as the housing market or the banking sector, can impact upon public finances and result in financing problems for a government.

Chart 1(b) highlights differences in the development of nominal unit labor costs between individual euro area countries, with low growth in Germany and Austria standing in contrast to substantial increases in Ireland, Greece, Spain, Italy, and Portugal. These differences also showed up in persistent country-specific variations in inflation rates, and hence in divergent real interest rate levels (ECB, 2008). Chart 1(c) depicts developments in real effective exchange rates relative to 35 industrialized countries. The picture this provides is very similar to that for unit labor costs: Germany and Austria experienced a real depreciation, while price competitiveness in Ireland, Spain, Italy, and Portugal underwent a continuous deterioration in the run-up to the crisis. Finally, chart 1(d) highlights what is likely the most widely discussed uneven development within the euro area: persistent and (until the crisis) expanding current account surpluses in Germany, the Netherlands, and Austria side by side with consistently mounting deficits in the other countries.

<sup>6</sup> *Frankel and Saravelos (2011) offer a survey of this literature and conduct their own empirical analysis to provide a prognosis for the most recent economic crisis.*

<sup>7</sup> *These two countries experienced the bursting of a real estate price bubble which had previously delivered high but ultimately unsustainable levels of economic growth and a temporary spike in public revenues.*

Persistent current account surpluses and deficits do not necessarily have to present a problem, as they can be a sign of different national preferences and stages of economic development: for example, countries with an aging population should plan ahead by seeking to build up current account surpluses; developing transition economies with a lack of national savings are dependent upon inflows of capital and investment. As long as the inflow of capital is

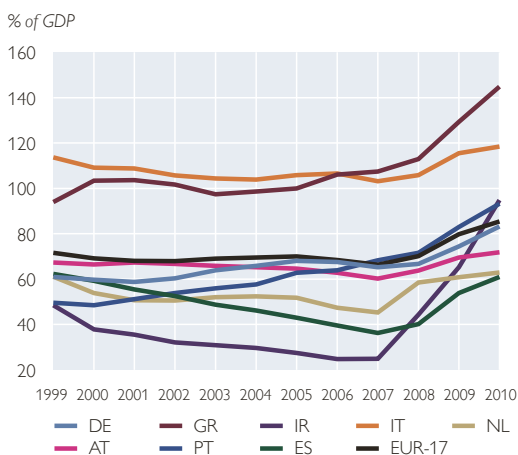
not used for consumption purposes, this enhances the economy's long-term growth potential, providing the scope for later repayment of external liabilities. However, where persistent current account deficits are regarded as problematic, in the sense of being ultimately unsustainable,<sup>8</sup> this can lead to a reversal in capital flows and to economic crises (Aeppli, 2011).

Within a monetary union such as the euro area, the question also arises

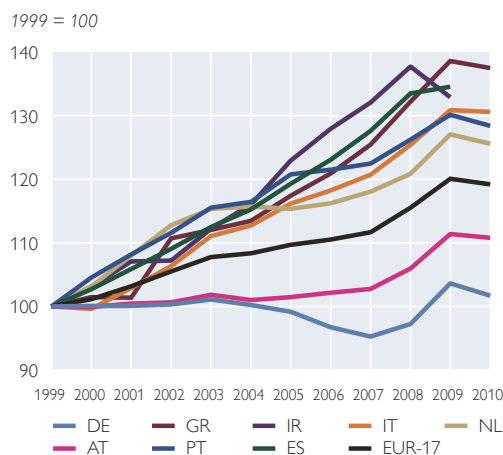
Chart 1

**Development of Macroeconomic Indicators in Selected Euro Area Member States**

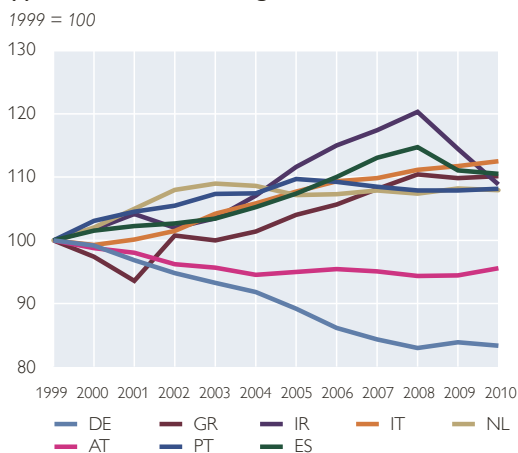
**(a) Government debt**



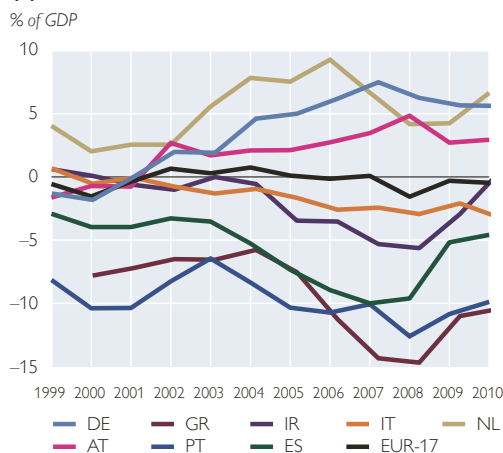
**(b) Nominal unit labor costs**



**(c) Real effective exchange rates**



**(d) Current account balances**



Source: OeNB, Statistics Austria, ECB, Eurostat.

<sup>8</sup> This can be the case when capital inflows are channeled into a country's national (private and public) consumption and not invested, or because investor confidence is shaken as a result of political developments, etc.

as to whether there is a causal connection between diverging current account balances; specifically, whether the export surpluses of Germany, the Netherlands, and Austria are *simultaneously* the import surpluses of the crisis countries. The trade linkages involved are, however, more complex than that: on the one hand, a substantial component of Germany's success as an exporter is attributable to markets outside of the EU and has to do with, inter alia, a concentration of its export base on high-growth markets in Asia. By the same token, the export weakness of the southern European countries likewise has structural causes – i.e. loss of price competitiveness and a productivity gap relative to the northern European countries. Moreover, Germany's exports go hand in hand with substantial imports of intermediate goods from the crisis countries (Belke, 2010; Bornhorst and Ivanova, 2011; and Moser, 2011, as well as the literature cited therein).

The ECB began issuing warnings on these types of divergent developments at an early stage (ECB, 2008). In a draft paper on the EIP, it addressed the problem of divergences in competitiveness and imbalances within the euro area and indicated that the tools used to deal with competitiveness issues in the past had been inadequate (ECB, 2010).

#### 1.4 Potential Solutions

The developments of the last decade have shown that macro imbalances can lead to the development of crisis situations and that in the event of a crisis, countries may not have the necessary tools to deal with the situation effectively. For this reason, it is essential that such imbalances be reduced or

eliminated. The EIP has been designed to make this intention a reality, by implementing a procedure which – like the SGP – seeks to adopt a comprehensive approach to anticipating and counteracting the build-up of imbalances, or rectifying imbalances rapidly and effectively once they have materialized.

Nevertheless, the question of who holds the primary responsibility for correcting the build-up of imbalances in specific cases, such as the emergence of current account surpluses in some Member States and current account deficits in others, has been the subject of some intense discussions. For example, in principle the surplus countries (most notably Germany) could make a contribution to bringing down deficits by improving the export prospects of the deficit countries through a program of fiscal expansion or higher wage growth. However, even a marked increase in Germany's imports (see above) would only slightly lower the current account deficits in the GIIPS countries (Greece, Ireland, Italy, Portugal and Spain). In other words, although Germany's current account surpluses would be reduced, the current account balances of the southern European countries would not necessarily see a commensurate improvement. Moreover, the potential for fiscal expansion in the surplus countries is limited due to the sharp rise in public debt levels over the last few years.<sup>9</sup>

Stronger wage growth would likely have a detrimental effect on Germany by lowering its competitiveness, since it would also run counter to Germany's efforts to boost its price competitiveness over the last decade (Moser, 2011).<sup>10</sup> Furthermore, allowing higher inflation in the euro area (Krugman, 2011) in order

<sup>9</sup> Weber (2010).

<sup>10</sup> In the early 1990s, Germany – the “sick man of Europe” – was given the blame for the lack of growth in the EU, as it had suffered from significant problems with productivity and thus competitiveness after reunification.



to enhance the relative competitiveness of the GIIPS nations without deflation would be inconsistent with the goal of price stability for the euro area. This leaves only internal deflation processes, coupled with structural reforms, as solutions to the problems of Greece, Ireland, Italy, Portugal and Spain.

In line with the intentions of the creators of the new macroeconomic governance architecture, the responsibility for preventing and correcting macro imbalances thus rests with the individual Member States themselves. The EIP provides a procedural framework for this process. Together with the reformed SGP and the European Systemic Risk Board (ESRB),<sup>11</sup> it constitutes the new toolkit for economic surveillance and the prevention of crisis developments in the euro area and EU.

## 2 Procedure for the Prevention and Correction of Macroeconomic Imbalances

The future mechanism for the early detection, prevention, and correction of macroeconomic imbalances consists of two regulations, the contents of which will be outlined below.<sup>12</sup> As with the SGP, the procedure can be divided into two components: a *preventive* arm, for the regular assessment of imbalance risks, and a *corrective* arm providing for remedial measures to deal with excessive macroeconomic imbalances.

### 2.1 Preventive Arm

The macroeconomic surveillance procedure starts with regular checks on Member States in the form of an alert mechanism for excessive imbalances. Alert mechanism reports are published in November of each year as part of the European Commission's annual growth

report with a view to providing an initial overview of developments in key macroeconomic indicators. The alert mechanism consists of the so-called "scoreboard" – a set of macroeconomic indicators complemented by an accompanying qualitative analysis in the form of a report published by the European Commission.

The scoreboard consists of ten indicators of external and internal imbalances, complete with threshold values (box 1). If values above or below these thresholds are recorded, further analysis will be conducted. The threshold values are simply guidelines for the evaluation, as they are not meant to be interpreted mechanically, but rather only in conjunction with the accompanying qualitative analysis.

Based on the results obtained from the scoreboard and the qualitative analysis, the European Commission will draw up a list of those Member States at risk of being affected by excessive imbalances. After discussion in the Council of the European Union (subsequently referred to as "the Council") and the Eurogroup, a detailed, in-depth analysis of the affected Member States will be carried out. This will include an assessment of causes and potential effects of macroeconomic imbalances. The analysis will be carried out by the European Commission in collaboration with the affected Member State. The stability and convergence programs (SCPs) which countries submit to the European Commission in April of each year as part of the European Semester will be taken into account in the Commission's decision-making process. In addition, the ECB can also carry out surveillance missions in affected countries.

<sup>11</sup> Pointner and Wolner-Röblhuber (2011).

<sup>12</sup> Council of the European Union (2011a and b).

The in-depth analysis can lead to three different outcomes: (1) The European Commission does not detect any macroeconomic imbalances and consequently does not take any further steps; (2) the European Commission detects macroeconomic imbalances and advises the Council to issue recommendations for preventive action to the affected Member State based on Article 121(2) of the Treaty on the Functioning of the European Union (TFEU); or (3) the European Commission detects excessive imbalances which could jeopardize the functioning of monetary union and advises the Council to issue recommendations for corrective action to the affected Member State based on Article 121(4) TFEU. Only in cases where the outcome of the in-depth analysis corresponds to (3) above will the EIP be initiated, thus bringing the mechanism's corrective arm into play. In cases where the outcome of the in-depth analysis corresponds to (2) above, the European Council will issue recommendations on the correction of the macroeconomic imbalances to the Member State as part of the country-

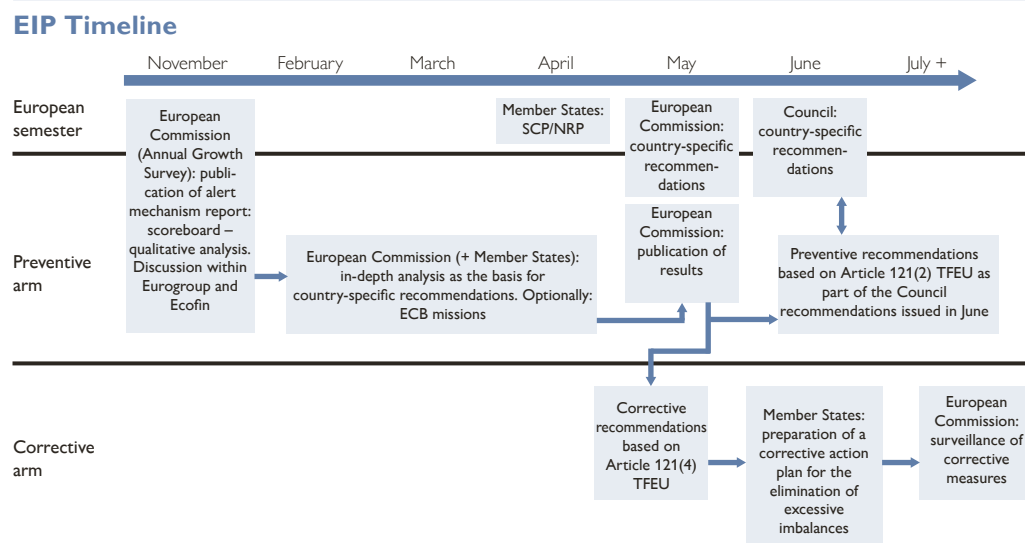
specific recommendations issued in June; these recommendations will be solely preventive in nature. However, the procedure will be terminated at that point and the corrective arm will not be brought into play. Chart 2 provides a summarized overview of the timeline for the steps making up the preventive arm of the EIP.

## 2.2 Corrective Arm

Once an excessive imbalances procedure has been launched, the Member State concerned must submit a corrective action plan, based on a Council recommendation in accordance with Article 121(4) TFEU, within a specified deadline. This plan must explicitly define measures for the correction of the imbalances detected. The Member State must also submit a timetable for the implementation of these measures.

The corrective action plan will be evaluated by the Council (based on a recommendation from the European Commission) within two months. If the plan is deemed inadequate, the Council will issue another recommendation in accordance with Article 121(4) TFEU

Chart 2



Source: Austrian Federal Ministry of Finance, European Commission.



based on a proposal from the European Commission, inviting the Member State to submit a new corrective action plan. When a corrective action plan is adjudged adequate by the European Commission/Council, the Member State will be asked to implement the corrective actions defined in the plan in compliance with the submitted timetable. Actual implementation shall be assured via a reporting and surveillance procedure, including surveillance missions conducted by the European Commission and possibly also by the ECB. If a Member State fails to implement the corrective measures adequately, the Council will issue a recommendation setting new deadlines for implementation.

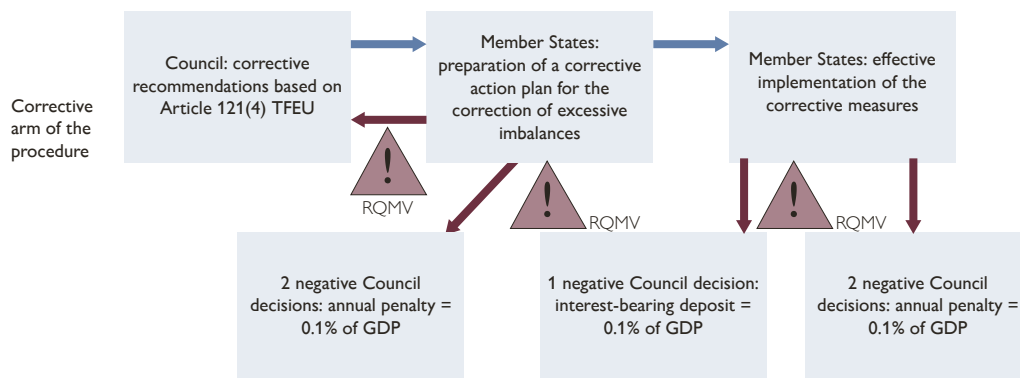
If a Member State is found to be in contravention of the EIP's corrective mechanism, "political sanctions" may be imposed. Alongside the obligations imposed on Member States through the surveillance and reporting procedure, a high level of transparency is also being explicitly targeted for the procedure. Thus, for example, in future the competent committee of the European Parliament will be able to summon representatives of the European Commis-

sion, the Council, and the Eurogroup for joint talks. The aim here is to bring decisions made in the context of the EIP closer to the public arena of politics. At the same time, it should also increase the pressure to act on the Member States experiencing excessive imbalances.

For euro area countries (but not, however, for the other EU Member States; this is in line with the SGP), the framework allows for financial sanctions in the event of contraventions of the EIP. For inadequate implementation of a corrective action plan after its acceptance, an interest-bearing deposit equal to 0.1% of the country's GDP will be imposed. This penalty is to be deposited with the European Commission. Two consecutive negative evaluations with regard to the corrective action plan or the implementation of corrective measures will entail an annual fine equal to 0.1% of the country's GDP. This yearly fine will continue to apply until the European Commission and Council have accepted a corrective action plan/have deemed the implementation of the corrective measures to be adequate. If a Member State has already lodged an interest-bearing deposit with the European Commission,

Chart 3

### Sequence of Events for the Corrective Arm of the EIP



Source: Austrian Federal Ministry of Finance, European Commission.

the deposit will be transformed into an annual fine.

The mechanism specifies that decisions on the imposition of sanctions are to be taken via a reverse qualified majority voting (RQMV) procedure. Where a Council recommendation is in place regarding an inadequate corrective action plan or insufficient implementation of corrective measures, the European Commission will submit a recommendation for the imposition of the relevant financial sanctions. If the Council does not reject this recommendation by qualified majority within ten days, it shall be deemed to have been accepted. The penalties paid by the affected Member States, like those paid in the context of the SGP, will be used

for the financing of the European Financial Stability Facility (EFSF) or, after its entry into force, the European Stability Mechanism (ESM). Chart 3 provides an overview of the sequence of events for the corrective arm of the EIP.

Affected Member States have the opportunity to object to the imposition of financial sanctions on the grounds of exceptional economic circumstances within ten days of the issuance of the European Commission's recommendation. The subsequent decision on whether or not to allow this objection is at the discretion of the European Commission. The EIP will be terminated once the Council, based on a recommendation from the European Commission, determines that the im-

Box 1

### Scoreboard

*The European Commission submitted an initial proposal for the scoreboard in mid-2010 (European Commission, 2010). This proposal was then further developed and refined over the course of several rounds of discussions between the European Commission and the Member States within the forum of the EU's Economic Policy Committee (EPC). This resulted in the development of a well-matched set of macroeconomic indicators. Four guiding principles were applied in the selection of the indicators (European Commission, 2011):*

- (1) The indicators should incorporate the most relevant elements of macroeconomic imbalances and losses of competitiveness.*
- (2) The early warning indicators should consist of an appropriate combination of flow and stock values and also threshold values. The threshold values are essentially based on percentiles from the individual indicator databases (e.g. first and third quartile in the case of an indicator which is to be interpreted symmetrically).*
- (3) The scoreboard represents an important communication tool.*
- (4) The statistical quality of the data should be high, and the data should be internationally comparable.*

*The indicators selected, ten in total, are divided into two groups. On the one hand, they are aimed at highlighting external imbalances and competitiveness issues; on the other, they focus on internal imbalances. Table 1 provides a detailed description of the indicators. The first group comprises the current account balance, the net international investment position, the change in the real effective exchange rate, the change in export market shares, and the change in nominal unit labor costs.*

*The second group contains the change in real house prices, private sector credit flow and debt, general government sector debt as a percentage of GDP, and the unemployment rate. The first nine values are plausible indicators of problems viewed against the backdrop of the discussion in section 1.2. The unemployment rate was proposed as an indicator within the context of the "trilogue" of the European Parliament, as a high level of unemployment is a key indicator for macroeconomic problems and indicates economic policy failures and/or structural problems within an economy.*

Table 1

**Scoreboard Indicators: Threshold Values and Data Base**

Indicator	External Imbalances and Competitiveness					Internal Imbalances				
	Current account balance	Net international investment position	Real effective exchange rate	Export market shares	Nominal unit labor costs	Real housing prices	Private sector credit flow	Private sector debt	General government debt	Unemployment rate
<b>Interpretation/transformation</b>	% of GDP; average of the last three years	% of GDP	Relative to 35 industrial countries (HICP as deflator); three years percentage change	Five years percentage change	Three years percentage change	Year-on-year change in %	% of GDP	% of GDP	% of GDP; definition as per SGP	Average of the last three years
<b>Data source</b>	Eurostat	Eurostat	DG ECFIN	Eurostat	Eurostat	Eurostat, ECB, BIS	Eurostat, ECB	Eurostat, ECB	Eurostat	Eurostat (LFS)
<b>Threshold values</b>	+6% / -4%  (lower bound: first quartile; upper bound: policy decision)	-35%  (first quartile)	Euro area: +/-5%  (first and third quartile)  Other Member States: +/-11%  (quartile + standard deviation for the euro area)	-6%  (first quartile)	Euro area: 9%  (third quartile)  Other Member States: 12%  (threshold value for the euro area + 3 percentage points)	6%  (third quartile)	15%  (third quartile)	160%  (third quartile)	60%  (SGP reference value)	10%
<b>Data base</b>	1970–2007	1970–2007	1995–2007	1995–2007	1995–2007	Up to 2007 (start year according to availability)	1995–2007	1994–2007	x	1994–2007

Source: European Commission (2011).

balances have been effectively eliminated.

### 3 Evaluation of the EIP

The problem that imbalances may trigger crises and endanger the stability of the euro area was identified years ago. As the euro area was not designed to be a transfer union, the prevention of macroeconomic imbalances is a key condition for it to be able to function (sec-

tion 1). The necessity of the objectives targeted by the EIP is thus undisputed. Nonetheless, the effectiveness of the new procedure has been criticized and called into doubt.

#### 3.1 Would the Scoreboard have Anticipated the Current Crisis?

The question is whether the scoreboard approach has been designed with sufficient scope to identify incipient im-

Table 2

**Scoreboard Indicators, 2005 to 2007**

		Current account balance	Net international investment position	Real effective exchange rate	Export share	Nominal unit labor costs	House prices	Private sector credit flow	Private sector debt	Government debt ratio	Unemployment rate
Threshold value		+6%/−4%	−35%	+/−5%	−6%	+/−9%	6%	15%	160%	60%	10%
AT	2005	1.9		2.7	12	1.4	2.5	12.2	132*	64	4.8
	2006	2.3	−21	−0.4	−0.2	1.1	1.8	11.6	144*	62	5
	2007	2.8	−18	−0.3	−0.6	2.8	1.5	24.8	152*	60	4.8
DE	2005	3.9	21	4.8	11	−0.5	−2.1	−0.9	128	68	9.9
	2006	5.4	28	0.2	3.3	−3.4	−0.8	0.9	125	68	10.1
	2007	6.6	27	0.6	2.1	−3.7	−0.4	3.6	123	65	9.6
NL	2005	6.8	−3	3.3	1.4	2.6	1.8	14.6	210	52	4.9
	2006	8	3	−1.1	−4.7	0.5	2.2	12.7	213	47	4.9
	2007	7.8	−6		−2.1	2	2.7	9.2	211	45	4.4
GR	2005	−6.6	−77	6.8	6	7.6	7.3	14.6	89	100	10
	2006	−8.2	−85	2.5	−5	7.9	9.3	16.7	96	106	9.8
	2007	−11.1	−94	1.9	3.9	9.3	1.7	15.4	104	105	9
IR	2005	−1.4	−25	12	6.4	13.9	5.7	24.3	192	27	4.5
	2006	−2.5	−5	3.4	−10.9	14.4	11.3	34.7	204	25	4.5
	2007	−4.1	−20	4.1	−15.7	14.6	4.1	20.9	214	25	4.5
IT	2005	−1.3	−16	7	−5.5	9.4	5	9.2	101	106	8
	2006	−1.7	−21	1.1	−12.7	7.1	3.1	9.5	107	107	7.5
	2007	−2.2	−22	0.7	−9.3	6.8	3.1	12	115	104	6.9
PT	2005	−8.4	−68	5.3	−4	8.6	−0.7	14.5	206	63	6.9
	2006	−9.8	−79	1.4	−5.6	5.5	−0.6	17.2	210	64	7.4
	2007	−10.4	−88	1.5	−5.4	2.8	−1.6	24.9	223	68	7.9
ES	2005	−5.4	−56	7.9	5.2	8.9	10.8	27.9	177	43	10.3
	2006	−7.2	−66	4.3	−3.4	9.3	7.7	37	201	40	9.4
	2007	−8.8	−78	4.2	−3.2	11	6.4	27	215	36	8.7

Source: European Commission (2011). \* Revised on December 7, 2011.

balances at an early stage, and whether it would have allowed us to anticipate the current crisis. Table 2 provides sample scoreboard indicator values for selected euro area countries for 2005–2007.

As in chart 1, the table covers Germany, the Netherlands, and Austria as well as Greece, Ireland, Italy, Portugal, and Spain. The timeframe for the data was deliberately limited to the 2005–2007 period in order to evaluate the scoreboard’s potential and its ability to anticipate the current crisis. The years for which the values exceeded or fell short of the threshold values are highlighted in red.

Particularly in Greece, Portugal, and Spain, the “current account” indicator came in well below the threshold value in the precrisis years. The stock values for the net international investment position obtained from the accumulated current account balance figures paint a similar picture. The indicators for the measurement of internal balances would also have exceeded the threshold values (above all in the case of private sector borrowing and debt levels). The only exception in the figures for the crisis countries is Italy, as only the export market share and debt indicators would have hinted at any problems. Then again, this does not seem odd, as Italy’s core problem at the

moment is above all constituted by its significantly elevated public debt ratio.

Among the countries with a current account surplus only the government debt indicator would have argued for an in depth-analysis in the case of Germany and Austria, and only the public and private debt indicators would have done so in the case of the Netherlands. In sum, table 2 would thus suggest that the scoreboard indicators would indeed have been capable of predicting euro area countries' vulnerability to crises.

### **3.2 Topics of Discussion: Symmetrical Treatment of Current Account Balances and Criticisms from Trade Unions**

During the development of the scoreboard and the associated threshold values, one hotly debated question was to what extent current account surpluses should also be viewed as an imbalance. Thus, representatives of the southern European states pressed for a "symmetrical treatment" of current account balances, while Germany in particular opposed this idea. Ultimately, a compromise was agreed: the scoreboard does now include a threshold value for current account surpluses; however, the (absolute) value is set considerably higher than that for deficits.

Trade unions have voiced frequent criticisms regarding what they see as the EIP's disproportionate focus on price competitiveness and low growth in unit labor costs (ÖGB, 2011; Rossmann, 2011). They maintain that this has resulted in a marked increase in income inequality, especially in Germany (OECD, 2011, table I).<sup>13</sup> Conversely, however, the high growth in unit labor costs in the GIIPS countries indicates a need for enhanced coordina-

tion between wage negotiators at the European level.

### **3.3 Open Questions Regarding the EIP**

Particularly as regards the evaluation of the EIP's corrective elements, a number of important questions are yet to be resolved. For example, in cases where the Council issues corrective recommendations based on Article 121(4) TFEU, the affected Member State must adopt corrective measures. The goal of these measures is to bring the affected indicator values back below or above the relevant threshold values. However, the question which must first be addressed in this regard is that of the actual controllability of the indicators; in other words, whether a complex indicator such as the current account balance or wage developments can actually be directly regulated by policy.

A final question discussed was whether or not the scoreboard should include a financial market indicator as a complement/interface to the ESRB. However, no consensus could be reached as to which value should be used for this. Therefore, the first scoreboard (for the 2012 European semester) will not contain this type of indicator. However, the European Commission intends to submit another proposal in this regard before the end of 2012.

An additional question arising with regard to the inclusion of a financial market indicator has to do with the jurisdiction of the EIP considering the roles of other EU institutions, in particular the ESRB, which is responsible for the prevention/correction of imbalances in European financial sectors. On the one hand, questions of jurisdiction between the EIP and ESRB need a definite reso-

<sup>13</sup> Moreover, Fitoussi and Stiglitz (2009) argue that an increase in income inequality was in itself a key factor in the onset of the economic crisis in the U.S.A.

lution; on the other, the added value of including a financial market indicator in the scoreboard is unclear. At this point it seems important to note that the scoreboard is not “set in stone” and that the EU regulation provides the scope for both the indicators themselves and their threshold values to be changed (Council of the European Union, 2011a, Article 4).

Key to the effectiveness of the EIP, and in particular the corrective elements, is ownership, i.e. the question of whether the Member States will actually support the corrective measures recommended/preferred by the European Commission/Council.<sup>14</sup> The independence and, ultimately, the superordinate function of the European Commission and Council are fundamentally a good premise for the effectiveness of the EIP’s corrective arm. Nonetheless, it involves a significant restriction of Member States’ scope for action in favor of a more integrated approach. Individual Member States would see it as surrendering the job of interpreting developments in macroeconomic indicators to the European Commission and Council. The application of the RQMV method in certain steps of the procedure (for example, assessments by the Council that corrective measures have not been sufficiently implemented) could defuse this conflict of interest. It is likely that the imposition of financial sanctions using the RQMV rule will

ensure a high level of effectiveness of the corrective arm of the EIP. However, as yet there are no practical examples of applications of the procedure from which to draw lessons.

#### 4 Conclusions

The implementation of the EIP constitutes a major step in the direction of global economic policy coordination, especially within the euro area. Ex ante coordination within the context of the preventive arm of the EIP will significantly reinforce future efforts to prevent macroeconomic imbalances. The integration of the preventive arm into the European semester will improve the consistency of country-specific recommendations and take surveillance of macroeconomic imbalances to a new level. With the corrective element of the procedure, the EU has created a powerful, effective mechanism for correcting excessive imbalances. In particular, the application of the RQMV rule in various steps of the procedure and when imposing sanctions should enhance the effectiveness of the EIP. However, a few question marks remain. On the one hand there is the question of how much direct influence individual Member States can exert on individual indicators, and on the other, there is that of the potential conflicts of interest EIP protagonists may face.

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<sup>14</sup> The ECB (2011) also fears that the EIP will be halted too frequently by the Council, and therefore advocates a self-imposed commitment on the part of the Council to comply, as a basic principle, with Commission recommendations on the continuation of the EIP, or to give specific reasons for any rejection of such recommendations.



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