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Macroeconomic Imbalances within the EU: Short and Long Term Solutions

What is an Imbalance?

What is a macroeconomic imbalance? And do macroeconomic imbalances matter? Two easy questions. Put them to an economist and she or he will most likely give you an authoritative description or definition of such an imbalance; and will then proceed to authoritatively tell you that they either matter enormously, or not at all. A pattern will emerge: first, the definitions or descriptions will not be consistent with each other; second: if they matter, then usually abroad.

I will start off with a simple definition: a macroeconomic imbalance is the (negative or positive) position of a domestic, external or financial variable in relation to a certain norm. This position may – if uncorrected over time – make the national savings/investment balance so untenable that it self-corrects abruptly, thereby causing significant adjustment shocks domestically; in the case of large economies also abroad.

Imbalances are caused by economic policies, or by their absence. They are therefore a lagged indicator of other variables that developed at a pace or in a direction that is not commensurate with the overall balanced development of an economy. At stake therefore is the issue of sustainability and liquidity. A deficit or a surplus per se may well be a desirable equilibrium outcome and thus not an imbalance, for instance reflecting an efficient international allocation of capital.

As imbalances influence developments in partner countries they are an important factor in international policy making. At the global level the main task of the IMF has been and is focused on preventing, detecting or mitigating national economic imbalances that may lead to an unsustainable external position of countries, and may have important spillover effects. It has an array of lending instruments at its disposal that can be utilized if imbalances lead to capital flows that are inadequate for satisfying the external financing needs of a country. The G 20 process has rediscovered this issue in the light of global imbalances in current account positions, and has agreed on a surveillance exercise.

Addressing Potential Imbalances in the Euro Area

Within the European Union risks of macroeconomic imbalances were recognized in the Treaty. A set of economic policy coordination tools was designed in order to prevent such disequilibria; and a balance of payments support facility was set up in order to assist in overcoming such a crisis.

The design of the euro area as per the Maastricht Treaty followed the principles that

– at entry, fulfillment of and adherence to the fiscal, financial, monetary and exchange rate criteria would guarantee that the relevant economic parameters that could engender imbalances were largely in balance,

- market discipline will be sufficient for nudging the public sector towards prudence and sustainability by prohibiting monetary financing and a privileged access of the public sector to the financial sector, and by a rule on not bailing out Member States,
- loose economic policy cooperation and more stringent fiscal policy coordination through the relevant Treaty Article and (later) the Stability and Growth Pact (SGP) would be sufficient for keeping these variables on track, together with an independent monetary policy geared exclusively towards price stability,
- and such was the conviction that no imbalances could emerge that no financial safety net was designed to provide balance of payment support to euro area Member States in difficulties.

When setting up monetary union the question of asymmetric shocks received wide attention, as this was seen as the weak flank of a monetary union with

less than perfect factor mobility across national borders, and autonomous fiscal policies. The issue of divergent developments of competitiveness were less widely discussed, and seen as a lesser order problem.

Upon entry into monetary union and the elimination of exchange rate risk, risk premia moved downward with great speed, by a good 800 basis points for some Member States compared to only a couple of years previously. Subsequent developments of rapid credit growth and accelerating private indebtedness were undoubtedly a result of these developments. There is a bright side to this, as increased private sector leverage post-1998 may have had a one-off "convergence euphoria" component.

Economic policy cooperation in the euro area institutionally takes place (only) in the Eurogroup – the (monthly) meeting of euro area Finance Ministers, the ECB President and the Commissioner responsible for Economic and Financial affairs. It is prepared in the Economic and Financial Committee/ the Eurogroup Working Group.

For well over a decade the debates were contentious primarily when it came to applying the SGP. Greece acceded EMU on a wrong statistical fiscal basis. Nearly ten years ago the Pact faced its first stern test in view of excessive deficits in Germany and France. With the decisive meetings taking place under Italian Presidency the SGP was watered down.

Beyond fiscal coordination a monitoring of overall economic developments takes place; Ireland in 2002/03 actually received a warning for expansive fiscal policies fuelling inflation that were considered to be untenable if not corrected. This produced political reactions from the Irish side that were so negative that other euro area Member States were possibly shocked into a policy of non-interference especially in non-fiscal policy areas.

In the meantime financial integration was proceeding strongly after the adoption of the euro, and cross-border

capital flows into government debt, non-tradeable sectors and interbank markets were significant. The asset price increases in the non-tradeable sectors (mainly real estate) were analyzed and discussed extensively, but with the exception of Spain policy reactions were muted. And even the Spanish reaction to the real estate developments did not suffice, as later developments showed. Stronger reactions were prevented by domestic interest groups or simply due to analytical failure of domestic policy makers. The domestic imbalances were largely seen as constituting a problem of the Member State concerned, not of the euro area as a whole.

The build up of negative current account positions of euro area Member States over the last decade was on the other hand – with a few exceptions – not seen as critical. By contrast, the drifting apart of competitive positions as measured by diverging relative unit labor costs was increasingly seen as a centrifugal issue for the euro area by the European institutions. President Trichet regularly attempted to convince Finance Ministers that these developments were unsustainable, but the Ministers concerned did not act or react sufficiently. The reasons for this complacency were diverse, but could include the following, namely

– that imbalances in a currency area were considered to be self-correcting through medium-term nominal adjustments that would, admittedly, take some time to occur (but occur they would – more or less automatically – as losses of price competitiveness triggered the appropriate price/quantity adjustments),
– that sovereign risk differentials in a currency union virtually ceased to exist and as there was no risk there would be no punishment,
– and, finally, that the euro area had a quasi-coercive policy instrument in the form of the SGP, but no other policy tool at its disposal that could realistically be expected to influence policy behavior of national actors. As all other policies were firmly anchored in national responsibility, from wage to financial policies the incentives were skewed against policy coordination. Policy cooperation in and of the euro area was firmly confined to the Eurogroup meetings of Finance Ministers, and thus reflected the fiscal approach to policy coordination as laid down in the Treaty.

Addressing Imbalances in the EU

In the European Union of 27 economic policies, even though a matter of common responsibility according to the Treaty, were in reality not closely coordinated. ECOFIN work tends to be focused on legislative acts required for completing and deepening the Internal Market. The Treaty based Economic Policy Guidelines, beloved by their authors and drafters, are decided upon by Ministers without substantial discussion, and successfully shelved after the traditional pre-summer decision. Process produces papers, not substance, unless there is a negative externality associated with policy inertia.

The issue of external imbalances actually received increasing visibility amongst policy makers, inter alia in the context of the ERM II procedures as some new Member States prepared for or attempted entry into Monetary Union.

The most visible case of imbalances was that of Latvia, where euro area officials engaged in intensive debates with the authorities on the causes of their current account deficit, and appropriate remedies. Seemingly, there were al-

ways good reasons for the large deficits not being a concern – ranging from idiosyncratic shocks due to the import of railway stock to the nearly tautological effect of growth differentials in the catching up process. In those days every policy maker could recite Balassa-Samuelson effects even if asleep.

Discussions with many New Member States from 2004 onwards focused on:

- External Imbalances: current account positions and real exchange rate movements received closest attention, international reserve positions were hardly ever analyzed;
- Financial imbalances: credit growth and foreign exchange credit growth were addressed, but were intensively discussed only when the sustainability of fiscal and financial positions in CEE were already at the forefront of international attention; there was no meaningful ongoing dialogue between supervisors and macro-economic authorities at the European level at an early stage that could have contributed to crisis prevention or mitigation;
- Structural weaknesses in product and factor markets, linked increasingly to issues of competitiveness
- Fiscal imbalances were continuously monitored, but the policy advice of the EU was not taken seriously by all policy makers to whom warnings were addressed; a good example is Hungary which has remained in an excessive deficit procedure from the outset of its membership without major political problems.

Increasing external disequilibria due to a loss of competitiveness through steadily rising real unit labor costs were seen by national policy makers as being largely caused by growth differentials; increasing indebtedness of the private sector was seen as being a consequence of high growth, and not a cause of overheating and thus unsustainable growth; and increasing contingent liabilities due to forex exposures were seen as providing cheap (long term) finance for private households where domestic capital markets had no long-term instruments available.

In the end, the conditionality in balance of payment support programs addressed these issues, but we could have gotten there more easily with a higher degree of better policy coordination and cooperation.

In these programs, the issue of exchange rate adjustment was a highly contentious one: a traditional approach would have called for a rapid exchange rate adjustment in order to kick start export activity; with balance sheets largely denominated in euro this would have bankrupted many domestic credit holders, and consequently would have significantly increased the write off requirements of the banking system (widely foreign owned). A mixture of economic interests and analytical disagreement produced differing policy prescriptions, but mainly in favor of exchange rate stability. This required rapid internal devaluations through the wage and price mechanism. Ironically, the countries outside the euro adopted similar adjustment strategies to those within the euro area. The obvious exception is the UK where we have seen sterling devalue against the euro area as the UK attempts to address its external and internal imbalances.

What Is New in Our Tool Kit, and Why?

As the financial crisis turned more and more into a sovereign debt crisis for peripheral euro area economies our assessment of weaknesses in our toolkit evolved. Our understanding of the me-

chanics of the euro area changed as markets also changed their perception of risk differentials within the euro area.

Progress in our toolkit therefore builds on the (relatively new) fact that within a currency area with decentralized fiscal policies there is room for differentiated sovereign risk assessments by markets. This in turn has led to access to markets being contingent on investors being convinced of the sustainability of policies. At the outset of monetary union there had been attempts to produce "shadow" market mechanisms in order to discipline Member States into fiscally and financially responsible behavior. Now, we have what we wanted.

As some examples showed, quite dramatically, fiscal discipline in the EU and especially in the euro area had not been adequately stringent, thus leading to inter-temporally unsound fiscal positions. This was not due to recognition lags (with the one or the other notable exception) but due to the political economy involved in collaborative decision making and the loss of market discipline as sovereign risk became only a lower-order function of debt and deficits.

At the same time the widening of differentials in competitiveness occurred as wage and price developments were not oriented towards stable (notional) real exchange rates within the euro area. National wage and structural policies need to better reflect this, which is especially interesting given the autonomy of decision making of policy actors, especially in the field of wage setting.

And, lastly, the contribution of the financial sector to imbalances shows clearly that financial regulation, but especially supervision need to be geared more to a highly but not completely integrated financial market with decentralized fiscal backstops and supervisors. Given the "industrial policy" type behavior of national governments towards their financial sectors market based solutions to financial crisis are more difficult in the EU than in other

large economies that have symmetrical responsibilities for financial and fiscal issues.

The Safety Net

As already mentioned the euro area did not have an adequate safety net for Member States facing external financing constraints until 2010. The complete tale of the debates on whether such a mechanism should be based on EU, Community or intergovernmental methods needs to be told separately.

After lengthy and very principled debates Greece received a loan from (most of) the euro area Member States as well as one from the IMF. The policy conditionality was and is strict, and the pricing of the euro area loan was designed so as to prevent moral hazard, i.e. so as not to incite others to enter such a program. These concerns were fairly rapidly seen as naïve. The pricing has been changed in the meantime.

Contrary to some expectations markets were not convinced by the

Greek adjustment program that all that needed to be done had been done, and spreads continued to remain high for many euro area Member States. In May 2010, after lengthy and politically charged negotiations, the EFSF and EFSM were set up. These two facilities were designed to have a volume of EUR 440 and 60 billion respectively. Lending from these two facilities, in conjunction with the IMF, is ongoing for Ireland and Portugal.

Recognizing that these temporary facilities did not answer the need for a permanent and more structured safety net the decision was taken in March

2011 to have, as of mid-2013, a permanent euro area safety net, the European Stability Mechanism. It will dispose of paid-in capital of EUR 80 billion, and an overall lending volume of EUR 500 billion. As its predecessors it is expected to lend in conjunction with the IMF.

The latter issue is an important point in the global discussions on regional safety nets: whilst it appears increasingly necessary to have regional solutions for regional problems it would be politically and economically counterproductive if they were not all linked to a global instrument. This would ensure a hub and spokes system with quality assurance, comparability of approaches to policy failures and problems, and would ensure that regional solutions did not cause global imbalances.

Fiscal and Macroeconomic Surveillance

Within the EU, and especially within the euro area, a lot of reflection has gone into the design of systems that should ensure that a repeat of the fiscal imbalances of the past decade can be avoided. A set of 6 legislative acts has been agreed on by Ministers, and is presently being negotiated with the European Parliament.

These acts should strengthen the SGP by a variety of measures: it should become more difficult to politicize (and thus bring to a halt) an excessive deficit procedure; there should be a higher degree of quasi-automaticity in some of the procedures and sanctions at an earlier stage; not bringing down debt levels at a steady pace towards and under 60% of GDP should give rise to sanctions; and the quality of national fiscal frameworks should be enhanced. Sanctions should be more easily imposed, and should be gradual in the sense that Member States should not be automatically threatened with the "atomic bomb option" of the highest financial sanctions.

Additionally, the EU has designed a macro-economic surveillance process that should detect the emergence of external and internal imbalances at an early stage. A wide range of indicators will be used in an alert mechanism in order to give early warnings. Such warnings will be issued to the Member State concerned, and in the case of excessive imbalances with an invitation to correct the emerging imbalance through appropriate policy action. If no policy action is taken, sanctions could be applied. This reflects the lessons

learned over the last years that a wide range of policies may have area-wide destabilizing influences, whilst policy responsibility remains firmly at the national level. Producing processes that satisfy both constraints is and will be the challenge as we emerge from the crisis.

Financial Stability Instruments

Within the EU the financial sector is especially closely interconnected, even though financial integration is incomplete and uneven. The growth of cross border activities has been pronounced over the past two decades as a consequence of Internal Market legislation, and later of the single currency. Imbalances in the financial sector have generally been pronounced in industrialized economies in the past years, and especially in the EU the process of cleaning up balance sheets is not over yet. Due to these strong inter-linkages contagion risks play an important role in Europe. Not so long ago this interconnectedness was seen as an important stability factor through risk diversification. Both may be true, though not at the same time.

A specific feature of the EU financial sector is that due to the dense web of branches and subsidiaries the question of fiscal responsibility for banking sector support is less clear than in other parts of the world. Is the home government "responsible" for all activities of its banks? Or is it responsible for activities of its banks, including branches abroad, but not of subsidiaries? Or is it only responsible for domestic activities? As the governments of Iceland, the UK and the Netherlands know, this is more than an academic question!

The issue of burden sharing has still not been completely clarified, and may never be completely clarified ex ante. With the introduction of cross border stability groups we hope to reduce the probability of such occurrences by increasing the quality and timeliness of mutual information across relevant markets.

The myopia of supervisors confined to seeing only small parts of important market developments outside their jurisdiction was an issue in the crisis. Through the establishment of the three European authorities for banking, insurance and securities we hope to achieve better supervisory cooperation, and a larger and more consistent set of single or very similar rules and practices. Over time we will need to move towards a European supervisor, but the politics of Europe are not ready for this step yet. And then the question of burden sharing and back stopping needs to be more clearly solved.

Whilst micro-prudential progress has been achieved by building on existing groups, macro-prudential surveillance in the EU has started from scratch. The European Systemic Risk Board (ESRB) was set up last year, and has become operational as of the beginning of this year. It is closely associated with, but separate from, the ECB. Its function is to detect and warn about emerging imbalances, with a strong focus on financial sector imbalances. But its surveillance function can obviously not be confined to the financial sector, and needs to encompass all those parameters and sectors which could cause such imbalances to emerge. An example would be a real estate bubble which, if uncorrected, would cause imbalances in the real economy and the financial sector of the country concerned. And possibly beyond. We will need to work on the inter-linkage of the work of the ESRB and the EU's macroeconomic imbalance procedure so that they complement each other and do not overlap or underlap. We will need to avoid un-

necessary duplications with the IMF FSAPs. And we will need to find an appropriate way of channeling advice to policy makers in a manner that maximizes the probability that they will act.

Does this Suffice? What Are the Politics of the Longer Run?

The EU has reacted impressively so as to decrease the probability of future crisis. It has also set up a safety net that should be available for those Member States that despite all surveillance exercises fail to correct their imbalances in a timely manner. Does this suffice?

As set out above a number of new procedures have been set up. They are administered by Finance Ministers, and in some instances the reports and analysis go the Heads of State. But do they address the root causes of recent imbalances?

The euro area is set up as a decentralized policy space with a single monetary policy. The purpose of many of the new EU policy processes and measures is to incite nominally (largely) independent policy makers to behave in a responsible manner, i.e. to ensure the sustainability of their policies, and thus

also share in the responsibility for the sustainability of the euro area.

One element obviously is that we need better national policies. We now have the processes at the European level. How do we now get the results?

As we have seen policy areas well outside the domain of central bankers and Finance Ministers have contributed to existing imbalances. Time and again Finance Ministers return from Brussels with advice about their fiscal plans that the Commission and the Council have carefully worked out, and at home they do not have an audience. And for the policy fields that are somewhat removed from fiscal policies this holds even more true.

Better institutions for supervision of a European financial sector will be part of the long term solution, building around a single European supervisor. If this is achieved, the financial sector will increasingly become a sector which can contribute to European growth with lesser risks of regional instability. Then the vision of risk diversification will have become more of a reality than it is at present. The political and fiscal implications of such a solution are complex, and therefore will not come about in the short run.

Looking at wage and price developments in a number of Member States it is clear that external constraints have historically played and still play a smaller role in some countries than, say, in Germany or Austria. This is understandable as the diverse national institutions come from a different background of exchange rate policies, and thus a different tradition of wage and price policies. We will therefore need to develop a common understanding of national actors and institutions of what is required in terms of mutually compatible policies across a large range of policy areas.

It will be necessary that social partners from all Member States share an analysis of prospective developments of growth, productivity and prices.

Wage formation and price developments need to have a clearer focus on stability and sustainability than they have had in the past. In some Member States of the euro area it could be argued that some social partners have not yet joined monetary union. It will be a crucial element of European policy making, with an important role for the President of the Eurogroup to bring about this historic change.

Policy makers responsible for structural policies need to understand the role and function of their policy measures in the context of intra-euro area balances. At present this is still not the case. Policy makers responsible for the design and parametrics of retirement policies for example need to understand the euro area aspects of intertemporal imbalances.

In short: the euro area needs to become a truly political and broadly based policy area. It needs to move beyond the narrow confines of fiscal coordination and start economic policy coordination. The political process needs to be opened up to a larger class of policy coordination other than monthly meetings of finance ministers. Therefore, guidance but also responsibility of Heads of State must become the norm without micro-management, and with a truly broad based and well prepared discussion. If this is achieved the euro area will be able to play an important role at the global level. If this is not achieved, then the processes we have designed will not suffice to stop imbalances emerging in the future through an adequate mix of process and policy.