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ECONOMIC AND MONETARY AFFAIRS

Monitoring Macroeconomic Imbalances in Europe: Proposal for a Refined Analytical Framework

NOTE

Abstract

The crisis has awakened attention towards broader macroeconomic imbalances in EMU, and in particular private debts and divergences in price and cost competitiveness. We believe a too rigid monitoring exercise is undesirable. It will be necessary to address the different causes of the imbalances, including devoting attention to the use of private debt and the different components of unit labour costs developments, namely wage as well as productivity growth.

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Executive Summary

Background

The recent crisis in Europe unveiled macroeconomic imbalances other than undisciplined fiscal positions. EU institutions are suggesting a broader macroeconomic surveillance framework that should function as a warning mechanism to avoid similar situations in the future.

Aim

This notes aims to address the most critical components of a wider macroeconomic surveillance framework, as recently proposed by the European Commission, in particular trying to identify some of the relationships existing between fiscal policy, broader macroeconomic imbalances and competitiveness developments.

Large macroeconomic imbalances (such as current account deficits) and protracted losses in competitiveness have increased steadily across Member States over the past years and, at the time of the crisis, have heightened the financial vulnerability of Member States and of the Euro area as a whole. As such, these imbalances should be corrected.

The empirical evidence indicates however that most macroeconomic imbalances in EMU have not been caused by undisciplined fiscal positions. The EU Commission's proposal to extend surveillance by creating an alert mechanism for macroeconomic imbalances, including other indicators beyond public deficit and public debt, such as current account balances and real effective exchange rates, is therefore welcome.

The new tool of the surveillance framework should consist of a scoreboard establishing a set of indicators revealing external and internal imbalances, combined with qualitative expert analyses. As already pointed out by the EU Commission, however, there should not be a mechanical link between the results of the scoreboard and the policy actions, as most of the critical positions of Member States derive from the poor governance in dealing with differentiated determinants of the same imbalances.

For example, the current account position of Portugal has historically displayed very large deficits, while the same deficits have been much smaller for Spain, where instead private debt levels have been a source of concern. Along the same lines, private debt levels per se provide little information about the probability of a country to incur into a credit crisis (e.g. Netherlands).

In this document we would thus identify some guidelines to be used when proceeding in such a qualitative assessment of the surveillance framework. In particular, indicators such as the resilience of the national financial sector to shocks, or the use that has been made of the accumulated debt, whether it was employed to finance consumption or investment, and in what sectors, should also be employed in the analysis. We finally conclude by discussing three open issues, only marginally touched by the Commission's Communication, that need to be discussed more thoroughly.

1. The new broader macroeconomic surveillance framework

The recent crisis in Europe has opened the question of the sustainability of macroeconomic imbalances and reinvigorated interest in competitiveness divergences in Economic and Monetary Union (EMU).

On 30 June, the EU Commission issued a Communication on enhancing economic policy coordination[1]. The document builds on the ideas already set out in the EU Commission's Communication of 12 May, the orientations agreed at the European Council of 17 June and the progress of the Van Rompuy Task Force, whose final report is expected in October.

The Commission's Communication essentially suggests a framework for tackling broader macroeconomic imbalances whose broad outline is similar to the one of the Growth and Stability Pact (SGP), equally foreseeing a preventive and a corrective arm. By and large, the overall policy framework would thus comprehend a monitoring of divergences in the current account positions of Member States an analysis of the different competitiveness trends, as well as the traditional possibly strengthened assessment of public finances of the euro-area countries (See Box 1).

Based on these proposals, we plan to analyze the rationale and the potential critical components of the broader macroeconomic surveillance framework envisaged by the EU Commission, touching also on the of the governance structure that have been neglected.

With this aim, the first section describes the main determinants of current account imbalances with special reference to the EMU, as well as the link between the same imbalances, competitiveness trends and public finances. Section two follows up on these links, and discusses some critical components in the governance of the broader macroeconomic surveillance framework suggested by the EC, identifying some guidelines for its application.

1.1 The drivers of current account imbalances

By definition, current account imbalances signal a mismatch between domestic saving and investment. Surplus countries save more than they invest or, to put it differently, they consume less than they can afford given the level of desired investment. They are in turn able to lend abroad. Excessive savings (or low consumption) can either come from the private sector or from the public sector and it is here that fiscal policy comes into the picture. Deficit countries demand more than they have saved or, to put it differently, high consumption implies that little or no saving is generated to support investment. These countries would thus aborrow from abroad to support either domestic investment or even consumption itself . As above, it is either the private or the public sector in need of borrowings from abroad.

In sum, the main factors behind current account surpluses are as follows:

- *Weak domestic private sector demand* due to low consumption and leading, by default, to saving in excess. This is for example at the origin of Germany's impressive trade surplus. Domestic demand remained close to stagnation for over a decade following the re-unification shock. Moreover, continued wage moderation in EMU further contributed to feeble consumption and to the rise in corporate savings.

1 EU Commission (2010a)

- *Low investment* through, for example, balance sheet adjustment in the corporate sector. Germany is again a case in point as, here, at the turn of the century, firms started to reduce domestic investment and increasing financial saving by default[2].
- *Cultural factors* also explain the higher propensity to save by households in certain countries more than in others. Specific institutional features of saving markets further support risk-aversion (e.g. conservative mortgage markets). This is well exemplified by the cases of Germany and Austria.
- *Fiscal discipline* implies relatively high saving in the public sector. Traditionally, it was believed that current account and fiscal deficits were strongly associated (the so-called twin deficits hypothesis). The hypothesis was challenged by economic developments in the late 1980s. In the EU the case of Spain in the 2000s, among others, is indicative of the fact that current account and fiscal policy positions are not tightly associated. (see Figure 2).
- *The common monetary policy* may be responsible for perpetuating the mismatch between domestic saving and investment in a low-demand, low inflation country, even if only under certain circumstances. The real interest rates in the low-demand country will be higher than the euro-area average. Savings will rise, whilst national investors will prefer investing abroad, so that saving will be in excess of desired national investment.

The factors that drive current account surpluses would drive deficits too, with only a few differences:

- *Strong domestic private sector demand* due to strong consumption and leading automatically to low saving. In most cases, the EMU convergence process was responsible for it. Cohesion countries such as Spain, Portugal, and Greece started preparing for EMU access in the early 1990s at a time when their macroeconomic performance was different from the rest of the EMU candidates, most notably Germany. In those years, they benefited from a sort of "early dividend" of EMU in the form of lower inflation and interest rates, which gave a strong boost to domestic consumption compressing private savings[3]. In the last decade, households accumulated new debt for about 33 percent of GDP in all three countries (Figure 4).
- *High investment* supported, as in the case of consumption, by the low interest rates delivered through the EMU convergence process and the decline in real interest rates resulting from higher-than-average inflation. Most of it was financed from abroad, as cohesion countries were still catching-up relatively to the rest of the euro area. This mechanism was further facilitated by deeper financial integration and foreign capital mobility (e.g. FDI from other EU countries).
- *Fiscal laxity*, which implies budget deficits in the public sector and might contribute to current account deficits (according to the twin deficits hypothesis). This was especially the case of Greece but as noted in the case of current account surpluses, the correlation between external and fiscal policy positions is weak in EMU (see Figure 2).
- *The common monetary policy* plays an important role here too. Strong domestic demand fuelled inflation in deficit countries, whilst price growth remained subdued in the largest EMU member states (i.e. Germany). Below-average interest rates provide no incentive to save and are a strong boost to investment. At the same time, above-average inflation within fixed exchange rates, in the absence of an adequate wage setting mechanism led to a deterioration of price competitiveness, which eroded the export performance of these countries.

2 EU Commission (2010b)
3 Nielsen and Kohlhas (2010).

1.2 The empirical evidence for EMU

Whilst extensive attention has been devoted in the past to the question of global imbalances, their causes, sustainability and possible cures[4], the debate had touched only marginally the case of EMU. It was in fact often believed that imbalances within EMU would be transitory and of a benign nature, as they would signal the fact that, under capital mobility, savers can lend to international investors in the periphery of Europe to support catching-up processes.

In reality, it is now clear that:

- The macroeconomic imbalances which arose in the early stages of monetary unification are not transitory; rather, they have built up over time showing a relatively high degree of persistence;

- They did not have a benign nature, has they were associated with, and contributed to the unsustainable credit positions developed by certain Member States.

Figure 1 describes the evolution of the current account as a proportion of GDP in Germany and in the group of the most indebted countries (Portugal, Ireland, Italy, Greece and Spain). As it can be seen, the current account imbalances are not temporary on aggregate,[5] but there is a clear divergence, even if the crisis since 2007 has somehow contributed to contain the size of the imbalance[6]. Prima facie, Europe seems to be divided between creditor (essentially Germany) and debtor countries, with a country's trade deficit being another country's surplus. They also represent the same portion of euro zone GDP. Figure 2 shows the value of Germany's and of the periphery's current account position relative to the euro zone GDP. So, even their macroeconomic relevance and capacity to affect euro zone average conditions is comparable.

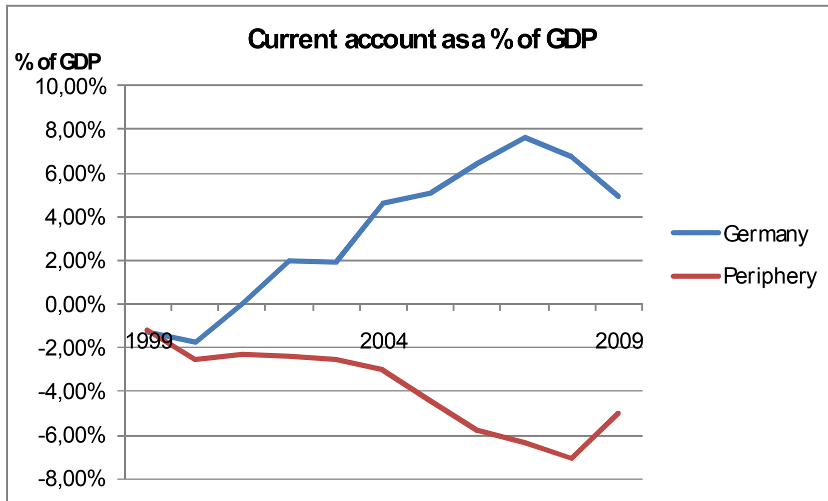
Behind this seemingly perfectly symmetrical picture, one should nevertheless explore whether the financing of current account deficits has indeed remained mainly within the euro area, a potential indication of the 'benign' nature of these disequilibria, or not. As a matter of fact, a geographical coverage of cross-border financial flows is not systematically available for euro-area Member States, and is also complicated by the fact that bilateral flows from one country to another often transit via third countries.

4 See for example Eichengreen (20070.

5 However within an heterogeneous situation across the considered countries in terms of size of the trade deficit, as already mentioned.

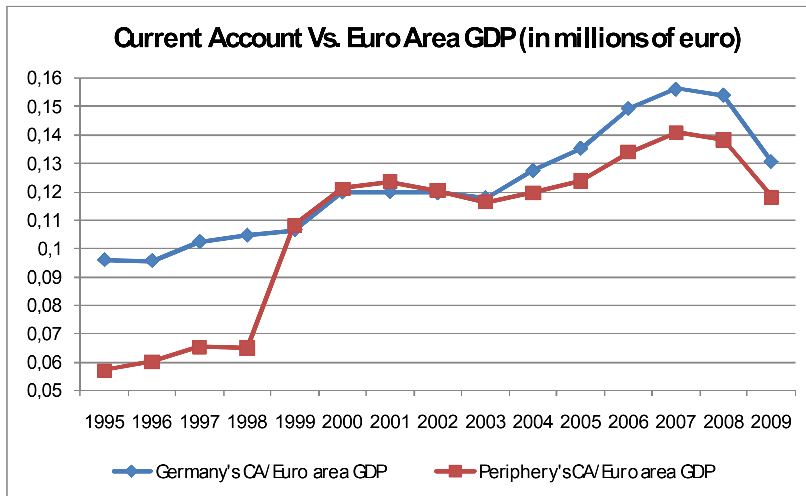
6 As clarified by the European Commission (2010c), the recent convergence may be cyclical (due to the collapse in global demand in surplus countries and the substitution of imports in some deficit countries), with the pre-crisis divergence trend likely to resume once the recovery gains strength.

Figure 1: Trade imbalances



Source: Bruegel calculations, OECD Database.

Figure 2: The weight of trade imbalances



Source: Bruegel calculations, Eurostat.

Preliminary and partial evidence available from the European Commission (2010) on the one hand seems to point to the fact that the financing of current account deficits has remained mainly intra euro area during the financial crisis. On the other hand, however, the current account position of the major surplus country (Germany) has grown asymmetric over time, with the intra-euro area component of the trade surplus remaining by and large constant in the period 1999 - 2009, while most of the trade surplus has arisen from trade outside the euro zone.

1.3 Current account imbalances and price competitiveness

In analysing the drivers of trade imbalances we have limited the analysis to mismatches between domestic saving and investment, while we have not mentioned the role of export growth. Surplus countries typically benefit from robust export performances that allow them to generate the trade surplus. They de facto lend abroad also in the form of exports, and can do so because low prices, which are associated with their modest consumption, make them especially competitive. Productivity gains would lead to a further improvement in the Real Effective Exchange Rate (REER), adding up to the country's price and cost competitiveness. Deficit countries, on the other hand, are price uncompetitive. Sustained consumption typically delivers high prices. When these are associated with low productivity, the REER further appreciates, potentially jeopardising the country's export performance.

Empirically, however, the REER, export growth and current accounts are loosely related [7]. The Netherlands are a case in point, as here a significant trade surplus is associated with poor price competitiveness, as measured by ULC-based REER[8]. Moreover, trade deficits are more often cause by strong demand for imports rather than by poor exports. In this respect, competitiveness improvements in deficit countries would mainly make them better able to repay their debts with returns from exports.

1.4 Current account imbalances and public finances

Another potential factor possibly leading to the critical behaviour of current account imbalances might be related to the fact that some EMU members did not deliver on fiscal discipline. To validate this claim, in Figure 3a, we plot the average change in the current account balance over 1999-2007 and in the actual public budget balance in deviation from the average of each country's main trading partners (EU12). Indeed, the correlation is not as tight as it should be if the current account position was mainly driven by the fiscal policy stance. Figure 3b describes the levels of the current account and of the fiscal balance relative to the main trading partners just before the crisis (2007). The image conveys a similar message. In Greece and Portugal, current account deficits might have well be driven by negative public saving (i.e. public deficits) but the trade deficits of countries such as Spain and, to some extent, Ireland have probably less to do with fiscal policy and more with other economic distortions.

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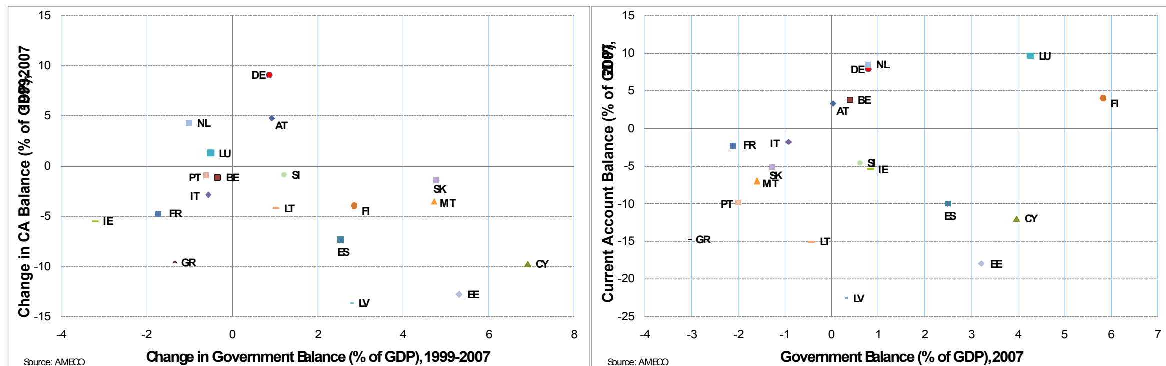
7 EU Commission (2010b).

8 The Real Effective Exchange Rate measured using Unit Labour Costs, thus taking into account productivity and wage dynamics.

Figure 3: The weak correlation between fiscal and current account positions

(a) (b)



Source: Marzinotto, B. , Pisani-Ferry J., and Sapir, A. [2010].

The recent crisis itself indicates that macroeconomic imbalances cannot all be ascribed to the lack of fiscal discipline. The Greek crisis was fiscal in nature from the start, but Spain exemplifies a different situation[9]. The Spanish current account deficit mirrored rising private debt levels, with borrowings from abroad being used to finance consumption and especially investment in the real estate sector. The strong fiscal stimulus put in place by the Spanish government to support the national economy in the crisis and the risk that private liabilities turned into public liabilities fuelled speculations on financial markets with the result that the Spanish became also fiscal in the end, even if the situation was never comparable to that of Greece.

2. The Governance of the Broader Multilateral Surveillance Framework

The evidence provided insofar has suggested that, for a number of reasons, macroeconomic imbalances in the EMU, contrary to what was originally believed at the onset of the Maastricht Treaty, do not have a benign nature, and have grown unsustainable in a number of Member States. Moreover, they are not only determined by fiscal policy positions, while the link with the evolution of the REER is of a very heterogeneous nature. Indeed, the recent experience in EMU shows that the most acute episodes of crisis which have recently hit some Member States have been the result of a different combination of causes: unsustainable developments in the private sector, adverse dynamics in the REER induced by excessive wage growth with respect to productivity and, in some circumstances, the accumulation of public finance debt, have contributed to current account imbalances and, ultimately, have generated credit crises.

The EU Commission seems to be aware of the latter situation and has suggested extending surveillance to macroeconomic imbalances other than fiscal deficits. In particular, it has proposed to monitor country-specific developments in current account positions, price competitiveness developments, housing prices, government debt, and private debt to GDP, setting quantitative targets for these indicators.

We argue that a rigid, quantitative approach to such a vast array of different indicators may create confusion, pre-emptying the strength and the efficacy of the monitoring and of the possible sanctioning exercise. Most of the critical situations at the level of the Member States cannot be mechanically associated to the outcome of one or another economic

9 Marzinotto, Pisani-Ferry and Sapir (2010).

indicator, but rather depend on the lack of an adequate governance of a series of imbalances emerging within a country.

This speaks against a too rigid monitoring exercise. We argue that a qualitative assessment of the main triggers of macroeconomic imbalances is warranted. In what follows, we try to outline what we believe are the most critical components of the governance of the future surveillance exercise.

2.1. The use of private debt

First and foremost, the future monitoring exercise will have to look at the evolution of the private debt. Indeed, as far as macroeconomic imbalances are concerned, its level is not as important as the financial conditions under which it has been accumulated, and the use that was made of it.

Relatively high levels of private debt are less worrying when the national financial sector is well-capitalized and generally resilient. Progress in strengthening the resilience of the banking sector is thus important to the extent that it supports the objective of a broader macroeconomic surveillance framework.

Secondly, debt-financed investment is more risky if concentrated in unproductive and bubble-prone sectors (e.g. housing markets). A closer look at housing prices, as envisaged in the Commission's guidelines, is thus warranted. Recent analyses indeed confirm a tight association between developments in real house prices and current accounts[10].

The focus on the use of the private debt is also important to the extent that it provides an indication of the most effective strategy to correct an existing imbalance. For example, wage restraint is an appropriate strategy to tackle an imbalance that was mainly generated by excessive consumption. It would not necessarily support adjustment where the imbalance came from over-investment in very specific sectors.

Even when focusing on surplus countries, it would be important to assess where the rise in net lending came from, whether it was generated by households, non-financial corporations or government. Germany, for example, saw an impressive rise in saving by firms at the turn of the century stemming from lower investment and related balance sheet adjustment (Figure 4). Stronger investment growth here would ease the burden of adjustment on deficit countries, but would also be economically beneficial to the national economy, as it would lay down the foundations for stronger potential output and long-term growth.

2.2 Prices, wages and productivity

The EU Commission has recognized the importance of looking at labour market developments as well as at the evolution of the REER. Here it is important to recall that, when assessing macroeconomic imbalances, the dynamics of prices and wages have to be looked at from at least two channels. First of all, a policy aiming at lower prices and wage moderation would be useful to control unsustainable developments in the private sector, because given a stable monetary policy stance disinflation in a country implies that real interest rates will increase, putting a halt to over-heating.

Second, and more important, lower prices and wages per se might not contribute to solving current account imbalances if they are not associated to consistent dynamics of productivity, as summarised in the behaviour of ULC. In other words, it might well be the case that the adjustment that most Member States have incurred during the crisis, in which investment has been cut much more than jobs, has generated a downward shift in

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10 EU Commission (2010b).

productivity which might not be easily compensated by wage moderation policies, especially in the current context characterized by generally low levels of inflation, and thus downward nominal rigidities.

As a result, it would be better to disentangle the different components leading to the evolution of competitiveness as proxied by ULC-based REER, making a more explicit reference to overall competitiveness levels, i.e. productivity growth. The latter reinforces the idea that broader macroeconomic surveillance is related to EU2020 and structural reform under the BEPG.

In any case, a closer alignment of wage and productivity growth can only be achieved through labour market deregulation and in particular a shift towards stronger decentralization in wage bargaining. Social partners have thus an important role to play and should be involved in the operations of the new framework by means of a strengthening of the Macroeconomic Dialogue.

3. Conclusions and Open Issues

The crisis has highlighted the importance of emerging macroeconomic imbalances within the EMU on top of rising fiscal deficits. The EU Commission has proposed an enhanced macroeconomic surveillance framework that foresees the monitoring of a number of quantitative indicators, compounded by expert analyses.

As shown by the evidence discussed in this Report, such a broader approach to the non-monetary governance of the EMU is welcome, but its implementation should entail a relatively high degree of flexibility and political judgment as most of the critical situations at the level of the Member States cannot be mechanically associated to the outcome of one or another economic indicator.

Moreover, as far as the macroeconomic imbalances related to the evolution of competitiveness across Member States are concerned, we have also shown that the detected divergence does not only depend on a particular dynamic of price or wage competitiveness, but rather to the link between those and productivity growth. Since the latter link ultimately depend on the working of product and labor markets at the national level, it then follows that effective improvements to the actual governance of EMU include also the need to strengthen the involvements of social partners.

With specific reference to the operational framework proposed by the European Commission, we have identified three relevant issues which have been only marginally touched by the Commission's Communication, and thus should be discussed more thoroughly throughout the legislative procedure leading to the set-up of the enhanced surveillance exercise.

1. The governance of the macroeconomic imbalances should be evaluated more thoroughly. The European Commission has proposed that the latter should follow a framework similar to the Stability and Growth Pact, with a preventive arm based on a set of clearly defined indicators, leading to early warnings, and a corrective arm in which Member States are obliged to react to the emerging imbalances. Given the evidence reported, it is our opinion that the preventive arm is properly defined, with the already discussed caveat of avoiding a strict mechanical approach based only on quantitative indicators, while the implementation of the corrective arm remains problematic.

In fact, provided that a clear set of measures can be identified, together with a viable roadmap, it remains to be seen:

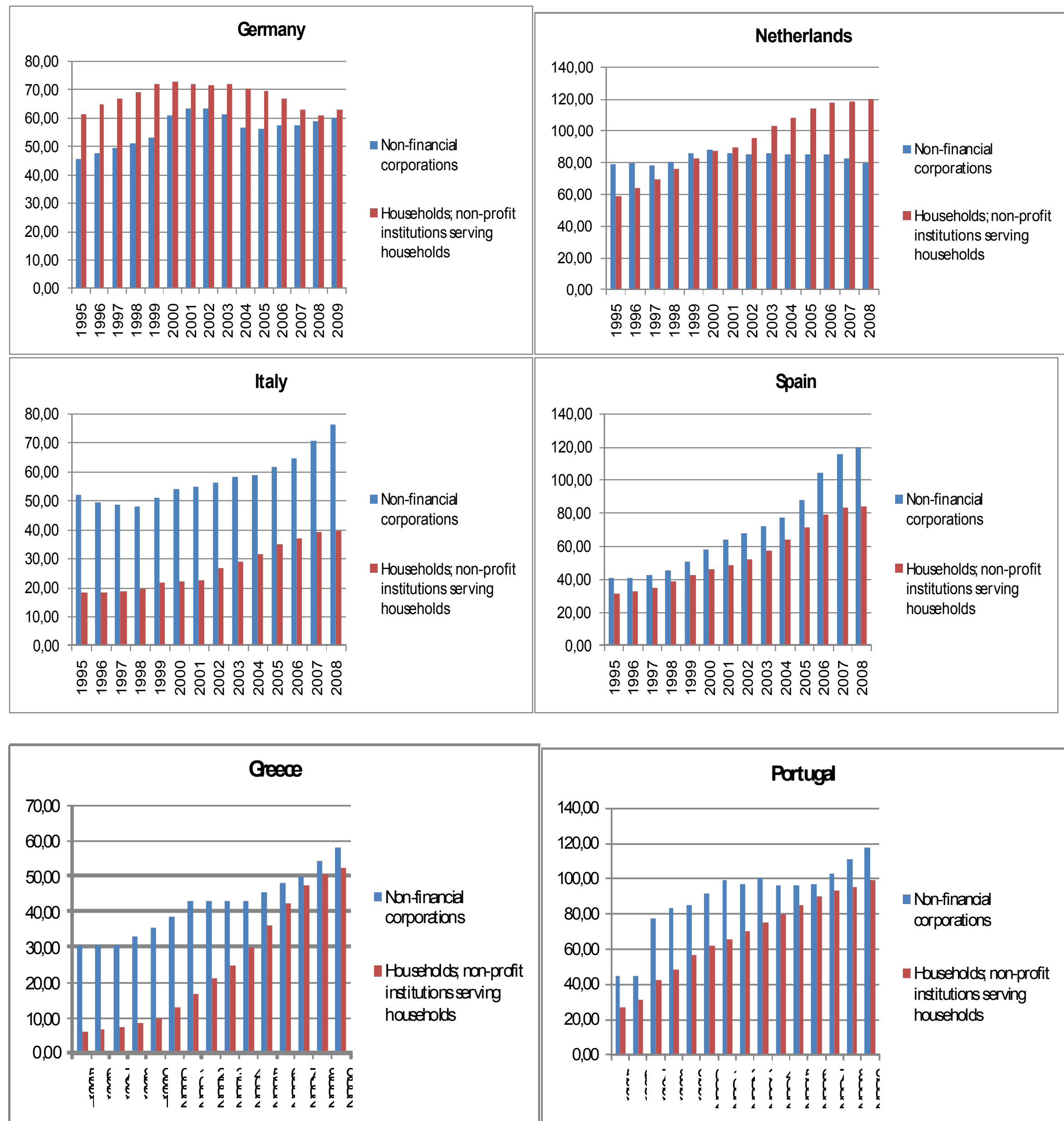
- whether the competence of the suggested action falls within the scope of the EU-level of governance (e.g. in the case of a suggested reform of the wage formation mechanism)
- whether corrections to the existing imbalances can be effectively implemented by the national Government in a defined time-span (e.g. in the case of a loss of competitiveness induced by a change in the global pattern of comparative advantages)

Given these constraints, and in light of the already discussed existing link between competitiveness divergences and productivity growth, it would be more appropriate on economic ground, and more effective on the policy one, to coordinate more explicitly the corrective arm of the enhanced surveillance mechanism with the commitments undertaken by the national Governments within the framework of the EU2020 exercise.

2. Surplus and deficit countries should not be treated symmetrically. As Figure 1 shows, one could in principle assume that, within the EMU, the deficit of a set of country is compensated by the surplus of others, in a symmetrical way (see also next point). As a result, since competitiveness is always defined in relative terms, if the symmetry hypothesis holds, one could suggest that, to reduce imbalances, either the countries in deficit become more competitive (reduce prices, increase productivity), or the countries in surplus 'voluntarily' become a bit more inefficient (e.g. increasing wages more than their productivity levels, or reducing productivity altogether) to compensate for the imbalances of the laggards. In a closed economy the latter could be a possible experiment, because no effects would emerge with respect to the rest of the World. In an increasingly globalised economy of which the EMU is one of the key hubs, however, an adjustment 'to the middle', apart from its very scant political feasibility, entails an overall loss of competitiveness for the entire area, with potentially adverse welfare consequences for the entire EMU. If across Member States the political willingness is there in any case for a principle of solidarity to apply, in which both deficit and surplus country contribute to the redressing of the imbalances, then a viable solution is the setup of some enhanced forms of fiscal redistribution, thus strengthening the role of the EU budget.

3. Better data are needed on the study of the imbalances. Beyond the apparent symmetry reported in Figure 1, in which the trade surplus of Germany is as large as the sum of the deficits of the most problematic EMU countries, one should nevertheless explore whether the financing of the current account deficits (that is the capital counterpart of the balance of payments) has indeed remained mainly within the euro area or not. As a matter of fact, a geographical coverage of cross-border financial flows is not systematically available for the euro-area Member States, and is also complicated by the fact that bilateral flows from one country to another often transit via third countries. Preliminary and partial evidence available from the European Commission (2010) on the one hand seems to point to the fact that the financing of current account deficits has remained mainly intra euro area during the financial crisis. On the other hand, however, data show that the current account position of the major surplus country (Germany) has grown asymmetric over time, with the intra-euro area component of the trade surplus remaining by and large constant in the period 1999 - 2009, while most of the trade surplus has arisen from trade outside the Eurozone. A more thorough analysis of these dynamics through the availability of better data remains thus to be performed.

Figure 4: Private debt by type of debtor



Source: Bruegel calculations, Eurostat.

Box 1: The European Commission's proposal

In June 2010, the European Commission submitted a list of detailed proposals designed to strengthen policy coordination in the EU. The communication addresses the gaps in the existing governance system that allowed unbalances to develop unfettered and did not provide sufficient incentives for countries to comply with the existing frameworks. The Commission provides the details for an enhanced "sanctions toolbox", as well as the processes and timing of a European semester for policy coordination designed to allow ex-ante European input to national policy decisions. I additional to the proposals related to national fiscal frameworks and the SGP, a detailed framework for broader macroeconomic surveillance is provided. These proposals are expected to be translated into draft legislative proposals by the end of September 2010. In keeping with the spirit of SGP, the suggested macroeconomic surveillance framework comprises a preventive and a corrective arm, the latter applying to Member States that present significant risks.

Preventive arm

The alarm system designed under the preventive arm of the proposal consists in two parts:

1) A scoreboard, consisting in a set of indicators. The Commission indicates that these would include "measures of the external position and price or cost competitiveness, as well as internal indicators". The communication specifically mentions the following:

- Current account balances
- Net foreign asset positions
- Real effective exchange rates (based on unit labour costs and a GDP deflator)
- Increases in real house prices
- Government debt
- Ratio of private sector credit to GDP

The 75% and 25% percentile of the statistical distribution of each of these measures could form the basis of the alert thresholds, although the Commission recognizes their necessarily arbitrary nature. The communication also states that:

- The thresholds could be different for euro-area and non-euro area countries.
- REER in euro-area countries would receive greater attention than in non-euro area countries
- The results of the scoreboard would not be directly and mechanically linked to policy recommendations

2) "Qualitative expert analyses". The communication does not give any details on this point, though it is mentioned that the recommendations issued on the basis of the alert mechanism could address a broad range of policy issues and would be incorporated into annual country-specific recommendations alongside those issues under the thematic surveillance of structural reforms included in the corrective arm.

Corrective arm

Countries deemed to be in a significant risk situation would be placed in a position of « excessive imbalances ». The Member States concerned would be subject to stricter surveillance and regular reporting to the Ecofin Council and the Eurogroup, regarding the implementation of policy recommendations issued by the Council. Under the Commission proposal, the preventive arm would also contain a specific set of enforcement mechanisms for euro-area member states, though the contours of these mechanisms are not detailed.

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