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The “Relative” Importance of EMU Macroeconomic Imbalances in the Macroeconomic Imbalance Procedure

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ABSTRACT

The European Commission has recently published results of its “in-depth review” in the context of the so-called Macroeconomic Imbalances Procedure (MIP). This provides a valuable occasion to reflect on the design and effectiveness of the MIP. The authors note that the MIP is envisaged to warn of future crisis within the euro area, so it does not make sense to use absolute indicators or thresholds, especially if they are backwards looking. Threads to the “smooth” functioning of the EMU come from countries which deviate from the average and the corresponding indicators should be forward looking as corrective policies cannot do anything about the past.

European Union | Eurozone crisis | Economy | Finance

keywords

The “Relative” Importance of EMU Macroeconomic Imbalances in the Macroeconomic Imbalance Procedure

by Daniel Gros and Alessandro Giovannini*

The European Commission (EC) has recently published results of its “in-depth review” (IDRs) in the context of the so-called “Macroeconomic Imbalances Procedure”.¹ The Commission has identified imbalances in 14 EU countries of which 9 Members of the European Monetary Union (EMU): Belgium, Germany, Ireland, Spain, France, Italy, Netherlands, Slovenia and Finland. Only in three cases (Croatia, Italy and Slovenia) the EC has recognised the existence of excessive imbalances that requires strong and comprehensive policy measures to undertake significant adjustments.

The publication of these results provides a valuable occasion to reflect on the design and effectiveness of the Macroeconomic Imbalance Procedure (MIP). In fact, the MIP framework, introduced in 2011 as part of the EU’s so-called “six-pack” legislation,² has been designed to early identify the emergence of risky macroeconomic imbalances that could damage or jeopardise the functioning of the EMU.

A first issue is whether one should look at stocks or flows. The stocks (of debt for example) are fixed in the short run. Economic policy can usually only affect the flows, i.e. deficits and surpluses (the debt reduction in the context of the Greek private sector involvement operation constitutes an exceptional operation on a stock (of debt)). Officially this distinction between stocks and flows is not made

¹ European Commission, *Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances* (COM(2014) 150 final), 5 March 2014, <http://eur-lex.europa.eu/legal-content/en/NOT/?uri=celex:52014DC0150>.

² Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances, <http://eur-lex.europa.eu/legal-content/en/NOT/?uri=celex:32011R1176>.

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explicitly, but the relevant EU regulation defines an “imbalance” as follows:

any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the economic and monetary union, or of the Union as a whole³

The Regulation refers implicitly more to flows, than stocks, which makes sense given that the MIP and its scoreboard are engineered as a preventive tool, meaning that it should prevent the built up of stock imbalances which then might precipitate a crisis. Looked the problem this way it is clear that the external imbalances, which characterised a number of Southern euro area Member States until, recently have almost disappeared. All of the countries that were until recently under considerably financial stress are now running current account surpluses.

Is this warning system able to correctly identify these risks? Let us start by taking a cue from the experience matured in the alert mechanisms for natural disasters (floods, hurricanes volcanic eruptions, etc.). Here an efficient system is such if it is able to “detect impending disaster, give that information to people at risk, and enable those in danger to make decisions and take action”.⁴ A simple definition, which could be applied (with some modifications), to the economic/financial field: an efficient alert mechanism should be able to correctly “screen” all the economic/financial occurrences of a country, detect only those that are signalling possible “disasters” and provide solid basis for policy makers to take effective corrections.

The scoreboard indicators presented in an annual Alert Mechanism Report (AMR), together with the IDRs, should be therefore able to accomplish this task: using a set of eleven indicators covering the major sources of macroeconomic imbalances it represent the basis for the subsequent in-depth studies to determine whether the potential imbalances identified in the early-warning system are benign or problematic. However, the designing of some of indicators the AMR could potentially prevent the EC and the Member States from being able to identify those imbalances that could pose “serious risk” from those that are not. If, in fact, too many “alarms” bell together, it is difficult to understand which are really more important than others, i.e. which imbalances could seriously pose damages to the EMU. To understand this point, let us concentrate on the part of the scoreboard relating to external imbalances and competitiveness.

A key point is that the Excessive Imbalance Procedure (EIP) should to warn of impending problems within the EMU. It is thus questionable whether one should use absolute indicators thresholds. For example, if all countries had a large external deficit, a sudden stop to capital inflows would affect all of them at the same time.

³ Art. 2 of the Regulation (EU) No 1176/2011.

⁴ John H. Sorenson, “Hazard warning systems: Review of 20 years of progress”, in *Natural Hazards Review*, Vol. 1, No. 2 (May 2000), p. 119.

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But given that the euro exchange rate is flexible, the sudden stop to capital inflows would play out quite differently than a sudden stop inside the euro area.

And if most euro area countries run external surpluses, a particularly large surplus in any one country should not be regarded necessarily as an “imbalance”. This consideration applies more in general to all the three main indicators of the competitiveness block.

A first indicator here is the evolution of Export Market Shares.⁵ This indicator shows the change in export market shares over five years, based on Balance of Payments Eurostat data, with a lower indicative threshold of -6%. In the 2013 Scoreboard, only three over seventeen euro area States did not exceed this limit (see Table 1).

Table 1. Scoreboard indicators: absolute vs relative indicators

	Market Share		REER		Current account balance	
	Absolute value	Relative to EA weighted average	Absolute value	Relative to EA weighted average	Absolute value (as % GDP)	Relative to EA consolidated value (as % GDP)
Belgium	-14.9	0.9	-4.3	0.6	-0.4	-1.3
Germany	-13.2	0.8	-8.9	1.3	6.5	5.6
Estonia	6.5	-0.4	-3.4	0.5	0.9	0.0
Ireland	-16.3	1.0	-12.2	1.7	2.3	1.4
Greece	-26.7	1.7	-4.5	0.6	-7.5	-8.4
Spain	-14.6	0.9	-5.2	0.7	-3.1	-4.0
France	-14	0.9	-7.8	1.1	-1.8	-2.7
Italy	-23.8	1.5	-6.2	0.9	-2.3	-3.2
Cyprus	-26.6	1.6	-5.8	0.8	-6.7	-7.6
Luxembourg	-18.3	1.1	-2.3	0.3	7.0	6.1
Malta	4.5	-0.3	-7.7	1.1	-1.6	-2.5
Netherlands	-12	0.7	-6	0.8	8.8	7.9
Austria	-21.2	1.3	-4.7	0.7	2.2	1.3
Portugal	-16	1.0	-4	0.6	-6.5	-7.4
Slovenia	-19.9	1.2	-4.5	0.6	1.2	0.3
Slovakia	4.2	-0.3	-3.2	0.5	-1.7	-2.6
Finland	-30.8	1.9	-8.3	1.2	-0.5	-1.4

Red: above the threshold / above the EA weighted average

Source: authors' elaboration on Eurostat scoreboard platform⁶ data, 2014.

⁵ Declan Costello and Jonas Fischer (eds.), “Scoreboard for the surveillance of macroeconomic imbalances”, in *European Economy. Occasional Papers*, No. 92 (February 2012), http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/op92_en.htm.

⁶ Available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/macroeconomic_imbalance_

Why this is relevant? The rationale of the competitiveness indicators is that the absence of the exchange rate instrument between member countries it becomes more difficult deal with external imbalances. However, if most of the Member States experience a similar trend, the Euro exchange rate can react limiting the need of big structural adjustments ad level of individual member countries.⁷

A similar consideration holds also for the Real Effective Exchange Rate (REER) indicators that measures if the percentage change over three years has exceed the indicative thresholds of +/-5%. Comparing the trend with the trend of the euro area, it emerges that only Ireland has a very divergent trend, while considering the absolute indicators nine countries were signalled by the scoreboard.

Final, another element that have generate a large debate in the past months has been the Current Account Balance indicator, that measure the three-year backward moving average of the current account balance expressed in percent of GDP, with the indicative thresholds of +6% and -4%. Table 1 shows that it makes a big difference whether one looks at the indicators per se, or relative to the euro area. For instance the difference between Germany and the euro area taken as a whole remains comfortably below the threshold. One could thus argue that if one looks at the deviations from the euro area average it would not be appropriate to consider Germany as having violated a threshold (but this would continue to be the case for the other two counties running large current account surplus, namely Netherlands and Luxembourg). The countries running a current account deficit instead will continue trigger a flashing red light: moreover, the French deficit remains modest, but it would appear far away from the euro area average.

In particular regarding current account imbalances one has to take into account that the MIP and its scoreboard are a preventive tool.⁸ Thus, the indicator should be forward, not backwards, looking. For Germany, the forward-looking average (2012-14) still triggers the indicator, but on a forward-looking basis, none of the formerly deficit countries has an imbalance any longer, as these countries run now surpluses.

procedure/indicators.

⁷ Moreover, the loss of in export market share is common to all advanced economies due to structural change in international trade imposed by the rise of emergent countries. Therefore, the absolute change of the single Member States is not an effective indicator per-se. This problem has been recognized also by the Commission that has now started to publish a new additional indicator that compare the export performance of each country with the export performance of a group of advanced countries. See: European Commission, *Refining the MIP scoreboard. Technical Changes to the Scoreboard and Auxiliary Indicators Accompanying the ... Alert Mechanism Report 2014* (SWD(2013) 790 final), 13 November 2013, <http://eur-lex.europa.eu/legal-content/en/NOT/?uri=celex:52013SC0790>.

⁸ See Daniel Gros with Matthias Busse, “The Macroeconomic Imbalance Procedure and Germany: When is a current account surplus an ‘imbalance?’”, in *CEPS Policy Briefs*, No. 301 (13 November 2013), <http://www.ceps.be/node/8593>.

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Concluding, as the MIP is envisaged to warn of future crisis within the euro area, it does not make sense to use absolute indicators or thresholds, especially if they are backwards looking. Threads to the “smooth” functioning of the EMU come from countries which deviate from the average and the corresponding indicators should be forward looking as corrective policies cannot do anything about the past.

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