DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

MACROECONOMIC IMBALANCES IN THE EURO AREA

NOTE

Abstract

The presence of macroeconomic imbalances in the Euro Area is not necessarily a source of concern. Budget deficits are unsustainable but current account imbalances related to net private saving imbalances are typically self-correcting, although correction can take the form of a crisis in the presence of financial imbalances. The Six-Pack solution is misguided, unlikely to work and damaging to the overall architecture. The Fiscal Pact and the European System of Financial Supervision, on the other hand, are appropriate responses to unsustainable imbalances. Policymakers would be well inspired to focus on implementing correctly these important innovations, which make the Excessive Deficit Procedure and the Excessive Imbalance Procedure redundant and potentially harmful.

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EXECUTIVE SUMMARY

The presence of macroeconomic imbalances is unavoidable within any monetary union. The sources of such imbalances were in fact carefully analyzed and predicted in the academic literature, along with alleviating measures. Policymakers chose to ignore these warnings. The current crisis has revealed the cracks. The cost, in terms of lost income, high unemployment, public debt build-up, social stress and individual sufferings is gigantic.

Macroeconomic imbalances are related in often-subtle ways. In particular, current account imbalances can be related to budget imbalances or to imbalances in the private sector. The experience in the Euro Area so far is that current account imbalances have been driven by private sector imbalances. In some cases, these imbalances have been created by unsustainable, excessive credit growth; in most other cases, they are self-correcting. At any rate, the view that current account imbalances have led to the sovereign debt crisis is incorrect. It is also the case that the common monetary policy cannot deal with the macroeconomic imbalances.

Four main conclusions emerge. First, fiscal discipline, the root cause of the crisis, needs to be established. The recently adopted Fiscal Treaty finally circumvents the reasons that have led to the failure of the Stability and Growth Pact. By decentralizing the task of imposing fiscal discipline, the treaty is free of the conflict between collective supervision and national sovereignty of fiscal policies.

The second conclusion is that unsustainable credit booms have developed because national bank regulators and supervisors failed. The newly created European System of Financial Supervision aims at improving the situation, without replacing the national bodies.

The third conclusion is that the Six Pack legislation is misguided. Like the EDP, the EIP faces the hurdle that the relevant policy instruments are in national hands. Its aim are better served in the hands of national fiscal institutions and of the European System of Financial Supervision. The Six Pack is not just redundant, it is also counter-effective because unenforceable laws undermine the objectives that they aim at serving.

Finally, policymakers should focus their efforts in making the good reforms work. This means adopting effective national fiscal institutions and ensuring that the European System of Financial Supervision is given and exercises the required authority, and that its various institutions work harmoniously together.

1. INTRODUCTION: THE COST OF DENIAL

In the 1980s and 1990s, a huge academic literature – the Optimum Currency Area – has explored the conditions under which a common currency is desirable and could work in Europe.[1] This literature identified country-specific disturbances (called "asymmetric shocks") and different impacts of the common monetary policy (called "asymmetric effects of common shocks") as sources of difficulties. It suggested that Europe was likely to be subject to such disturbances because of limited labour mobility, but that reasonably common production and trade structures implied that these disturbances would not be too frequent. This literature noted that there were ways to compensate for these risks, mostly through adequate common insurance systems, but that the adoption of such systems required a sense of common interest that could be limited. Another part of the literature clearly identified fiscal discipline as a fundamentally necessary attribute of the common currency. Finally, the literature expressed deep concern about the inappropriateness of the national-based bank regulation and supervision systems.

By and large, policymakers have ignored this literature as they crafted the Maastricht Treaty and the Stability and Growth Pact. While the academic literature insisted on real convergence as a condition for success, official agreements squarely focused on nominal conditions for admission to the Euro Area, in the form of the five convergence criteria. The academic literature criticized the absence of adequate transfer mechanisms and warned that the Stability and Growth Pact was flawed, but policymakers chose to ignore the warnings and to deny that the Euro Area architecture was incomplete and partly inadequate. Policymakers were focused on making the common currency appear as an unmitigated good idea and then to prove that it was a remarkable success. Communication strategies took over and swept under the rug any suggestion that the new arrangement was less than perfect.

The sovereign debt crisis has revealed the cracks. The cost, in terms of lost income, high unemployment, public debt build-up, social stress and individual sufferings is gigantic. Policymakers have failed their citizens.

If that were not enough, they are set to fail again. The recently adopted "Six Pack" legislation, decided by the Council, mooted by the Commission and adopted by the European Parliament, is as ill-thought through as the Stability and Growth Pact. Policymakers are as impervious as ever in their self-assessment. The Commission, for instance, writes:
"The EU and its Member States have taken a series of important decisions that will mean stronger economic and budgetary coordination for the EU as a whole and for the euro area in particular. As a result, the EU's interdependent economies will be better placed to chart a path to growth and job creation."
(http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/364)

In fact, the Six-Pack agreement relies on a faulty analysis of the crisis, promoted by the European Commission in an attempt to recover some of its power lost to the severe prevalence of inter-governmentalism. The European Parliament too has indulged into power struggle and proudly announces:
"it is also important to remember a whole host of other improvements which came about through pressure from MEPs. Taken together, these improvements should make the "six pack" both a firmer body of rules in comparison to the current system but also enable a more intelligent application of the rules."

[1] An overview can be found in Baldwin and Wyplosz, *European Integration*, McGraw Hill, 2009.

(http://www.europarl.europa.eu/news/en/pressroom/content/20110920BKG27073/html/FAQ-on-the-economic-governance-six-pack)

These refinements concern procedures and details, but they fail to deal with the faulty analysis that underlies the new instruments.

2. A FAULTY ANALYSIS

The Six Pack legislation aims at strengthening the Stability and Growth Pact by making it more encompassing and more automatic and at establishing a monitoring of macroeconomic imbalances (current accounts and labour costs, mainly) with a new set of associated sanctions. The underlying reasoning is that:

1. The Euro Area crisis is a consequence of fiscal indiscipline.
2. Fiscal indiscipline occurred because the Stability and Growth Pact had been flouted but a stronger pact can succeed.
3. The crisis was also the consequence of other macroeconomic imbalances, such as housing price bubbles, large current account imbalances due to diverging labour cost trends.

This report will argue that (1) is correct but (2) and (3) are wrong. It follows that the Six Pack legislation is not an adequate response to the crisis. Fortunately, the Fiscal Compact finally approved in March 2012 goes a long way toward dealing with (1), although too many loopholes remain for comfort or simply hope.

Concerning (2), in brief, the Stability and Growth Pact has failed for reasons that have long been know (see, for example, my Briefing Notes to the Committee of Economic and Monetary Affairs of 2001, third quarter and 2004, first quarter). Although some improvements have been gradually implemented, including defining the budget in cyclically-adjusted terms and paying more attention to the debt path, the pact still suffers from the fact that fiscal policy is very clearly a matter of national sovereignty. “Strengthening” the Commission and making fines more automatic will not resolve this inconsistency between two different pieces of European legislation. In the end, sovereignty is likely to continue trumping “orders from Brussels”.

The next two sections will deal with (3). This is a controversial issue; indeed a number of economists agree with this statement. Policymakers have accepted it in a sort of preventive manner: maybe we do need to bring in current account imbalances and labour costs to explain the crisis, but dealing with them cannot hurt, it can only help. I will argue that it can and will hurt.

3. CURRENT ACCOUNT IMBALANCES[2]

Growing current account imbalances were noted before the crisis but studiously overlooked by policymakers.[3] As new converts often do, policymakers have since over-reacted. It is important to understand what lies behind the undisputed fact that current accounts have indeed diverged. Two observations are crucial.

[2] Part of this section’s analysis has been presented in my Note of 2010, 3rd quarter.

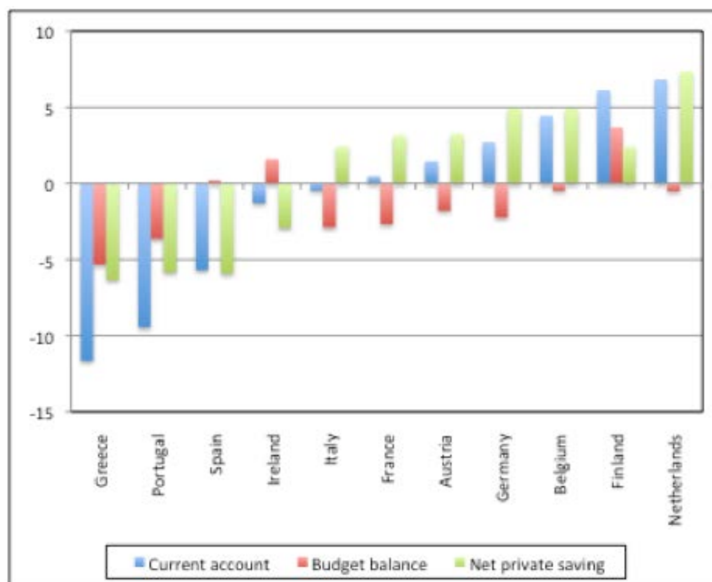
[3] See e.g. Mongelli and Wyplosz, “The Euro at Ten: Unfulfilled Threats and Unexpected Challenges”, in: Bartosz Mackowiak, Francesco Paolo Mongelli, Gilles Noblet and Frank Smets (eds), *The Euro at Ten – Lessons and Challenges*, European Central Bank, 2009.

First, bilateral divergences between two countries – or two groups of countries – have no economic meaning. A country may run a deficit with one trade partner, a surplus with another, and an overall balance. These patterns may reflect the comparative advantage principle that is a fundamental justification for international trade. The obvious example is that China, an oil importer, may have a deficit with Saudi Arabia and a surplus with the European Union because it produces cheap products. The surplus with the EU, in fact, is needed to help China pay for its oil imports.

Second, the current account balance is necessarily the sum of the budget balance and of net private saving. This means that the three balances are unavoidably linked. One imbalance may cause another, or both may be caused by a common third factor. This is a difficult issue, not to be left to summary judgements. Figure 1 below should instil a strong sense of scepticism about why countries face current account imbalances.

For the older Euro Area member countries, the figure displays the current account, the budget balance and net private savings, averaged over 1999-207, the euro years until the crisis. The question is: is there a systematic pattern that explains the current account imbalances? To start with, note that the current account has been approximately balanced in Italy and France; in both cases, it has come along with significant budget deficits matched by positive private savings. The Northern countries are often linked with current account surpluses, which is indeed the case. Finland, which displays surpluses in both the budget and net private savings, stands apart. Elsewhere (Austria, Germany, Belgium and the Netherlands), the current account surpluses occur along with moderate budget deficits and large net private savings. The Club Med countries (Greece, Portugal, Spain) have large current account deficits, but they are the mirror images of Finland, not of the other Northern countries: negative net private savings are combined with large budget deficits, except in Spain where the budget outcomes are like in the Northern countries.

Figure 1: The three macroeconomic imbalances – Averages over 2000-2011
(Percent of GDP)



Source: European Commission, AMECO on line.
Note: Current account = budget balance + net private savings

The main lesson from Figure 1 is that current account balances are correlated with net private savings. There is no support for "twin deficits", the systemic combination of budget and current account deficits (or surpluses). In other words, don't blame government finances for the current account pattern, blame the voters. Unfortunately explaining net private imbalances is more difficult. Greece, Ireland and Spain underwent credit booms that fed high spending, but this explanation does not fit Portugal.

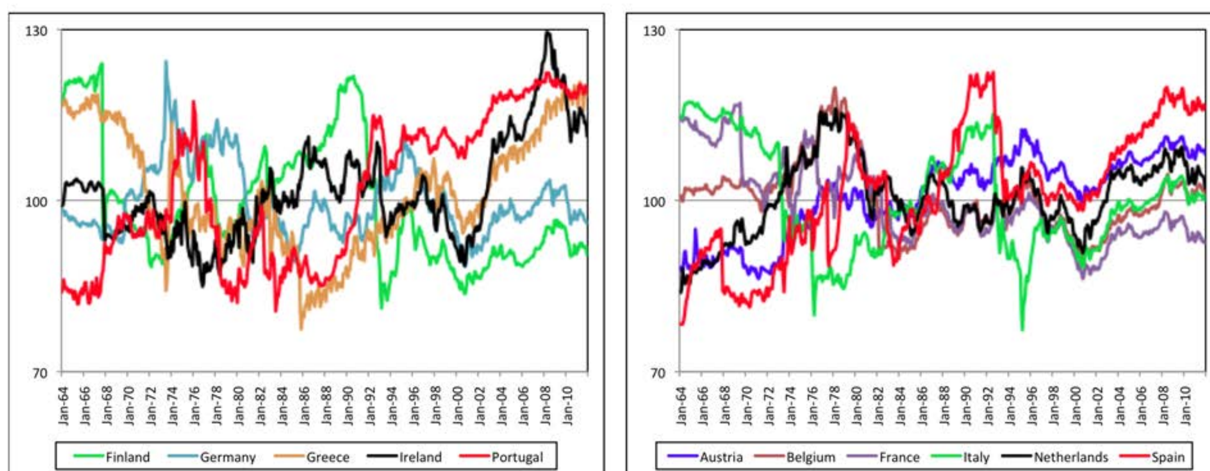
4. EXCHANGE RATE OVERVALUATION

Declining net savings point in the direction of external competitiveness. When the exchange rate is overvalued, foreign goods are relatively cheap and exports relatively unprofitable. This effect, called the Laursen-Metzler effect, is the prime suspect.

Detecting over and undervaluation is a complex task. Figure 2 takes a first informal cut. It plots the real effective exchange rate of the countries displayed in Figure 1. The rates are indexed so that, the average over the whole period 1964-2011 is 100. Under the assumption that the real exchange rate is trendless, one can argue that values above 100 correspond to periods of overvaluation and to undervaluation below 100.[4]

The figure shows that the adoption of the euro has put en end to the wide fluctuations that prevailed previously. It also shows that, since 2000, all countries have undergone a process of trend real appreciation, reflecting the growing strength of the common currency after its initial weakness. In more detail, we see that the real appreciation has been strongest in the Southern countries and in Ireland while the real exchange rates of Finland, France and Germany have remained undervalued.

Figure 2. Real effective exchange rates in the Euro Area. 1964-2011
Index 100 = sample average

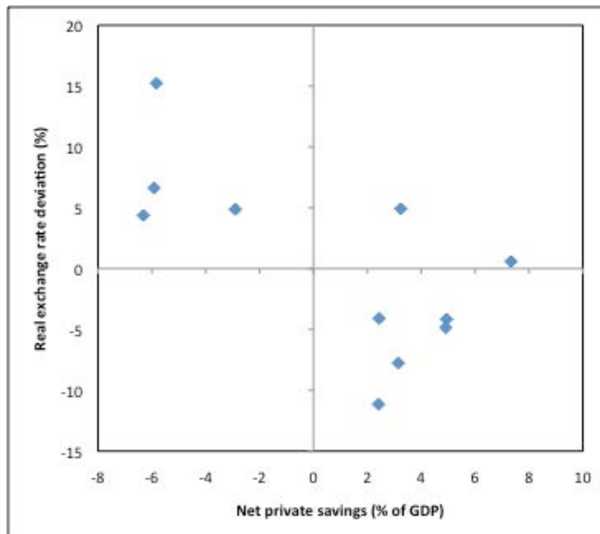


Source: Bank for International Settlements

[4] This assumption, called relative purchasing power parity, is known to hold in the long run for countries at similar stages of development if they do not undergo serious structural changes. This is why the evidence presented her is a rough first cut.

Figure 3 relates average net private savings (as a percent of GDP) over 1999-2007, as shown in Figure 1, to the differences in the average real exchange rate between the same period 1999-2007 and the pre-euro period 1964-1998; a positive value suggest an overvaluation. The figure suggests that, indeed, negative net private savings tend to occur when the real exchange is overvalued, and conversely net private savings tend to be positive where the real exchange rate is undervalued (the correlation is -0.68).

Figure 3. Net private savings and the real exchange rate



Sources: See Figures 1 and 2.

5. THE ROLE OF THE ECB

The divergent evolution of real exchange rates within the Euro Area should not have come as a surprise. They are a consequence of the Walters critique.[5] Real interest rates are lower in countries that join the currency area with higher inflation and then share the same nominal interest rate. As a consequence, the common monetary policy is expansionary where inflation is higher, and conversely it is contractionary in countries where inflation is low. Walters predicted growing divergence in inflation rates. Instead, inflation differentials have not widened but current accounts diverged.[6]

There is nothing that the ECB can do about that. It can only carry out its monetary policy for the Euro Area as a whole. Inflation differentials, whether inherited from the past or the result of new events, are bound to occur now and then. In principle, competitiveness losses should eventually bring about price (and wage) moderation while competitiveness gains will lead to rising inflation, so that the differentials are reversed and current account imbalances eliminated. This is understood to take time, but if left to operate, the mechanism is self-equilibrating.

[5] Alan Walters, "The Walters Critique" in: P. Newman, L. Milgate and J. Eatwell (eds.) The New Palgrave Dictionary of Money and Finance, 1994, p. 781-783.
[6] This is analysed in Mongelli and Wyplosz, op. cit.

This is exactly what happened after the launch of the euro. Low real interest rates led to rapid credit expansion, which in some instances fuelled a housing boom bubble. It so happened that, in some of these countries, low real interest rates reduced the cost of public borrowing, which encouraged some governments to simultaneously expand their budget deficits.

An important implication is that the sovereign debt crisis was not *caused* by current account imbalances. Negative net private savings and large budget deficits were a common consequence of the Walters critique effect.

6. THE NEW GOVERNANCE ARCHITECTURE

Excessively rapid credit growth is the responsibility of the bank regulators and supervisors. They obviously failed to take appropriate action, such as raising credit requirements. Similarly, in spite of its declared interest for monetary aggregates, the ECB did not send clear warning signals. The newly created European Systemic Risk Board (ESRB) should task itself with detecting regulatory and supervisory lapses in conjunction with the European Banking Authority (EBA).

The Excessive Imbalance Procedure (EIP) will rely on a large numbers of indicators (the scoreboard) to detect imbalances and to provide countries with instructions under the threat of fines. Like the EDP, the EIP will face the fact that the policies that it may require are in the realm of national sovereignty. The failure of the EDP led to the sovereign debt crisis because budget deficits were left to linger. Will the predictable failure of the IEP lead to similarly disastrous consequences?

If the ESRB and the EBA fulfil their mandates, macroeconomic imbalances due to inadequate credit growth (net private savings disequilibria) will be taken care of. If the new Fiscal Pact, which appropriately seeks to decentralize fiscal discipline, delivers on its objective, the EIP's limitations – and the predicted failure of the new strengthened EDP – are of no consequence. In other words, among the many governance changes decided since the start of the sovereign debt crisis, two are potentially helpful: the creation of the European System of Financial Supervision (which includes the ESRB and the EBA) and the Fiscal Pact. The rest, especially the Six Pack extension of the Stability and Growth Pact, is redundant.

7. CONCLUSIONS

Should the Six Pack legislation dispensed with, then? One view is that the Fiscal Pact is part of the overall architecture. This may be legally so, but from an economic viewpoint, it is the new pact – if properly implemented – that is the appropriate solution to the fiscal discipline requirement.[7] Another view is that more is better and that the EDP and IEP can provide support to the Fiscal Pact and to the interventions of the ESRB and the EBA. These views ignore the deleterious effects of obligations that are not enforced because they are not enforceable. Not only does it undermine the credibility of the European system of governance in the eyes of those – citizens, financial markets – who cannot discern the subtleties of the architecture, but it can also confuse policymakers. A relevant example is the ease with which the Treaty's no-bailout rule has been effectively ignored once the EDP has been violated. Adding rules on top of each other, mixing useful and useless ones, is a terrible way of drawing the lessons of the crisis.

[7] I have argued in favour of a decentralized arrangement of this type in many notes to the Committe of Economic and Financial Affairs of the European Parliament, most recently in the reports of 2010, 1st and 2nd quarters.