Europe in Crisis

Balancing Imbalances: Improving Economic Governance in the EU after the Crisis

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The EU's response to the crisis: an overview

The recent financial and economic crisis is the largest economic shock to hit Europe since the Great Depression of the 1930s. It has caused dramatic losses in output and employment, and eroded the sustainability of public finances in a number of EU member states (see Table 1). The crisis has had a strikingly differentiated impact on individual EU countries, which was linked to a number of reasons.[1] One of the most prominent ones was the accumulation of increasingly large macroeconomic imbalances and expansion in competitiveness divergences in the pre-crisis period. The unwinding of these imbalances, particularly in the euro area, then contributed to the gravity and propagation of the crisis in a number of member states by deepening the contraction as well as aggravating the situation of public finances.

The speed and scale of the crisis took all countries and international organisations by surprise. The EU has nonetheless responded in a coordinated and comprehensive manner. The primary aim was to ensure financial stability and deal with the impact of the recession. In the early stages, the focus invariably was more of a crisis management nature. Action was taken to stabilize the financial system and its institutions. Thanks to resolute policy reactions, including expansionary monetary and fiscal policies, financial meltdown was avoided and the output losses were relatively limited in a historical perspective and given the scale of the crisis.

Over time, the focus of policy action has shifted to measures to address the long-run consequences of the crisis on growth and fiscal sustainability and policies to prevent future reoccurrences. The EU now has developed, and is implementing, a comprehensive response to the crisis spanning virtually all realms of economic and financial policy. In terms of its breadth, ambition and state of advancement, it compares very favourably with other countries around the world.

The main logic behind this approach is governed by the need to address a triplet of mutually intertwined objectives: (i) to successfully accomplish the financial repair and fix the regulatory weaknesses in the financial system; (ii) to proceed with fiscal consolidation and put the strained public finances back on sustainable paths; and (iii) to boost growth and competitiveness in the EU in order to alleviate the necessary adjustment and limit the long-run costs of the recession. To achieve these objectives, this approach combines the following main elements (see Figure 1):

- *Policies to restore health and stability of the banking and financial systems.* These include an overhaul of regulatory framework for financial services[2] and the establishment in November 2010 of a new framework for the surveillance of systemic macro and micro financial risks through the European

Table 1

Impact of the crisis on key macroeconomic variables in the EU

	2005–07	2008–10	2011–12*
GDP growth rate (%)	2.7	– 0.6	1.9
Per capita GDP growth rate (%)	2.3	– 1.0	1.6
Unemployment rate (%)	8.1	8.6	9.3
Government debt (% of GDP)	61.1	72.3	82.8

Note: * ECFIN 2011 Spring Forecast.

Source: European Commission.

* European Commission.

[1] For a thorough discussion of the causes and impact of the crisis in the EU – see European Commission (2009).

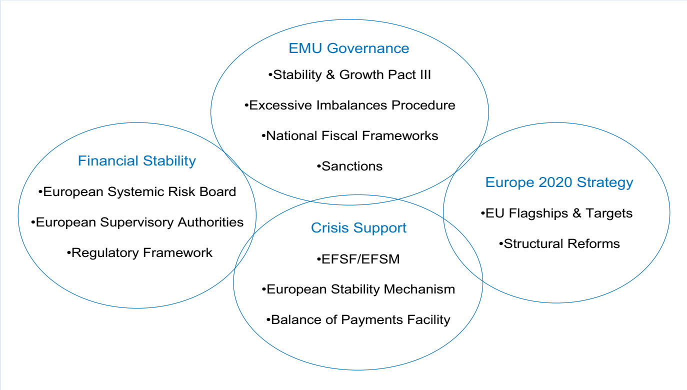
[2] This overhaul of the supervisory framework is complemented by improvements in the financial regulatory environment, including for banks, hedge funds and credit rating agencies, by the development of crisis resolution mechanisms for banks and by improvements in consumer protection.

Systemic Risk Board (ESRB) and three European Supervisory Authorities.

- *Support mechanisms for vulnerable countries.* As the crisis revealed important vulnerabilities in several EU member states, specific support has been provided to them in order to help them withstand market pressures and implement appropriate policies to regain confidence. While these vulnerabilities were of differing nature, external and internal imbalances were a critical factor and magnified the impact of the crisis. While these vulnerabilities were of differing nature, external and internal imbalances were a critical factor and magnified the impact of the crisis. Several non-euro area countries – Hungary, Latvia and Romania – have benefitted from Balance of Payments (BoP) assistance in recent years and the size of the BoP Facility was increased from 12 billion euros to 50 billion euros in 2009. In response to the fiscal crisis in Greece in May 2010, the European Financial Stability Facility (EFSF) and European Financial Stabilisation Mechanism (EFSM) were established for euro area countries up until 2013, and additional programmes are now also in place for Ireland, Portugal and Greece. The European Council of 24/25 March 2011 has agreed a permanent crisis resolution tool entitled the European Stability Mechanism (ESM).
- *The Europe 2020 strategy to raise growth and jobs embedded in a European semester.* Surveillance under Europe 2020 will focus on promoting structural reforms to remove the most important bottlenecks to sustainable growth from member state perspectives. The Community dimension is also a key component, with the European Council setting five headline targets for the Union to achieve by 2020, and agreeing detailed work programmes in seven flagship initiatives.[3] Moreover, the organisation of economic surveillance has been adapted to fit a European semester approach with two key features. First, surveillance of fiscal policy under the Stability and Growth Pact (SGP), on macroeconomic imbalances under a new Excessive Imbalances Procedure (EIP) and on growth/jobs under the Europe 2020 strategy are to be aligned in time to take account of policy interlinkages. Secondly, the European Council will agree policy orientations in spring each year to provide *ex ante* policy guidance in relation to the national budget cycle so as to strengthen policy synergies and avoid policy inconsistencies. The Euro Plus Pact, agreed by the European Council in March 2011 underlines the enhanced role which the European Council intends to play in shaping economic policy priorities and ensuring follow-up implementation.[4] These innovations should create conditions for achieving simultaneous progress on fiscal consolidation and enhancing growth potential.
- *Establishing a new system of economic governance in EMU.* The economic crisis revealed stark shortcomings in the approach to economic policy coordination in the EU. Systemic improvements in the conduct of policy coordination and enforcement of rules are crucial to proceed with the necessary consolidation of public while ensuring balanced growth and smooth adjustment to (idiosyncratic) shocks. In September 2010, the Commission presented six new legislative proposals to strengthen economic governance. It includes proposals to strengthen the preventive and corrective arm of the SGP (*inter alia* to allow for a more graduated approach to the imposition of financial sanctions earlier on in the procedure), the creation of a new EIP including the possibility to impose sanctions for euro area countries and a proposal for a Council Directive on requirements for budgetary frame-

Figure 1

OVERVIEW OF THE EU'S RESPONCE TO THE CRISIS



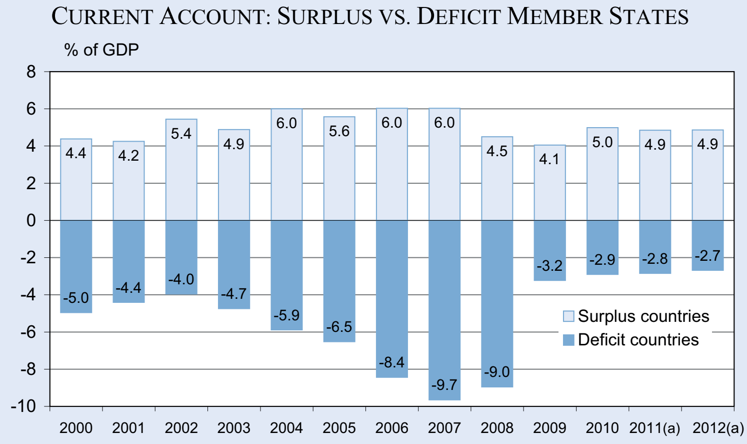
Source: European Commission.

[3] 'A digital agenda for Europe', 'Youth on the Move', 'Innovation Union', 'An industrial policy for the globalisation era', 'An agenda for new skills and jobs', 'European platform against poverty' and 'Resource-efficient Europe'.

[4] In the 'Euro Plus Pact', euro area member states and others on a voluntary basis (Bulgaria, Denmark, Latvia, Lithuania, Poland, Romania) will pursue the following objectives: (i) foster competitiveness; (ii) foster employment; (iii) contribute further to the sustainability of public finances; and (iv) reinforce financial stability.

works of the member states. There is broad consensus on the substantive elements of these proposals shared by the Council and European Parliament.[5] At the time of writing, the legislative proposals were taking final shape in trilogues involving these two institutions as well as the European Commission. The aim is to achieve final adoption in June 2011.

Figure 2



Surplus countries: BE, DK, DE, LU, NL, AT, FI and SE
Deficit countries: the rest of the EU

(a) ECFIN Spring Forecast

Source: European Commission.

The remainder of this article focuses on one of the most important and innovative parts of the governance proposals: the procedure to monitor and correct macroeconomic imbalances. This proposal stems from a widespread recognition of the role macroeconomic imbalances and competitiveness divergences played in increasing vulnerability of the most exposed EU countries and the huge costs associated with their disorderly unwinding. The second section below examines the evolution of macroeconomic imbalances and provides the rationale for a new and dedicated surveillance procedure. The third section then describes the main features of the Commission's proposal.

Macroeconomic imbalances before, during and after the crisis

In the decade preceding the crisis, macroeconomic imbalances in the EU and within the euro area increased considerably (European Commission 2010a). The warning signs were that current accounts of some member states increased to staggering deficits while for others current account surpluses built up (Figure 2). External imbalances can be problematic but not necessarily worrisome if deficits/surpluses are natural responses to changes in underlying fundamentals and the related saving and investment decisions of households or businesses. For instance, countries in the catching up phases often run current account deficits by investing in building up the stock of productive capacity. This, in turn, increases the prospects of future income and ensures their ability to repay the borrowed capital. Similarly, countries with ageing population may find it opportune to save today, i.e. run current account surpluses, to avoid a drop in consumption in the future (Obstfeld and Rogoff 1996).

However, high and persistent current account imbalances pose a policy challenge and need to be tackled if they are driven by market failures or inappropriate policy interventions. In this respect, external imbalances might reflect other types of imbalances such as excessive credit expansions or asset bubbles. In these cases, the capital imported is not invested in productive activities that would enable the future repayment of today's incurred liabilities. Current account positions can also be a sign of an imbalance if they reflect weaknesses in domestic demand.

Indeed, the growing imbalances in the EU and particularly in the euro area reflected, at least in part, unsustainable macroeconomic developments. Some member states saw their price and cost competitiveness improve markedly, while others significantly lost competitiveness. Price and cost competitiveness indicators, such as Real Effective Exchange Rates, clearly document the increasing divergences in the EU and euro area (Figure 3). In addition, some euro area countries have shown a worrying gradual deterioration in export market shares.

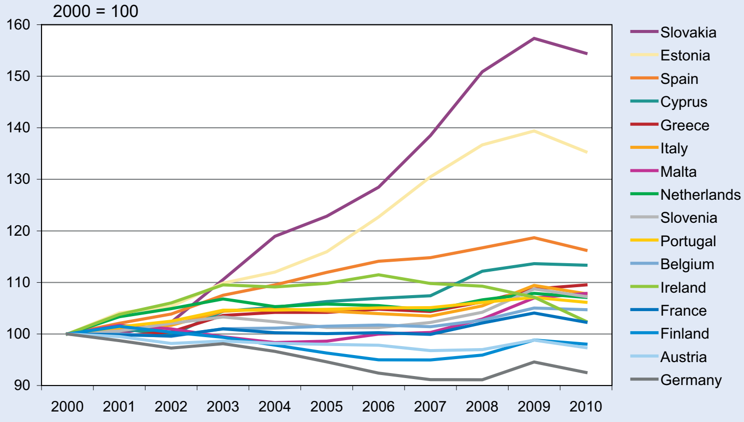
The growing external imbalances were reflected in a build-up of domestic imbalances such as excessive credit growth in the private sector, housing imbalances as well as structural weaknesses of domestic demand and the inappropriate adjustments of wages to a slowdown in productivity. In particular, countries such as Greece, Spain or Ireland experienced rather

[5] See, for example, the report 'Strengthening Economic Governance in the EU' of the Taskforce chaired by the European Council President Herman Van Rompuy and the reports prepared by the rapporteurs in the European Parliament, i.e. the Ferreira and Haglund reports.

Figure 3

COMPETITIVENESS DEVELOPMENTS IN THE EU

Real effective exchange rate indexes (ULC deflated) relative to the rest of EU27



Source: European Commission.

fast rates of growth which were to an important degree driven by domestic demand booms and expansions in non-tradable sectors, notably, albeit not exclusively, construction.

As a result of this process, fuelled by low financing costs and increase in cross-border capital flow, resources were often channelled into unproductive uses. Figure 4 shows that the excessive credit expansions stimulated demand and pushed current account into deep deficits in some member states. Similarly, housing prices grew fast in many EU countries, in several cases developing into housing bubbles. Conversely, domestic demand in other member states appears to have been constrained, in part, due to existing rigidities in product markets. This, together with mispricing of risk in financial markets, resulted in increasing current account surpluses.

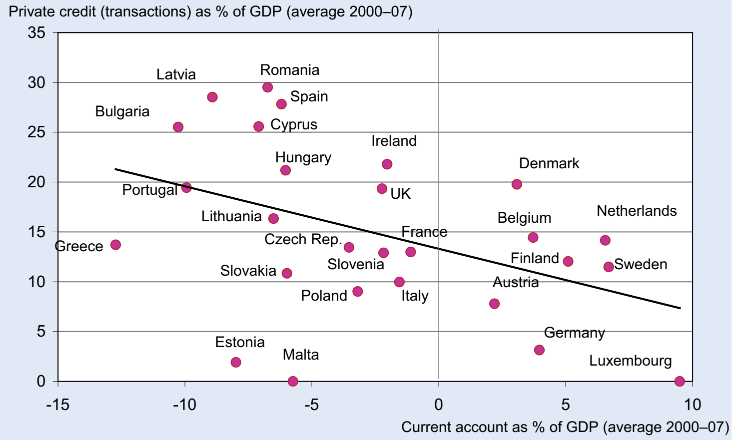
The excess savings of surplus countries tended to mirror the negative savings of deficit countries in the years preceding the crisis. This can be related to the increased level of financial integration within the EU, the 'euro area bias' in capital flows and the fact that capital was flowing 'downhill', i.e. from richer to catching up countries.[6] The rapid convergence in nominal interest rates in future euro area members is likely to have played an important role in this process and has initiated opposing adjustments in capital stocks. In particular, euro area members which benefited the most from the reduction in capital costs also experienced the strongest deterioration in current accounts.

When the crisis struck, the existence of large imbalances proved highly damaging to the EU economies. The recession has brought about some correction in external positions but the adjustment has been very painful, especially for countries with high deficits. Figure 5 documents that changes in external positions, i.e. current account or trade balances, are driven by developments in domestic demand, particularly in the euro area. The economy with the largest contraction of domestic demand during 2009–2011, Ireland, is also the one with the largest correction of the trade balance. Only a few countries managed to increase their trade balance without such movements of domestic demand. The adjustment process has also been associated in a number of EU members with a massive rise in unemployment which may indicate insufficient price/wage adjustment. Correspondingly, there is limited adjustment in competitiveness positions.

It is also instructive to look at the sectoral composition of imbalances. It was mainly private sec-

Figure 4

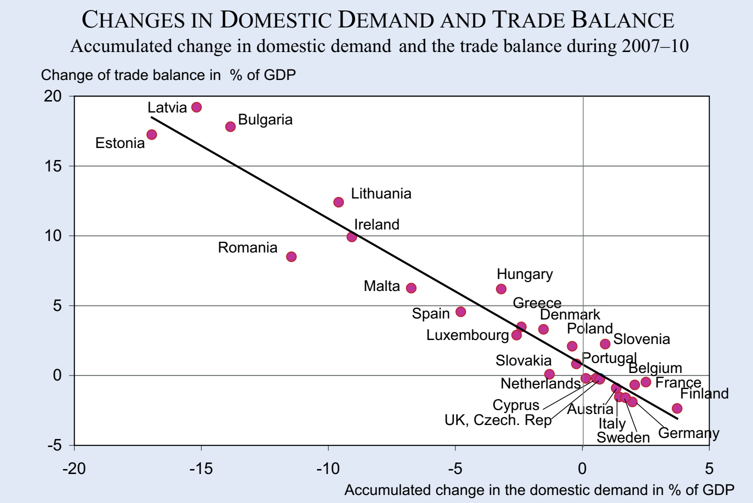
EXTERNAL AND INTERNAL IMBALNCES BEFORE THE CRISIS



Source: European Commission.

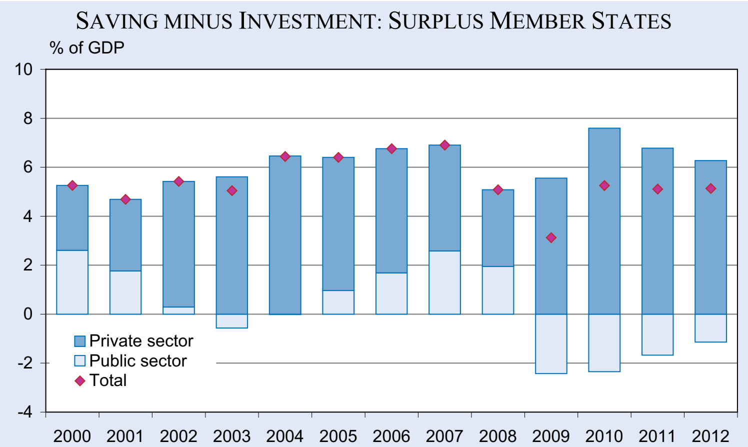
[6] The role of financial market integration and the 'euro' bias has been documented by a number of studies. Among some are Berger and Nitsch (2010) and Balli *et al.* (2010).

Figure 5



Source: European Commission.

Figure 6

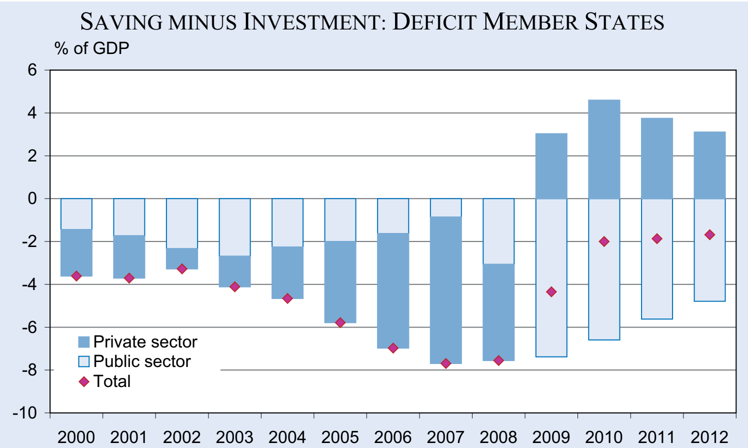


Surplus countries: BE, DK, DE, LU, NL, AT, FI and SE
Deficit countries: the rest of the EU

Data for 2011 and 2012 are based on ECFIN Spring Forecast

Source: European Commission.

Figure 7



Surplus countries: BE, DK, DE, LU, NL, AT, FI and SE
Deficit countries: the rest of the EU

Data for 2011 and 2012 are based on ECFIN Spring Forecast

Source: European Commission.

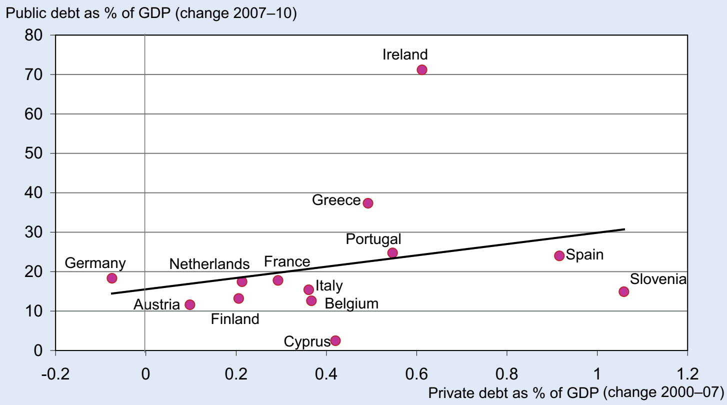
tor balances which were driving the divergence in external positions before the crisis erupted (Figures 6 and 7). While in surplus countries the financial balance of the private sector on average improved, in deficit countries it progressively deteriorated up to 2007. Although government sector balances were largely positive in surplus countries and the opposite was the case in deficit countries, their contribution to overall imbalances was generally more limited. The rebalancing in deficit countries came through sharp balance sheet adjustments in the private sector, while the already negative government sector balances deepened further due to counter-cyclical fiscal expansions. In surplus countries, the government sector balances also turned negative while private sector balances moved further in the positive territory on account of balance sheet repair, albeit its extent is considerably more limited than in deficit countries.

The unwinding of external and internal imbalances has also had adverse implications for public finances, particularly in countries with excessive private debt levels (Figure 8). Implicit or explicit government guarantees for the troubled banking sector resulted in the transfer of risk from private to public sector. Additionally, sharp contractions in the overblown sectors, e.g. construction, and the related increases in unemployment contributed to the deterioration of public finances through fall-outs in tax revenues and increased unemployment support.

While having shrunk, external imbalances have not vanished altogether. Except for Ireland and Estonia, current accounts are forecast to remain in deficit in the

Figure 8

PRIVATE VS. PUBLIC DEBT IN EURO AREA[a)] MEMBER STATES



a) Contains Member States which joined before the start of the crisis, i.e. EA15. LU and MT are not included due to the lack of data.

Source: European Commission.

coming years, including for countries that have been experiencing more moderate deficits such as France or Italy. Among the surplus countries, current account surpluses are not projected to fall substantially.

Looking forward, a key question is whether the recorded reductions in external imbalances have been cyclical or structural. In the latter case, imbalances could widen again in the upswing. The weak price/cost reactions experienced so far might indicate that more structural adjustment is needed. Further adjustments are thus more likely to come from domestic demand contractions than export increases given the weak cost corrections observed and the experience with adjustments so far.

Despite the rebalancing in the current account positions, the accumulated external liabilities of the deficit countries are substantial and point to the need for further adjustment. The stock counterparts of current account positions, the Net International Investment Positions (NIIP), have been gradually increasing, reflecting the large accumulation of debt that many countries experienced before the crisis (Figure 9). Moreover, the NIIP as a share of GDP further deteriorated in a number of EU deficit countries in 2009, despite improvements in current accounts, on account of weak growth dynamics.[7]

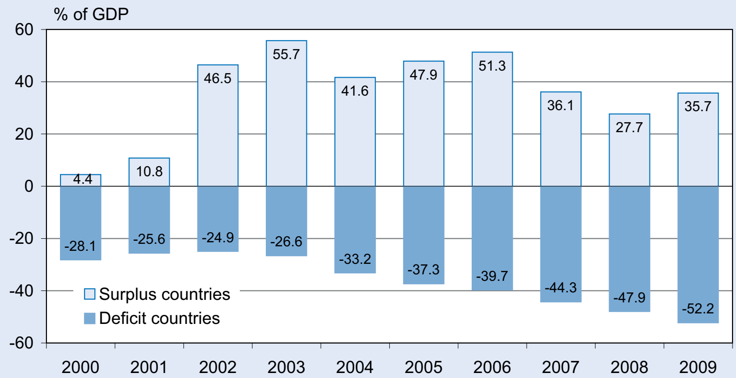
Enhanced surveillance and macroeconomic imbalances

Today, it is relatively straightforward to see that in the years preceding the crisis, low financing costs and other factors fuelled misallocation of resources, often to less productive uses, feeding unsustainable levels of consumption, housing bubbles and accumulation of external and internal debt. Indeed, previous Commission analysis did identify imbalances in several areas of the EU economies.[8] However, at the time, the policy discussions and responses were not systematic and lacked teeth.

To remedy this, the European Commission proposed to establish a procedure to prevent and correct macroeconomic imbalances. The EIP procedure will fill a gap in the surveillance of macroeconomic policies in the EU. It will have a broad scope and encompass both external imbalances, including competitiveness trends, and internal imbalances. Its design builds on

Figure 9

INTERNATIONAL INVESTMENT POSITION:
SURPLUS VS. DEFICIT MEMBER STATES



Surplus countries: BE, DK, DE, LU, NL, AT, FI and SE
Deficit countries: the rest of the EU

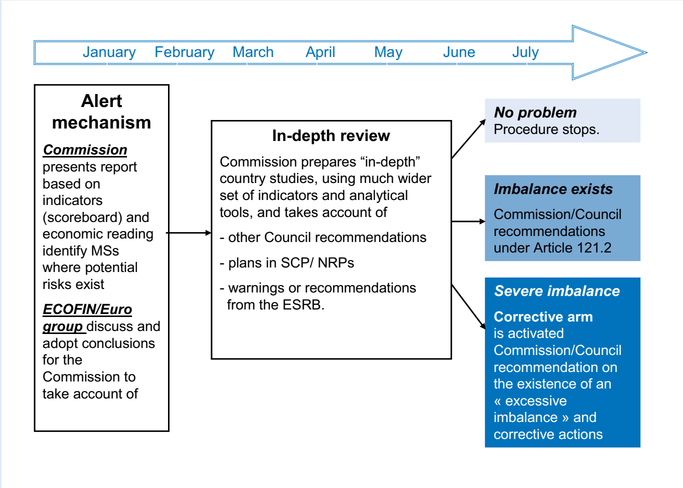
Source: European Commission.

[7] In Ireland, in particular, despite reversing the current account deficit to a surplus, the net international investment position in 2009 deteriorated (– 98 percent of GDP from 72 percent of GDP) due to a dramatic fall in GDP.
[8] For example, in the framework of the Commission services' review of competitiveness developments and imbalances, the informal surveillance in the Eurogroup as well as assessments in the context of the SGP and the Lisbon strategy. An overview of the Commission's analysis can be found in European Commission (2010b).

the experiences from the recent crisis; it is however flexible enough to take on board new trends and developments as potential future crises can have different origins.[9]

Figure 10

EIP SURVEILLANCE



Source: European Commission.

The strong financial interlinkages in the euro area and the failure of financial markets to allocate savings efficiently underline the need to monitor both high external deficits as well as surpluses. Clearly, the urgency and extent of the desirable policy action will differ with deficit countries facing far greater challenges. Sustainable adjustment to current account imbalances requires significant improvements in price/cost and non-price competitiveness in deficit countries and considerable reversions in their structure towards the tradable sector. On the side of surplus countries, further efforts are needed to remove structural impediments to private sector demand and, particularly, investment. The emphasis thus needs to be on structural measures that would support constrained domestic demand. Adjustments in current account surpluses should not be pursued through engineering fiscal expansions or unjustified increases in salaries. It is encouraging that the economic pick up, especially in Germany, is to an important degree driven by improvements in domestic demand. Nevertheless, further structural measures are warranted to sustain this favourable rebalancing of sources of growth.

These directions are also embedded in the European Commission's proposal for a package of country-specific recommendations which was published in early June as part of the first European semester cycle. The recommendations aim at reducing imbalances in both deficit and surplus countries, with a broader set of measures of often greater intensity suggested to deficit countries.

[9] Francesco Giavazzi and Luigi Spaventa in their VoxEU column entitled 'The European Commission's Proposals: Empty and Useless' argued that monitoring should focus exclusively on credit growth and policy action should concentrate on financial markets as they see unchecked credit expansions to be the main culprits of past imbalances. The analysis in the previous section shows that this would be too narrow a view. While credit conditions surely played a crucial role, other factors such as losses in competitiveness or declines in export shares were also important. Hence, the broad scope is warranted to capture the variety of specific country situations in the EU and euro area.

The EIP surveillance will be complementary with the work of the ESRB in the areas of common focus such as financial markets or credit developments. Particularly, the relevant recommendations made by the ESRB will be taken into account in the EIP, so to strengthen their enforceability. The possibility of the ESRB to address recommendations to a wider set of actors, including private sector ones, will complement the EIP's outreach which is limited to national governments.

How the EIP will work

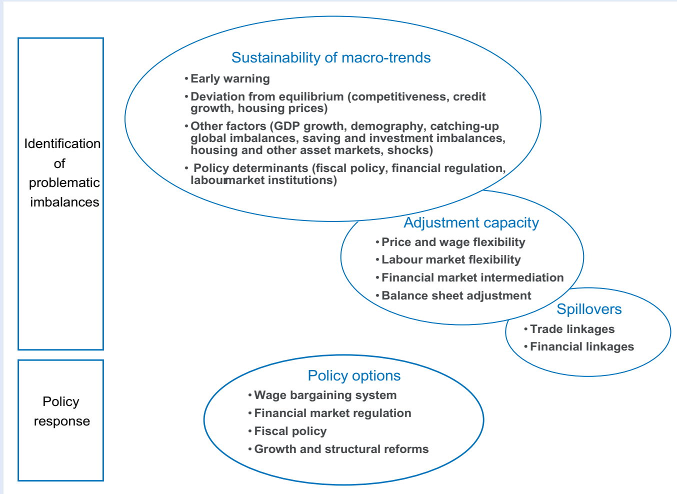
The procedure will have two key elements: (i) 'a preventive arm', focused on the early detection of macroeconomic imbalances through a regular monitoring and assessment; and (ii) 'a corrective arm', which kicks in when harmful imbalances are identified (Figure 10).

The preventive arm starts with an 'alert mechanism' to identify member states with potentially problematic levels of macroeconomic imbalances. The alert mechanism includes a scoreboard of forward looking indicators, which combined with an economic reading of results by the Commission services, could provide an early-warning of the emergence of potential imbalances. The aim of the alert mechanism is to identify those member states where 'in-depth' study is required to determine whether an imbalance is problematic or benign. It is the in-depth study, and not the scoreboard/alert mechanism, which is the central feature of the preventive arm of the EIP and which will be basis for any policy recommendations addressed to member states.

If the 'in-depth' study concludes that the imbalances are 'excessive' in that they are severe or jeopardising the functioning of EMU, the 'corrective arm' of the process will be activated and the member state concerned will be subject to an 'Excessive Imbalance Procedure' (EIP). This will involve stepped-up surveillance centred around a remedial action plan put forward by the member state in response to more prescriptive country-specific policy recommendations issued by the Council. The action plan should detail the policy responses and their calendar and be agreed by the Commission and Council as an, *ex-ante*, sufficient policy response if well implemented. Strict progress reporting and implementation monitoring will accompany the process to ensure follow up.

Figure 11

ANALYTICAL CHALLENGES IN ASSESSING MACROECONOMIC IMBALANCES



Source: European Commission.

In addition, if a euro area member fails repeatedly to act in compliance with the agreed action plan (or to put forward a sufficient plan) it will be subject to yearly financial sanctions until the Council establishes that corrective action has been taken. If credibly enforced, the possibility to impose sanctions will be a crucial element. An important feature is that such sanctions should be voted, in the Council, with a reverse qualified majority. Unless a qualified majority is against, the sanctions will apply automatically. This major shift, which also applies to the proposed reforms to the SGP, will address one of the most widely criticised shortcomings of the existing surveillance arrangements.

The analytical challenge

The surveillance on imbalances and competitiveness poses analytical challenges (see Figure 11). In particular, it is key to distinguish between benign and harmful macroeconomic trends, and to identify possible policy responses, both to prevent emergence of excessive imbalances and facilitate their correction once they arise.

When trying to distinguish between harmful and benign macroeconomic developments, there is a need to link them to underlying policy mistakes and/or market failures. Importantly, country specific features (and possible distortions) of the goods and labour markets, the asset markets (including real estate) and the financial sector need to be taken account of. To this end, it may be useful to consider (i) *the sustainability of macroeconomic developments* (e.g. by using a range of methods to analyse the policy determinants of imbalances and to measure deviations from estimates of dynamic equilibrium positions); (ii) *the country's adjustment capacity* (a persistent accumulation of external debt, for instance, should be qualified more rapidly as an imbalance if the adjustment capacity is low and its correction is therefore likely to be protracted and costly); and (iii) *the spillovers to other EU member states* (an imbalance is more likely to be classified as harmful to the functioning of EMU if its unwinding can generate strong knock-on effects on other member states).

A wide range of policies are relevant in addressing the issue of imbalances, including fiscal policies, financial market regulation or structural reforms. The latter increase the flexibility of product and labour markets and are thus essential both for the prevention and correction of imbalances. First, well-functioning markets help prevent inappropriate wage and price responses to country-specific shocks. Second, they also facilitate adjustment processes through the required changes in

[10] See, for instance, the indicator-based assessment framework (LAF) which allows for benchmarking of member states' performance in 20 policy areas spanning labour markets, product markets and the domain of knowledge and innovation. Link: http://ec.europa.eu/economy_finance/db_indicators/laf/index_en.htm.

relative prices and wages together with a smooth reallocation of labour and capital in the economy. Evidence indicates that despite some progress there is still considerable room for improvements in the functioning of labour and product markets.[10]

Conclusions

The proposed legislation on preventing and correcting harmful imbalances will fill a major gap in macroeconomic surveillance at the EU level. However, success needs to be earned and the next challenge will be to ensure that the framework is applied effectively in practice. Part of that will be to overcome some of the political-economy constraints that hampered the policy coordination processes in the past. The enforcement capacity of surveillance tools, such as the SGP, proved to be limited as short-term political reasoning prevailed over long-term interest of the EU and the euro area as a whole. It is, therefore, important that the procedure has appropriate incentive structures built in and that there is a wide political buy-in.

In this respect, it is also important to recall the overarching objective of the exercise, namely to ensure smooth functioning of EMU. This not only requires sufficient adjustment capacity in our economies to deal with shocks but also keeping the imbalances and competitiveness divergences in the euro area under control. To achieve this, there should be contributions from both countries with large current account deficit as well as countries with large surpluses. Without doubt, the degree of urgency to act, and also the depth of necessary policy responses, is considerably bigger for deficit countries due to their vulnerability to changes in market sentiments and the risk of negative spillovers to other countries. Nevertheless, to the extent that there are important domestic market and policy failures in surplus countries these should also be addressed. Therefore, in the case of surplus countries, action needs to focus on structural reforms which boost productivity and release pent up demand. Policy measures aiming at reducing surpluses through expansions of fiscal policy or leading to competitiveness losses such as unwarranted increases in salaries would clearly not be useful nor desirable.

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