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Avoiding Another Crisis in the Euro Area: Public and Private Imbalances and National Policy Responses

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ABSTRACT Early critics of the euro’s design pointed to the disruptive potential — both political and economic — of country-specific shocks in a monetary union that is a far cry from an optimal currency area. The euro crisis has confirmed the risks associated with a ‘one-size-fits-all’ monetary policy, decentralized financial supervision, and inadequate fiscal backstops. This article examines how the active use of national fiscal policies and macroprudential policies can mitigate these risks. Cross-border coordination of macroprudential policies is essential to ensure their effectiveness. In addition, area-wide reforms are necessary including a more complete banking union with a well-funded common backstop.

KEY WORDS: Euro crisis, macroprudential policies, international policy coordination

Introduction

Euro-sceptics have long pointed to the disruptive potential — both political and economic — of country-specific shocks in a monetary union that was not an optimal currency area. The euro crisis has confirmed the risks associated with a ‘one-size fits all’ monetary policy, decentralized financial supervision, and inadequate fiscal backstops. When the euro was designed, significant concerns were expressed about its implications for fiscal discipline in individual members and the possible spillover to other members. Some designers feared that expectations of a ‘bailout’ would give rise to moral hazard (and insufficient market discipline), triggering larger public deficits, and government debt levels. This preoccupation affected the
constraints placed on fiscal policy, which were addressed by treaty provisions — no monetary financing of government deficits and no required ‘bail-outs’ — and by the stability and growth pact (SGP).

The issue of private sector (corporate and household) deficits and debts and the risks that those imbalances can pose were, in contrast, largely ignored in part because the ‘Lawson Doctrine’ held sway. According to this view, current account deficits were only bad if they stemmed from government deficits because in the absence of distortions, private sector imbalances were rationally determined and welfare improving — the ‘efficient market hypothesis’. Possible pressures on macro-imbalances and supervision flowing from larger funding, in particular from banks, to private borrowers (from a bigger euro-area financial market), were not a central part of the euro-design debate.

The institutional framework for banking supervision under the euro relied consequently upon two principles: (1) national competence enshrined in ‘home country control’; and (2) cooperation among the competent national authorities. The ECB’s role in banking supervision was to contribute ‘to the smooth conduct of policies pursued by the competent authorities’ by promoting cooperation. This setup was considered to have two main advantages at the time. One, it minimized any potential conflict between the conduct of policies by the ECB to achieve price stability and to financial stability (e.g., lender of last resort function). Two, national responsibility for national banking systems would preserve continuity, would benefit from their greater knowledge and expertise, and would properly align incentives, avoiding mutualization (e.g., national deposit insurance schemes).

The cost of any bank/supervisory failure would be borne by the relevant national fiscal authority, which thanks to the SGP would be able to absorb these costs without endangering fiscal solvency. However, this national approach also risked having different national supervisory practices creating an uneven playing field that could help maintain ‘national champions’ in the banking sector by limiting competition, allow national banks to support domestic industrial policies, and help assure government access to bank credit. In effect, home country bias would be reinforced.

Some critics focused on the possibility that asymmetric economic shocks could lead to strong country-specific booms/downswings against the background of the common monetary policy. As a booming economy expanded, its inflation rate would rise, and real interest rates at the national level would fall, intensifying ‘perversely’ the national boom. Higher national inflation would also result in loss of competitiveness vis-a-vis the currency union. Both factors would contribute to deterioration in the current account balance driven. These dynamics were central to the ‘Walters Critique’ developed in the late 1980s. Economic modeling work in the 2000s — notably in Brussels and Oxford — explored whether these national booms/downswings could reach destabilizing levels, and whether ‘active’ national fiscal policies had a role to play in dampening such country-specific cycles.
The financing implications of persistent national current account deficits were under appreciated at that time. With a bank-dominated financial system, intra-euro imbalances would be overwhelmingly intermediated by commercial banks using debt instruments. In addition, national banking systems possessed an inherent advantage in providing retail financing to their domestic corporations and households. With lower real interest rates in periphery countries, loan demand boomed and periphery banks were able to supply that heightened demand, owing to their expanded access to wholesale euro funding. Banks’ risk management practices bolstered by official prudential supervision were supposed to preserve the financial health of individual banks and the national banking system as a whole.

This article reconsiders these issues in light of the euro-area crisis. It argues that the euro-area experience with wide swings in competitiveness, and the persistence of large current account deficits, supports the case for focusing national fiscal policies on dampening country-specific cycles and therefore, although the SGP is necessary, it is not sufficient to ensure macrofinancial stability. The new Macroeconomic Imbalance Procedure (MIP) is thus welcomed as it fills a previous void by helping to identify worrisome imbalances in the private sector and proposing remedial policy actions, although MIP improvements are needed. In addition, macroprudential policies can help dampen financial sector booms and busts at the national level, contributing to better-suited monetary conditions at the national level as well as enhanced financial stability. Within the single financial market, prudential policies are, however, unlikely to prove effective unless they are coordinated across the euro area. The European Systemic Risk Board (ESRB), and the ECB’s new single supervisory role, both offer scope for such coordination. Finally, even considering the positive steps toward banking union, individual euro-member financial systems are still too exposed to country-specific shocks compared to the more geographically diversified exposure of the US financial market.

Pre-crisis Concerns about Private Sector Imbalances

The pre-crisis EMU architecture was criticized by those economists who were concerned potentially problematic adjustment dynamics within the monetary union. Specifically, when a euro member was hit by a country-specific shock, the common monetary policy and constrained national counter-cyclical fiscal policy would not be sufficiently stabilizing — the Walters Critique:

- One euro-area member might enter a country-specific boom, causing higher-than-average inflation. With no national monetary policy to react, the key market mechanism that could eventually slow the economy would be a loss of competitiveness. This mechanism would also need to counteract the ‘perverse’ fall in the national real interest rate associated with rising national inflation.
- This boom could extend over a long period. The current account balance would deteriorate, and wage costs would rise: subsequently, a slowdown induced by a lack of competitiveness (and higher
unemployment) would improve the current account balance and put downward pressure on real wages. However, this process could be protracted and difficult — socially and individually costly.

- Some economists using models thought that such swings in competitiveness/wages would be stable. Others feared overshooting, and perhaps a destabilizing oscillation and advised the active use of national fiscal policy to dampen country-specific cycles. Among the sceptics were Allsopp and Vines (2008), while the European Commission (EC 2006) considered internal euro dynamics to be stable.

These serious flaws in euro economic governance, as described in greater length in this volume by Giavazzi and Wyplosz, and de Grauwe and Ji, were the architectural cracks that widened into the euro crisis, although they focus heavily on the design flaws related to the European Central Bank. The near fatal nature of these design flaws coupled with enforcement and data shortcomings particularly related to the SGP have become increasingly recognized even by EU officials (see Trichet’s 2015 speech). While agreeing with these flaws, Vines stresses the important stabilizing role that should be placed by national fiscal policies; a point we also make while noting some real-time technical and political constraints.

Financial Market Lessons from Intra-euro Imbalances

But the euro-area crisis also pointed to financial issues — risk premia, capital flows, credit, and asset prices — which economic analysts tended to ignore previously:

- Financial booms can flatter the budget with very strong temporary revenues from banking, real estate, and private consumption, leading to a false sense of fiscal security and well-being.
- Risk premia should have risen earlier as the riskiness of private and sovereign imbalances became evident, but this mechanism occurred too late and abruptly.
- Weak risk management by private financial institutions coupled with inadequate official oversight was contributing factors.
- In addition, the official may have sent signals — from zero risk weights on sovereigns by supervisors and common collateral treatment by the ECB — that the private participants (incorrectly (?)) interpreted as blessing the compression in credit risk spreads for sovereigns within the euro area.
- In the downswing, very severe feedback — ‘doom loops’ — emerged between the deteriorating balance sheets of the private and public sectors, which had not been identified or analyzed before the crisis.

The euro-area crisis provides evidence of how quickly and severely financial integration can go awry. During the crisis, the single financial market became fragmented, dividing along national lines. This fragmentation was seen in higher interest rates on bank loans in core countries than in periphery countries and reduced net private cross-border exposures to periphery
countries. Fragmentation derived in part from the dominant role, played by national banks in retail lending, while bank funding was considerably more integrated. Periphery banks had assets concentrated in their households (and sovereign — correlated risk), which were funded in euros on shorter terms — maturity transformation — and priced at near zero credit risk. As periphery banks’ assets were perceived to be impaired, cross-border euro funding disappeared for these banks (and was largely, but not wholly, replaced by official funding). Had loans to the periphery’s private sector been distributed widely among euro-area banks (rather than just funded by them), such diversified risk sharing would have made dealing with an idiosyncratic (housing) bust more manageable. Put another way, the euro financial market was insufficiently integrated at the retail lending level.

In some cases, national authorities had to bail out their national banks, worsening their public debt positions. This deterioration in public finances caused their sovereign interest rates to soar and with that the funding costs for their national banks, which pushed up their lending rates. In yet other cases, the prospect of a bank bailout caused sovereign interest rates to rise. With banks holding large amounts of their government’s debt, a vicious circle resulted, which was reinforced by the depressing demand effects of higher bank lending rates and deleveraging (for an in-depth discussion in the Irish context, which has wider applicability, see Regling and Watson 2010). Market-driven interest rates were seen by some overshoot perversely. The ECB and EC took steps to help resolve these problems including notably by adapting its refinance facilities and creating new asset purchase programs, and by establishing the Single Resolution Mechanism and the Deposit Guarantee Scheme. A comprehensive analysis of these resolution efforts goes beyond the scope of this article. Nonetheless, the risk-sharing properties of these two pillars of the banking union are still far from complete, leaving national banking systems and their sovereigns still exposed to country-specific shocks; indeed, the euro banking union is still only ‘half a banking union’ (see Posen and Vernon 2014).

In short, the behavior of risk premia, credit, asset prices, and capital flows — both prior to and after the crisis — has added a further dimension to earlier concerns about unstable country-specific boom/bust cycles. Questions need to be answered about the proper roles for national macroprudential and fiscal policies, and the adequacy of euro-area policy coordination.

New Roles for National Fiscal and Macroprudential Policies

Nominal interest rate convergence, owing to the elimination of exchange rate risk, was an expected outcome of euro adoption. However, financial markets also priced sovereign credit risks at near zero, which was unproductive. As a consequence, financing constraints were eased excessively for some countries — Spain and Greece notably — and some sectors — real estate. The prominence of financial factors in explaining the euro-area crisis suggests a need for national measures targeted at dampening swings in credit and in asset markets and responding to perverse real interest rate movements.
The euro area and global financial crises demonstrated that financial stability cannot be assured only by the efficient operation of private financial markets. More intrusive financial supervision is needed. In addition, both crises spotlighted a conundrum for monetary policy; it was too blunt a tool to cope with sectoral — real estate — booms when inflation was well contained. Higher policy interest rates dampen activity in the entire economy and not just the housing sector. Within the euro area, the common monetary policy has similar limits; ECB policy interest rates were too low for some national economies — Ireland and Spain, for example — that were experiencing rapid economic expansion — real estate booms. Raising area-wide policy interest rates to slow activity in these booming economies would dampen unnecessarily activity in the entire euro area. The common — ‘one size’ — monetary policy therefore did not fit all economies equally well.

In principle, national fiscal policy was available to address country-specific cycles that were not in sync with the euro-area average. But this proved to be too challenging. Why?

- Economic expansions yielded sizable fiscal revenues which created political pressure to increase spending; this pressure was redoubled in cases where lower interest rates on sovereign debt created room to expand non-interest public expenditures.
- Economists underestimated the temporary component of fiscal revenues, making the structural budget appears stronger than it really was. This undermined the economic rationale for strengthening the fiscal position.
- Real-time statistical estimates of potential output — an unobserved variable — tend to be correlated with the business cycle — rising during a boom and falling during the bust. Thus, spare capacity can appear larger during the boom, imparting an unintended procyclical bias to fiscal policy.
- Moreover, consensus did not exist that for employing actively fiscal policy to mitigate swings in competitiveness and current account balances.

Overall, national fiscal policies failed to dampen the upswing sufficiently and, therefore, the subsequent bust was larger. So how can national economies within the euro area cope better with booms and thus mitigate the busts, assuring more securely future financial stability?

An initial answer begins by rethinking the measurement of the underlying fiscal position. Measurement of the fiscal stance needs to incorporate full information about the cyclical position and the durability of budget revenues. While harmonized statistical techniques provide a useful cross-country analytical benchmark, such techniques do not adequately utilize country-specific information, potentially mis-measuring the fiscal stance.

EC analysis of Spain, published before the crisis broke, illustrates that a careful country-level review can correctly identify measure countries’ underlying fiscal position during booms; these EC analysts rightly assessed
Spain’s structural fiscal deficit, while standard techniques — used by the EC for official purposes — produced higher fiscal revenues, owing to the asset price boom. In particular, standard techniques were estimated to have overestimated structural revenues in 2006 by 2¼–3.0 percentage points of GDP (Martinez-Mongay, Maza-Lasierra, and Igal 2007). Recent International Monetary Fund (IMF) estimates of Spain’s structural fiscal position in 2006 were downgraded by 3.0 percentage points of GDP compared with earlier IMF estimates and now correspond with the Martinez-Mongay results. (Contemporaneous mis-estimation of the underlying fiscal position in Ireland — 6.7 percentage points of GDP — was even greater than in Spain!)

Even if the underlying fiscal stance had been properly measured, the focus of national fiscal policy under the SGP was, and still is, on fiscal sustainability and not on national competitiveness or private sector imbalances. Thus, national fiscal policies were not, and have not been, assigned the task of moderating swings in competitiveness and private imbalances. Indeed, the changes to the SGP/EDP — the two and six packs — have made those procedures more technically complicated and thereby less understandable to the general public, risking their support. Indeed, those SGP/EDP changes did not alter the fiscal sustainability orientation, but gave the Commission more power to influence national fiscal policies toward meeting the needs of the euro area as a whole. Fiscal deficit policy, however, can be, like monetary policy, too blunt at tool to deal with asset/sector booms, while tax and spending policies, which are more precise, are often too political to be implemented in a timely and sufficient manner.

Macropuudential policies conducted at the national level can complement national fiscal policies or, if need be, substitute for inactive national fiscal policies. This concept has been termed ‘intellectually radical and potentially transformative’ (Baker 2013), although owing to countervailing political and practical challenges, he expected a gradual transformation. Therefore, it is useful first to describe these policies, and how they are different from microprudential supervision.

- Macropudential policy aims to promote ‘financial stability’ at the systemic level. This contrasts with the focus of microprudential supervision, which is on the financial health of individual financial institutions. Macroprudential policy takes a top-down perspective, while microprudential policy has a bottom-up perspective. These tools can be structural — working across business cycles — or time varying — working during the business cycle. Time-varying macroprudential tools are our chief interest.
- Macropudential tools are varied, overlapping at times with microprudential tools. Counter-cyclical capital buffers (CCCB), loan-to-value ratios (LTV), debt-to-income ratios (DTI), and capital flow measures (CFM) are examples of macroprudential tools; the first three tools are also in the hands of microprudential supervisors. One instrument with two hands on the lever creates a coordination issue.
How do macroprudential tools operate? Essentially, they make it more expensive to borrow, reduce the availability of credit, and/or build up buffers to protect against losses. LTV and DTI ratios can target segments of the economy, such as housing. Raising these ratios makes it harder to qualify for loans, reducing spending pressures in the targeted sector. On the other hand, capital buffers and CFMs can act to limit national credit expansions; particularly those fuelled by foreign inflows in the case of CFMs.

The effectiveness/calibration of various macroprudential tools has received considerable recent attention (e.g., from the BIS, FSB, IMF, and central banks). Empirical evidence suggests that macroprudential instruments can effectively address systemic risk if employed appropriately, timely, and properly targeted. For example, for countercyclical macroprudential measures, quantity-based measures (e.g., LTV) seem to be more effective than price-based measures (e.g., risk weights) in dampening housing price booms. These measures also take time (2–3 years) for their full impact to be realized. Evidence also suggests that macroprudential tools may be more effective when implemented jointly rather than individually. Macroprudential measures can have little, or no, ‘bite’ on nonbank flows.

CFMs can be deployed to cope with surges and sudden stops that can threaten both macroeconomic and financial stability. Their use, however, has its own separate and controversial history. Recently, the IMF has taken a new ‘institutional view’ finding in certain circumstances that CFMs can be useful and appropriate to support macroeconomic policy adjustment, particularly to cope with inflow surges. Such measures can also be imposed after a crisis breaks to help the adjustment process as has happened in Iceland and Cyprus. However, introducing CFMs can risk triggering a rush to the exit, exacerbating outflows rather than controlling them. Official actions that fragment the currency union may be necessary, however, in order to preempt fragmentation caused by the private sector. Macroprudential measures to dampen financial cycles within a monetary union should be seen in the same light: they bear resemblance to CFMs, but their intent is to prevent market-driven fragmentation of the single financial market and not to undermine the single financial market.

Political obstacles may emerge to the use of some macroprudential tools because of their distributional consequences, or quasi-taxation properties. These obstacles, uncertainties in identifying emerging vulnerabilities, and calibration concerns are among the reasons for ‘inaction bias’. Finally, macroprudential tools impose costs on the economy via the financial sector that must be evaluated against their benefits.

Time-varying macroprudential measures can do a degree substitute for a national monetary policy within a currency union. Such macroprudential policy can make monetary conditions at the national level better suited to a member’s economic circumstances, while structural macroprudential
policies can remain targeted on financial stability. Thus, a ‘one-size-fits-all’ interest rate policy can be tailored using macroprudential tools, to fit the needs of an individual economy within that currency union (Brzoza-Brzezina, Kolasa, and Makarski 2013; Quint and Rabanal 2013). But national macroprudential policy is a poor substitute for national interest rate policy, owing to leakages associated with an open financial system. These leakages can be plugged by national CFMs and by internationally coordinated macroprudential measures. While recognizing the advantages of more tailored national monetary conditions, the ECB has rightly pointed to possible abuses and risks (Dombret 2014).

In sum, dealing with country-specific booms and downswings entails recourse not just to national fiscal policies but also to national macroprudential policies; these latter policies may prove ineffective without cross-country coordination. The ECB, as the Single Supervisor, and the ESRB, as the EU-wide macroprudential agency, can contribute importantly to euro area and EU coordination efforts. The next section examines in greater depth these coordination issues, especially in a EU/euro context.

**Coordination of Macroprudential Policies**

The effective conduct of macroprudential polices requires cross-border coordination. Why is this? Financial institutions, including their branches, are supervised on a consolidated basis by their home supervisor. Host countries supervise their domestic financial institutions, which includes subsidiaries of foreign financial institutions. Thus, macroprudential tools applied by a host country would not apply to branches located in the host country. Moreover, corporations and even households could borrow directly from financial institutions domiciled abroad. The latter is especially true within a currency union (a fuller treatment can be found in Kincaid and Watson 2013).

The Basel Committee on Banking Supervision (BCBS) has recognized this coordination issue in the context of the international use of CCCBs. Specifically, their guidance to national supervisors (see BCBS 2010) established the principle of ‘jurisdictional reciprocity’. Under this principle, foreign supervisors apply to their banks that lend to the host country additional capital buffers posed by the host supervisor on their banks. All banks would thus operate on a level playing field when lending to entities in the host country. Unfortunately, this reciprocity principle only applies to CCCBs and not to the entire range of macroprudential tools.

These BCBS principles also apply to members within a currency union unless bank supervision is conducted at the supranational level. In November 2014, the ECB became the Single Supervisor for the euro area, harmonizing supervisory standards, and promoting their consistent application. The ECB cooperates with other EU financial regulatory bodies, notably the European Banking Authority, and the ESRB. It directly supervises 120 significant credit institutions, holding about 85 percent of the banking assets within the euro area, while the national competent authorities (NCAs), which are not in all cases the national central bank, supervise all
other credit institutions. The NCAs together with the ECB form the SSM. By narrowing the scope for regulatory arbitrage and national enforcement bias, the SSM can significantly enhance the effectiveness and even-handedness of banking supervision. But the new SSM is largely staff by former national supervisors who may bring their national bias with them. The SSM also must utilize accounting and audit regulations and practices that are still national competencies. Finally, the unwinding of the home country bias in bank portfolios will likely be subject to both technical and political challenges.

Macroprudential tools within the SSM are shared between the ECB and NCAs. Capital and liquidity buffers are determined by the ECB and apply to all banks governed by SSM regulations. NCAs can impose, following a notification period, stricter national prudential requirements to address national systemic risks. On the other hand, the ECB may, if it deems necessary and after a notification period, apply higher capital buffers than established by NCAs, in order to address national systemic risks. The reciprocity principle pertaining to CCCBs would allow the ECB as the euro-area supervisor to request that supervisors of non-euro EU banks with exposure to the country apply the same CCCBs. A similar request could also be made to non-EU supervisors, such as those in Switzerland. However, the ECB does not have the mandate to require euro-area banks to implement macroprudential tools such as LTV, DTI, and leverage ratios. These macroprudential tools remain in the hands of the NCAs.

Banks face competition from capital markets and non-bank financial institutions. From a macroprudential perspective, this competition is a source of leakage, undermining the effectiveness of these tools. The ESRB monitors the entire EU financial system: it can issue warnings and recommendations to the relevant regulatory bodies should it deem that financial stability is at risk. It can therefore help national authorities to dampen financial market swings that may accompany the inter-country adjustment process under EMU. The ESRB intends to overcome possible inaction bias by employing ‘guided discretion’ — the use of judgment anchored firmly by a clear set of principles that are supported by indicators and thresholds. Conceptually, this guided discretion is similar to the BCBS approach for CCCBs.

Coordination issues between supranational and national authorities at the EU level are (unsurprisingly) similar to those at the euro level. Capital and liquidity buffers are determined at the supranational level. National authorities can impose stricter prudential buffers to address national systemic risks. The use of these measures is subject to prior notification if the measure is expected to have significant cross-border effects on other EU members or on the internal market. Advanced notification allows other EU members to express their opinions on the proposed measures.

EU members can also deploy macroprudential measures that are not covered by EU legislation (Capital Requirements Regulation and Directive — CRR/CRD IV); the most noteworthy are LTV, DTI, and leverage ratios. The ESRB must provide an opinion to the Council, EC, and the concerned member, regarding the proper use of macroprudential measures. This
opinion would assess whether the measure is necessary, effective, and proportionate, or could be address by other instruments. The ESRB seeks to balance the financial stability needs of individual members against the adverse spillovers on other EU members and the potential negative impact on the internal market. Exact reciprocity is only possible if the other countries have the same instrument available, which may not always be the case. The ESRB may recommend reciprocal action on its own or following a request by the implementing member. Such a recommendation, as with all ESRB recommendations, is not legally binding; instead, a softer ‘act or explain’ mechanism applies to ESRB recommendations.

The ESRB has only limited initial experience with the national implementation of macroprudential policies within the EU. Reciprocal action was requested in only one case — by Estonia in 2014. EU members with large branches in Estonia were requested to reciprocate on a voluntary basis, applying a systemic risk buffer to all exposures and introduce a capital conservation buffer. Estonia has not as yet reported any experience.

The EU and euro area have developed impressive coordination structures for macroprudential policies. These structures are by necessity complex, owing to divisions between supranational and national responsibilities/competencies and between regulation of banks and nonbanks. Reciprocal action by other EU/euro members will in principle enhance the effectiveness of macroprudential policies. The degree of enhancement is uncertain, however, because several macroprudential tools need to be utilized jointly to achieve maximum effectiveness but these tools lie in different institutional hands (e.g., SSM, ESRB); institutional complexity may add to the well-known inaction bias. Size and impact asymmetries can make cross-border policy coordination more difficult. It remains to be seen whether the various governance arrangements (SSM, ESRB, EBA, etc.) will be sufficiently responsive to the policy requests from smaller members for assistance. For example, supervisors in large EU countries could come under pressure by their financial institutions not to apply the reciprocity principle because those institutions could fear losing market share to banks from non-participating EU countries and from banks outside the EU (remember that the excessive deficit procedure ran aground when it needed to be applied to France and Germany). Also, will the analysis and recommendations of the SSM and ESRB be sufficiently independent from those of the ECB to ensure proper coordination of euro-wide macroprudential and monetary policies? Finally, macroprudential policies may need to be deployed in conjunction with fiscal policies, adding to coordination burdens at the national and euro-wide levels.

New Warning Indicators and Procedures

As a crisis response, the MIP was created in late 2011 to identify emerging macroeconomic imbalances to remedy an omission in the euro economic governance. Private sector imbalances are now monitored via a set of (11) indicators and their thresholds. Excessive imbalances can be subjected to a corrective action plan (CAP) that should detail specific policy measures and
set an implementation timetable. As regards content, the policy response should be tailored to the member’s circumstances and should cover, as needed, fiscal and wage policies, labor markets, product and services markets and the financial sector. The MIP is a step in the right direction but additional steps are necessary.

MIP-indicators focus on both internal and external imbalances and their likely sources such as competitiveness and credit booms. Attention is thus directed on private sector imbalances, which were previously largely ignored by EU surveillance; government imbalances continue to receive attention under the SGP. MIP’s thresholds, however, tend to be set asymmetrically; 9 of 11 thresholds only signal excessive deficits with no threshold for an emerging excessive surplus. Two thresholds — for the current account balance and changes in the real effective exchange rate — are designed to capture both types of imbalances, but their thresholds are set asymmetrically — tighter on the deficit side than on the surplus side. The EU defends this asymmetry on the (arguable) grounds that deficits are more problematic than surpluses. Corrective actions therefore likely fall on deficit countries, creating a possible deflationary bias within the euro area (Bini-Smaghi makes a similar point, focusing more on euro adjustment programs and conditionality). Such a deflationary bias repeats the asymmetric adjustment mechanism — with its deflationary bias — witnessed at the global level.2

The MIP has a backward monitoring orientation because its 11 indicators utilize data that are mainly a year old. It cannot therefore identify turning points, or cotemporaneous crossing of MIP thresholds. Meanwhile, recommended policy actions are implemented only in the coming year at the earliest and their main impact would be felt only even later. An adverse feedback loop could result from the combination of backward-identified macroeconomic imbalances and forward-leaning policy actions. Employing current-year estimates and developing agreed forecasts could rectify these problems.

As regards the substance of the in-depth reviews and the associated country-specific recommendations, these are tilted heavily toward structural reforms pertaining to labor and product markets. Fiscal policy is viewed narrowly through the SGP lens, while monetary policy is basically ignored. The focus on structural reforms is problematic because the impact of structural reforms on macroeconomic imbalances is typically harder to calibrate and takes longer to materialize than the annual MIP horizon. In addition, some national authorities have questioned the specificity of recommended structural reforms, arguing that the Commission is intruding too deeply into domestic affairs and is exceeding its mandate; the Council has made on occasion Commission recommendations less prescriptive and less precise.

Turning to fiscal and monetary policies, the EC has a rules-based approach to fiscal policy that ignores monetary policy or monetary conditions. The adequacy of fiscal policy is assessed against SGP metrics and the convergence programs under the Excessive Deficit Procedures, if relevant. In the EC’s reports, no direct link is made between fiscal policy and
correcting macroeconomic imbalances or managing aggregate demand, or the implications for real growth and imbalances of the fiscal-monetary mix. Differentiated monetary conditions are also not cited as an influence on the recommended national fiscal stance. Indeed, in-depth reviews for three non-euro countries (Hungary, Sweden, and United Kingdom) do not make any mention of monetary policy, or the policy mix, and make no country-specific recommendation related to their monetary policies.

Macroprudential policy must contend with the ‘fuzzy’ concept of financial stability, although financial instability is obvious to all. This fuzziness contrasts with inflation, which is measured and reported frequently. Thus, a key question is what should trigger macroprudential intervention? It has long been recognized that multiple influences cause systemic financial vulnerability, making multiple indicators relevant for financial stability assessments. This multiplicity makes development of a transparent operational target for financial stability — comparable with projected inflation, or the fiscal deficit or public debt ceiling — a major challenge. Several researchers have stressed therefore that financial crises are associated with peaks in the financial cycle, in the tradition of Hayek, von Mises, and Minsky. Financial cycles can be parsimoniously characterized by credit growth and property prices. Empirical analysis supports the view that credit growth matters, but financial crises are also strongly associated with other factors, such as stable exchange rates.

Use of credit indicators as a trigger received a boost when the BCBS provided guidance to national supervisors (BCBS 2010) for employing a common methodology to calculate an internationally consistent credit/GDP gap to implement CCCBs. The appropriate threshold can, however, vary from country to country and as the BCBS stresses, country authorities should utilize other variables and qualitative information to assess risks. This methodology could also guide the use of other macroprudential instruments. Indeed, the June 2014 Financial Stability Report by the Bank of England utilized many BSBS indicators to make the analytical case to introduce a LTV limit on mortgage lending. The macroprudential research network of European System of Central Banks has made significant strides in developing early warning indicators and formulating macroprudential models and tools.

In sum, considerable progress has been made in a short time period in developing useful operational indicators that can identify emerging financial vulnerabilities and macroeconomic imbalances, particularly in the private sector, within the euro area and more broadly within the EU. But clearly, these efforts need to be refined further. In particular, the MIP-indicators need to become more forward looking and grounded in statistical analysis to better understand their strengths and weaknesses. National fiscal and macroprudential policies must also be utilized more actively to redress emerging macrofinancial imbalances; this will require a different mindset by supranational and national authorities. In this vein, signals given by MIP-indicators and financial stability indicators need to be interpreted coherently by the EC and ECB/ESRB; this will require new supranational coordination efforts as well as heightened coordination with national authorities. Developing greater confidence in these indicators and
warning systems could also help lessen ‘inaction bias’ — too little, too late — by all policy makers. Nonetheless, coordinated policy responses are at least equally crucial.

Conclusions

The euro crisis has validated pre-crisis concerns about perverse movements in national real interest rate and destabilizing swings in competitiveness, following country-specific economic shocks. Moreover, these destabilizing swings can be amplified by intra-euro-area capital flows, which were not foreseen. National fiscal policies actively counter such perverse and destabilizing forces but such a role requires a different mindset by supranational and national policy makers. In particular, while the SGP remains necessary, it is not sufficient, guidance for fiscal policy.

National time-varying macroprudential policy can also help dampen destabilizing swings in national financial markets. Such macroprudential actions are unlikely to be successful unless coordinated across countries and relevant authorities. A real test will occur when a NCA from a small country implements macroprudential policies to address its national imbalances and asks NCAs from large countries to take reciprocal actions that run counter to the business interests of their financial institutions. (The excessive deficit procedure proven ineffective when it came time to be applied to France and Germany.)

Stronger national policy responses to country-specific economic shocks within the euro area are complementary to an area-wide banking union with a well-funded common backstop. Reliance cannot be placed solely on the timeliness and adequacy of national fiscal and macroprudential measures, even when coordinated across borders, to prevent financial stress arising under EMU. The political economy of such pre-emptive actions can be problematic, and the traction of fiscal and macroprudential measures in such a context remains unproven.

More diversified risk sharing — e.g., less home country bias in asset holdings — by the euro banking system would help buffer national idiosyncratic shocks within the euro area; such buffering would be similar to the private risk sharing that takes place via financial markets in the United States. It remains to be seen whether the new SMM will unwind the previous national supervisory bias. A meaningful euro-area banking union would increase cross-border risk sharing by both the private and official sectors. In particular, a larger and more mutualized single resolution fund and deposit guarantee system is necessary. Such changes are indispensable complements to rethinking the conduct of national policies. However, the banking union as it has been presently constituted is incomplete.

The economic and governance reforms undertaken and underway will transform the euro architecture moving it from a loosely coordinated system predicated on the no-bail-out principle, to a more tightly coordinated system that recognizes more collective responsibility. This new framework is untested. Untested as yet by adverse market pressures and by the political economy forces that were the undoing of the excessive deficit procedure,
for example. Moreover, this new framework still falls short of the fiscal union that some have long viewed as necessary to underpin a successful euro project. But voters support for an ‘ever closer union’ and the further transfer of sovereignty to Brussels is far from assured. Thus, while the currency union has been strengthened by recent actions, the project may remain incomplete and therefore vulnerable.

Disclosure statement

No potential conflict of interest was reported by the authors.

Notes

1. SSM is the first pillar in the new Banking Union. The Single Resolution Mechanism with the Single Resolution Fund constitutes a second pillar, while the Deposit Insurance Scheme is the third pillar.

2. In comparing macroeconomic surveillance by the EU and IMF, Moschella (2014) also finds fault with the MIP’s asymmetric treatment and single-country, rather than systemic, focus, offering factors that may help explain the limited learning from IMF experience.

3. Fiscal policy is considered by the EC to be too cumbersome to utilize effectively for short-term demand management because of the need to involve national parliaments, which complicates coordination issues. Moreover, national (EU) fiscal multipliers are generally considered by the EC to be very small under normal circumstances.

References


