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Special analysis

Macroeconomic Imbalance Procedure

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Introduction

At the end of the last decade, one of the most serious economic crises since the EU (EC) was established hit Europe. The crisis revealed **the need for a change in the system of European economic governance**, which until then had not included any tool for closer cooperation in macroeconomic areas.

The aim of this concise analysis is to describe a relatively new measure – the **Macroeconomic Imbalance Procedure (MIP)**, which will bring to the management of economic affairs a completely new element, which in the future should not only uncover unfavourable economic developments in Europe, but also help resolve them effectively.

European economic governance and the crisis

Prior to the arrival of the crisis, the system of European economic governance was relatively complicated and difficult to understand and was analysed mainly at the academic and professional levels.

Today it still consists of coordination processes and mechanisms in various areas, which differ from each other for example **in the extent of powers of EU institutions** or the existence of forcing measures or a lack thereof. One of the responsibilities that stood before the European Union during the crisis was to reform this non-transparent arrangement and transform it into **a system as transparent and easy to understand as possible.**

This resulted in the European Semester, within which the economic policies of individual member states are coordinated through a series of until then not mutually related tools and entirely new tools. One problem was entirely apparent across almost all of the EU.

This problem amounted to the long-term **budget deficits of member states** and the resulting rise in public debt. This paradoxically is an area on which European economic governance has focused perhaps the most during its historical development (though without major results over the long-term horizon).

As became apparent during the crisis, long-term deficits and **the negative development of government debt** were not the cause of the problems in all of the countries affected by the crisis. Rather than irresponsible government financing being the cause, it is apparent instead that the crisis had a significantly negative effect on public finances.

This was pointed out several times during the crisis, and it was noted that a more serious problem than the growth of government debt was **the rise in private debts and an increase in the imbalances of payment balance accounts** across member states in the Eurozone.

MIP implementation

However, the EU lacked in its mechanisms any effective measures that would enable attention to be drawn to the unfavourable developments in individual member states beyond the extent of budget indicators. And even if **signs of a pending economic collapse** were revealed, which threatened the smooth functioning of the EU, no means existed for agreeing with individual member states on a further approach to solve the crisis.

The EU responded to this situation with **a package of six reform measures**, known colloquially as the "Six Pack". The package can be divided into three parts – **reform of the Stability and Growth Pact** (preventive and corrective parts), **supervision over macroeconomic imbalances** (again preventive and corrective parts) and **domestic budget requirements.**

The MIP is addressed specifically by Regulation No. 1176/2011 (preventive part) and Regulation No. 1174/2011 (corrective part).

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The respective regulations set as the aim of the Macroeconomic Imbalance Procedure **"to achieve perfected administration of economic matters in the Union."** It is clear from this that the MIP should not address only members of the Eurozone, but all EU member states.

The regulations describe the supervision so far only in relation to budget development in member states (as regulated by the Stability and Growth Pact) as sufficient and emphasise that **in order to prevent additional crises, it is necessary also to take broader macroeconomic factors into consideration**.

One important step was to select within which indicators these broader macroeconomic factors would be examined (including boundary values indicating a risk of imbalance), and in view of the previous unwillingness of member states to adhere to the agreed measures it was also necessary to set up an effective forcing mechanism.

Monitored indicators and their development

The authority to select specific indicators was assigned by the Regulations to the Commission, which should consult the Council and European Parliament regarding them. The Commission was supposed to ask the **European Systemic Risk Board (ERSB)** to comment regarding the indicators related to the situation on the financial market. The overview of indicators is labelled directly in the Regulation as **a scoreboard**, and besides the values of selected indicators, threshold values are also set in it, which if exceeded could indicate macroeconomic imbalance. The word "could" in this case is of great importance, since determination of whether there is an imbalance should be based on additional aspects of real economic development.

Indicator	Treshold value
Indicators of an external (im)balance	
Three-year average payment balance account (% of GDP)	< -4%, >6%
Country's net investment position (% of GDP)	>-35%
Indicators of competitiveness	
Change in REER value adjusted according to inflation for three years (in %)	± 5% in the Eurozone's case ± 11% for non-members
Change in the value shares on export markets during a period of five years (in %)	>-6%
Change of unit costs for labour during a three-year period	± 9% in the Eurozone's case ± 12% for non-members
Indicators of an internal (im)balance	
A year-to-year change in the prices of real estate, use of consumption as a deflator (in %)	>6%
Private sector lines of credit (in % of GDP)	>14%
Total private sector debt (in % of GDP)	>133%
Total public sector debt (in % of GDP)	>60%
Three-year average unemployment level (in %)	>10%
Year-to-year change of overall financial sector obligations (in %)	>16.5%

Here we can see one of the differences between the principles on which **the Stability and Growth Pact and the MIP Procedure** are based. Exceeding of the boundary value does not automatically mean that the member state would end up under the European Commission's microscope and would have to arrange a correction of the situation and accept recommendations under the threat of sanctions. Indication of an imbalance depends to a great extent on the Commission's stance. It can be quite flexible (as was apparent in the case of Germany and its excessively high payment balance account surplus values, which received a lot of media attention).

The construction of the scoreboard is based on the requirement **to reflect both internal and external types of imbalances**.

The scoreboard itself may undergo updating not only in relation to setting of boundary values, but also in relation to potential addition of a new indicator. The purpose of this analysis is not to describe the development of all monitored indicators. For each group of indicators, only one was selected, but even so it is relatively easy to understand the purpose and significance of the entire procedure.

Balance of payment balance account (external imbalance)

The payment balance is a statistical report of all economic transactions between residents and non-residents of the particular country. One of its parts is a current account, which includes trade balances (goods export and import).

The payment balance can serve for identification of problems in economies, during which repeatedly high current account deficits can culminate into an unsustainably high foreign debt. However, the problem will not necessarily only be the current account deficit, but its high surplus could indicate weakening domestic demand.

Therefore, this indicator does not have only a unilateral limit set within the MIP, since a macroeconomic imbalance can be indicated even due to a current account surplus. The Commission clearly states that **current account surpluses do not prompt as many concerns about the condition of the monitored economy as long-term deficits**, but for the Economic and Monetary Union to function smoothly, they need to be taken into consideration.

Doubts about examination and potential sanctioning of states with high current account surpluses were among the two criticisms that the Czech government at the time presented in its opinion regarding the draft regulation.

Something relatively well known is the fact that within a current account deficit indicator there are **major differences between southern and northern states**.

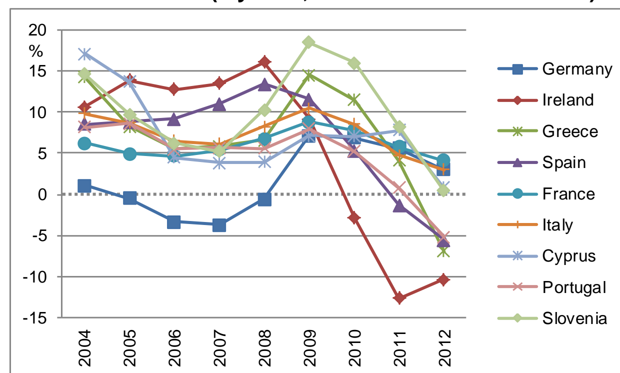
Unit labour costs (competitiveness)

The average labour costs per unit of output are one of the indicators of price competitiveness. Due to frequent volatility of unit costs, a change of unit work costs is included in the scoreboard for a period of three years.

This indicator in combination with consideration for development of what is known as the **Real Effective Exchange Rate** demonstrates the development of price competitiveness by highlighting the development of the cost of labour and productivity.

If, for example, we register a high rise in wages and at the same time negative development of the Real Effective Exchange Rate, then this means that the particular country is producing its product for a higher price and that it is unable to compete on international markets.

Unit Labour Costs (3-year Δ, selected Eurozone states)



Source: Eurostat, Macroeconomic Imbalance Procedure, Nominal unit labour cost index

The following graph shows how different the development was in the area of unit labour costs in selected Eurozone states. The only state that was able to reduce labour costs prior to the crisis was Germany, and the other economies enjoyed a noticeable rise.

With consideration for the development of the Real Effective Exchange Rate, the major loss in price competitiveness can be attributed mainly to Spain and Greece. Although Ireland has experienced the biggest changes in unit labour costs, in view of the development of the Real Effective Exchange Rate it can be stated that the rise in costs has been accompanied by more productivity.

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Real estate price change (internal imbalance)

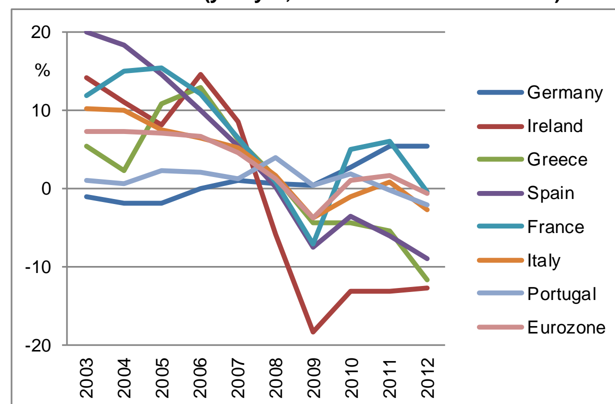
In view of the initial cause of the crisis on the U.S. mortgage market, it seems appropriate **to monitor the development of real estate prices**, the sudden growth of which could indicate a bubble forming in the real estate market.

This indicator can provide us with one of the possible explanations, according to which **the causes of Ireland's economic decline** can be highlighted at least partially.

In the period right before the crisis, some of the highest year-to-year rises in real estate prices were recorded, but their sharp decline during the crisis is significant.

Since the drop in the prices of Irish real estate is unprecedented compared to the situation in the rest of the monitored countries, the guide to solving the Irish puzzle can be looked for on the mortgage market. A less severe **burst of the real estate bubble** could be observed also in Spain. It should not be ignored that France has been through a similar development.

Real Estate Prices (y-to-y Δ, selected Eurozone states)



Source: OECD; OECD Economic Outlook 2013

MIP implementation process

Like with the **Stability and Growth Pact**, the arrangement of supervision over the macroeconomic imbalances is divided into what are referred to as **preventive and corrective parts**. Both branches of supervision are clearly defined in terms of time and are part of the European Semester process.

The MIP start dates back to November, when the Commission along with the Annual Growth Survey (AGS) also published the Alert Mechanism Report (AMR). The analysed **scoreboard** is part of the AMR in the previous part. The scoreboard always includes the current values of monitored indicators, which the Commission partially examines when evaluating the situation in the particular country in terms of occurrence of macroeconomic imbalances.

Exceeding of the values set in the scoreboard leads to more detailed analysis of the situation in the particular state with consideration for a number of other partial indicators, which are summarised in the AMR annexe. This approach ensures that exceeding of the limits is not interpreted mechanically as an imbalance.

Based on this qualitative analysis, primarily originating from the scoreboard, the Commission will create a list of the member states in which **more thorough examination is necessary for confirming or refuting the existence of imbalance.**

The Commission will take this approach in cooperation with the member state for preparing an in-depth review (IDR). Three potential situations could be arrived at from the findings of the IDR:

- First the Commission could state based on the IDR that in the particular state **there is no macroeconomic imbalance**. In such case, no additional steps will be taken in relation to the member state as part of the Macroeconomic Imbalance Procedure.
- Another possibility is that the Commission may state based on the IDR that in the particular member state there is a macroeconomic imbalance. An imbalance shall be understood as **"any direction towards a macroeconomic development, which unfavourably affects (...) the economy of a member state or of the EMU or EU as a whole."**
- A situation when, for example, indicators worsen, but in view of the development of the state and its surroundings this situation cannot be considered a threat, can also be described as an imbalance. The Commission will subsequently issue recommendations to the Council regarding the approach the member state should take to eliminate the imbalance.

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These recommendations will then become part of the recommendations within the European Semester, which the Commission will prepare during May and which the Council will approve in June.

- The third result of the in-depth research could be a statement regarding the existence of an excessive imbalance, which can seriously threaten the smooth functioning of the European Monetary Union. An excessive imbalance is specifically a situation in which **"a serious imbalance threatens or could threaten the proper functioning of the EMU."**

  The Commission will then make recommendations to the Council, which the member state could accept, in order to eliminate the excessive imbalance.

  The corrective part of the **Excessive Imbalance Procedure (EIP)** will be applied only of it is stated that there is an excessive imbalance. If an excessive imbalance is discovered, the particular member state must present a **Corrective Action Plan (CAP)** based on the Council's recommendations.

  This plan must include definition of measures for correcting the discovered imbalance, including a specific time framework for carrying out these measures. Based on the Commission's recommendations, the plan will then be evaluated by the Council, and two potential situations could arise.

- The Council could evaluate the plan as insufficient and in such case at the Commission's request could issue additional recommendations and call on the member state to present a new Corrective Action Plan.
- If the plan is deemed to be sufficient, the Council will approve it by issuing recommendations.

  The member state could move to implement the recommendations defined in the corrective plan. The implementation will then be ensured by regular submission of reports to the Commission and the Council.

If a breach of the Excessive Imbalance Procedure rules by a particular member state is discovered, political sanctions could be imposed. In the case of Eurozone member states, the votes of an **overwhelming qualified majority** can impose financial sanctions in the following situations:

- In the event of insufficient implementation of CAP (after its approval by the Council) a member state can receive **financial sanctions in the form of an interest-bearing deposit placed with the Commission at the rate of 0.1% of the GDP of the particular state**.
- In the case of two consecutive negative evaluations of the Corrective Action Plan or its implementation, the particular member state can receive a **yearly fine of 0.1% of Gross Domestic Product of the particular state**.

Such fine will be renewed each year (paid repeatedly by the member state), until the Council at the Commission's request accepts the Corrective Action Plan or determines that sufficient progress has been made in the implementation of the proposed measures.

Procedure results

In 2014, the Commission prepared detailed re-examinations of IDR for a total of 17 member states. As shown by the attached table, **in the previous year 13 countries were subjected to the IDR**, compared to only 12 states in the first year of functioning of the Macroeconomic Imbalance Procedure.

This finding does not fully correspond to the findings indicated by the Commission in the introductory summary of this year's AMR. In this case, it can be deduced that **"European Union member states' economies are continuing to eliminate external and internal imbalances."**

Although the situation among certain member states has improved in terms of the selected indicators, it cannot be assumed that an entirely positive development would occur in the macroeconomic area in the European space as a whole. **The Commission has identified excessive imbalances based on IDR in three states: Italy, Croatia and Slovenia.** So far none of these states has been included under the corrective branch of the procedure. This can be attributed to factors such as the fact that states that received a loan from the European Stabilisation Mechanism are adhering to a special programme and therefore are not included under the procedure.

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Results stemming from individual reports within the MIP (2012-2014)

		2012	2013	2014
Member states for which IDR was not processed - no risk of macroeconomic imbalances		Czech Republic, Germany, Estonia, Lithuania, Latvia, Luxembourg, Malta, Netherlands, Austria, Poland, Slovakia	Czech Republic, Germany, Estonia, Lithuania, Luxembourg, Austria, Poland, Slovakia	Czech Republic, Lithuania, Estonia, Poland, Slovakia, Austria
Member states for which IDR was processed	Risk of imbalance not confirmed	-	-	Denmark, Luxembourg, Malta
	Imbalance exists, but is not excessive	Belgium, Bulgaria, Denmark, Spain, France, Italy, Cyprus, Hungary, Slovenia, Finland, Sweden, Great Britain	Belgium, Bulgaria, Denmark, France, Italy, Hungary, Malta, Netherlands, Finland, Sweden, Great Britain	Belgium, Bulgaria, Finland, France, Ireland, Hungary, Germany, Netherlands, Spain, Sweden, Great Britain
	Excessive imbalance	-	Spain, Slovenia	Croatia, Italy, Slovenia
Member states included under the EIP		-	-	-

Source: European Commission

Conclusion

From the division of competencies among individual European institutions, where in the preventive part the Commission plays the main role and in the corrective part the Council (an inter-governmental body) does, it is apparent that **policy implementation remains up to member states**, since they are responsible for the final form of applied policies.

Nothing about this is changed by the fact that member states can be sanctioned. Nonetheless, with the adoption of two regulations regarding Macroeconomic Imbalance Procedure, an entirely new area of coordination of macroeconomic and social policies, the absence of which has been pointed out many times, has been added to the system of European economic governance.

The process involving areas falling under coordination can be expanded at any time at the Commission's mere discretion.

From this point of view, the Macroeconomic Imbalance Procedure not only introduces a new area of coordination, but in the future can be **a tool for advancing to even closer coordination.**

The de facto effectiveness of the procedure cannot yet be evaluated, but one of the objectives by which a discussion was launched about the seriousness of macroeconomic imbalances across the European space is already starting to be fulfilled.

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