Understanding the macroeconomic imbalance procedure
Origin, rationale and aims

SUMMARY

Both the global financial crisis and the European sovereign debt crisis uncovered a high level of macroeconomic imbalances, which constituted major economic fault-lines, and led to the spread and acceleration of these crises. Imbalances had built up over years, sometimes decades, and correcting them proved to be a long and painful process. The main source of imbalance was the consequences of an unprecedented expansion in demand, fuelled by large credit inflows into the euro-area periphery. This created major problems when the EU, already bending under the financial crisis that originated in the USA, saw its own financial markets lose confidence. The financial flows from Europe’s economic core to the periphery reversed, leaving the periphery vulnerable, and creating repercussions throughout Europe and beyond.

In parallel to coping with the immediate problems, lawmakers took steps to avoid a re-occurrence of such events. The EU’s economic governance framework, which had proven inadequate, underwent a major overhaul, with the addition of a macroeconomic imbalance procedure (MIP) being the most important part. The aim of the MIP is to identify and correct imbalances as early as possible in order to avoid deeper problems at a later stage, thus supplementing the Stability and Growth Pact (SGP). A framework was created in which each individual Member State, especially those part of the euro area, is thoroughly screened for macroeconomic imbalances, and preventive as well as corrective action is taken whenever necessary.

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Build-up of macroeconomic imbalances

The financial crisis originating in the USA, and later the sovereign debt crisis in the EU, painfully revealed the extent to which a number of Member States were suffering from macroeconomic imbalances. Some of these had been building up for years, if not decades. Nevertheless, this came as rather a surprise to policymakers, who had generally expected that European integration would reduce divergences between Member States. An evolution towards more homogeneity and heightened resilience had been expected. In 2008, it also became clear that the European economic governance framework, which in addition to a single powerful centralised monetary policy had been equipped with tools to address possible concerns in the field of government finances, severely lacked instruments to address macroeconomic imbalances.

The EU had already suffered from a general erosion of competitiveness relative to the rest of the world, especially vis-à-vis India and China. These countries, taking advantage of their low wages, were flooding European markets with cheap goods and services. The EU’s price competitiveness declined by 10% in the period from 1999 to 2008, whilst the USA and Japan made gains. Europe’s position in the world shifted to its disadvantage, and that trend was even more pronounced in its periphery.¹

Until 2008, the EU’s core experienced excessive savings on a massive scale. This excess capital stayed in the euro area and mainly found its way to the periphery, rather than seeking investment opportunities in a wider geographical context. This is thought to be a consequence of a strong home bias in the structure of the financial markets in savings-rich countries, including the opportunity to get higher yields without taking currency risks. Through an unprecedented credit boom, the periphery’s capital inflows fuelled demand, a process that – in the euro area – was facilitated by low interest rates, the lack of exchange rate risks, and differences in inflation rates. Resources went mainly into consumption and construction, not investment, and this was accompanied by a shift of production into the non-tradable sector. A rift in specialisation split the EU: some countries exploited comparative advantages and achieved economies of scale, whilst others went into what is sometimes called ‘bad specialisation’, by misallocating resources to less productive firms and sectors, thus reducing labour productivity. Wages grew faster than productivity growth by a considerable margin, and thus contributed to the generation of unsustainable credit-financed domestic demand, and increased current-account deficits. The reduction in labour productivity came in addition to other forms of non-wage loss of productivity. Further divergences played a role in the misallocation of resources, such as credit conditions (the banks’ low interest rates for mortgage credit acted as a strong factor channelling resources into the building industry), and bubbles built up, mainly in the construction sector.

In a nutshell, Europe experienced excess savings in some areas, and excess consumption in others. What was lacking was the development of a capacity to reimburse the external debt in a series of Member States which built up excessive consumption. Yet few saw the build-up of imbalances happen.²

Bubbles burst

In 2008, the catastrophic failure of Lehman Brothers in the USA sent shock waves around the world. This greatly amplified a financial crisis that had already started a year earlier, and its effects hit the EU (which lacked appropriate financial regulation), beginning with its core, while sparing much of the periphery. Until then the world had experienced highly

¹ Europe’s position in the world shifted to its disadvantage, and that trend was even more pronounced in its periphery.²
exuberant expectations by governments, firms and households, which led to unrealistic expectations concerning economic prospects. With the financial crisis unfolding, reassessment of all kinds of economic and financial risks began. Suddenly, attention focused on factors previously disregarded, such as productivity and competitiveness, growth potential, private and public debt levels, and the capacity of countries to reimburse their external debt. The reassessment, which coincided with a general crisis of confidence, did not bode well for the euro area’s periphery. Not only did the core’s saving surplus stop flowing into the periphery, but, to make things worse, the cross-border financial flows reversed, leading to large-scale withdrawals of foreign private resources. In the periphery, the roll-over of debt (taking up new debt to reimburse existing debt that reaches maturity) became impossible, because market participants took fright.

The periphery's principal source of imbalances was an expansion in demand, fuelled by large credit inflows. This created sizeable problems when these imbalances had to be corrected. What made this more painful was the suddenness of the reversal of credit flows, made when the risks related to the imbalances became apparent.

Without fresh capital inflow, demand plummeted, investment stalled, the banking sector deleveraged, and by 2010, public finances became unsustainable in several countries of the periphery. Vicious circles were created between the banking sector and state finances, which dragged each other down. The impact was brutal. Before 2008, those countries which had the largest current-account deficits also had the largest potential growth. After 2008, the larger the macroeconomic imbalances were, the larger the fall in potential growth, and the deeper the resulting recession. The existence of very large amounts of debt made the adjustment an even greater challenge.

Around 2010, with rapidly rising interest rates for government bonds, several states came close to a default on their debt. To avoid defaults, the International Monetary Fund (IMF) was called in for financial support, and the EU created mechanisms for the euro area which culminated in the creation of the European Stability Mechanism (ESM), with firepower in excess of €700 billion (for states outside the euro area, a balance of payments facility already existed). These loans were subject to conditionality, requiring governments to reduce their deficits and engage in structural reforms destined to correct the existing macroeconomic imbalances.

Macroeconomic imbalances (which include debt sustainability issues) were not the only reason leading to the crises. Other factors were also crucial, such as the lack of appropriate financial regulation (almost everywhere in the world), which led to excessive risk-taking by financial institutions, and the lack of EU mechanisms able to identify and solve upcoming crises of that kind. For this reason, the first institutional reaction to the crisis was the creation of the European

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**Selected spill-over effects**

Massive spill-over effects to other Member States could be observed when countries approached default. A non-exhaustive list includes major shocks to the financial system; transmission of crises to other countries, including domino effects within the periphery; rising unemployment; reduction of buffers previously built up for pension systems; reversal of fiscal consolidation efforts and rising public debt close to sustainability limits; necessity to mobilise huge amounts of money for rescue mechanisms and provide guarantees; risks of deflation; side-effects from exceptional monetary policy measures. Non-economic spill-overs included painful decision-making in relation to financial support; loss of credibility for the EU and the euro area following the modification or non-application of EU rules; decreasing political acceptance of the EU in general, and of the euro in particular, thus fuelling euroscepticism.
System of Financial Supervision, followed by the creation of the Banking Union, aimed at fighting the lack of confidence.

The periphery’s woes extended to other Member States. Export-oriented countries such as Germany and Finland were hit hard in 2008, when global demand collapsed and uncertainty led firms to postpone investments. The banking sector was another vector of crisis transmission from one country to another, creating vulnerabilities in many Member States. A large array of spill-overs between countries was observed (see box).

**Monitoring and correcting imbalances**

The EU Treaties do not confer powers on EU institutions to impose economic policies on Member States, except for avoiding excessive deficit. They do require Member States to conduct their economic policy taking the other Member States into account. Coordination of economic policies is achieved through Council recommendations, which are not binding, and which are not associated with sanctions. The size of negative spill-over effects observed after the near collapse of several Member States took everyone by surprise, and exposed the inappropriateness of the existing policy-coordination framework. In order to avoid a repetition of such events, new legal instruments had to be designed within the framework offered by the Treaties. To this effect the **macroeconomic imbalance procedure** (MIP) was created, and entered into force in 2011. It is designed to be stringent, and sanctions may apply.

The MIP is intended to prevent imbalances within Member States, to avoid negative spill-overs to other Member States. This might at first sound counterintuitive, as many understand imbalances would be measured between Member States. Indeed, part of the economic literature concentrates on imbalances between countries. However, despite all the merits of such a comparative approach, this is not the way the MIP was designed. The procedure very much concentrates on sparing other Member States from the fall-out from national policy mistakes. Learning from the crises, emphasis was placed on the economic sustainability of each individual Member State, and to this effect, on achieving a high level of competitiveness.

Article 2(1) of **Regulation No 1176/2011** defines 'imbalance' as 'any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the Economic and Monetary Union, or of the Union as a whole'. Additional clarity is given in the Commission **compendium**, where it is specified that 'the main rationale for a supranational surveillance mandate builds on the fact that macroeconomic imbalances in one country have relevance also for other Member States'. Therefore, 'the analysis concerns primarily country specific issues, but implications for the euro area and the EU need also to be addressed'. In essence, the 'assessment of spill-overs should in principle aim at assessing the implications for other countries arising from the crystallisation of risks linked to imbalances accumulated in a given country', and 'to help the Member States affected to establish corrective plans before divergences become entrenched'. The compendium stipulates that 'the MIP surveillance endeavours to avoid unsustainable booms in good times and unsustainable trends leading to losses of competitiveness'.

The type of imbalance the MIP tries to identify is related to the ability of a country to service its private, corporate, or public debt. The procedure is influenced by the analysis of origins of the crises, although each of the eight most affected countries underwent their own set of problems. To illustrate circumstances which may lead to imbalances, a
non-exhaustive list of factors observed in several countries, although to varying intensity, includes: (1) real wage increases much higher than productivity increases; (2) inflowing capital used for consumption rather than investment; (3) production capacity shifts from tradable to non-tradable goods and services; (4) declining economic competitiveness; (5) a persistent current-account deficit, leading to large external liabilities; (6) public policies favour specific sectors, such as construction, leading to bubbles; (7) government spending shifting from investment to consumption; (8) increasing relative importance of the government compared to the private sector; (9) high and increasing overall government debt; (10) rigidities, including barriers to entry, in the labour and product markets; and (11) a financial sector plagued by bad loans.

None of these factors constitutes an imbalance in itself, if no other or only few of the listed negative factors exist.6 For example, a very large current-account deficit would not be a problem if a country is in an economic catching-up process, imports investment goods rather than luxury cars, lays the foundations for sustainable growth, and is building up the capacity to pay back its debt. It is the combination of several negative factors which creates imbalances. If a number of factors (e.g. the combination of 2, 3, 4 and 5 above) concur and are persistent, then the chances are that the country may experience an imbalance, and might run into balance of payments problems, i.e. is unable to reimburse its debt. Other combinations of factors may constitute additional imbalances within a country.

Unless appropriate corrections are applied, that country is heading for trouble. The problems mentioned above can be addressed by national policy measures. The aim of the MIP is to ensure that the Member State concerned does so, and does it in time, i.e. before negative spill-overs start affecting other Member States.

**EU mechanisms put in place**

Beginning shortly after 2008, the aim of EU legislators was to avoid a re-occurrence of the problems they had just encountered. The existing European economic governance framework was heavily revised and expanded in 2011, with the adoption of the 'Six-Pack'. Two of these six pieces of legislation laid the foundation for macroeconomic surveillance and the correction of imbalances. The others mainly fine-tuned the Stability and Growth Pact, which is meant to ensure the sustainability of public finances, especially in the euro area, and formalised the administrative aspects of the governance framework. Other pieces of legislation and related treaties followed. These comprise the 'Two-Pack', the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG, or Fiscal Compact), and the Europlus Pact. In addition, substantial work went into increasing the resilience of the financial sector through improved legislation, as well as the creation of the Banking Union.

It was clear at this point that the existing economic-governance framework had failed. Almost exclusively centred on correcting government budget slippages, effective measures were possible only at a stage when it was effectively too late, governments
would have to pay fines at a time when they were practically broke, and the identification
and correction of macroeconomic imbalances, which was in principle a task left to the
Eurogroup and Ecofin Council formations, existed only on paper. Only one warning was
ever addressed to a Member State, and that was after 2008.

In particular, the macroeconomic imbalance procedure (MIP) is designed to avoid the
emergence of problems, preferably even before imbalances materialise, and to correct
existing problems in time, before balance of payments problems arise and/or a Member
State defaults on its public debt. In addition, the MIP is capable of identifying problems
the Stability and Growth Pact (SGP) does not detect, something that became necessary,
as some Member States which came under pressure after 2008 were considered to enjoy
sound fiscal fundamentals. The MIP concerns all Member States, except those under
financial-assistance programmes, and thus already being watched closely. Sanctions only
concern euro-area Member States.

The procedure works in several stages. A set of economic indicators are initially used to
flag up countries which may experience imbalances. The indicators chosen by the
European Commission concentrate on a small number of fields, which give a first, rough
indication of the possible existence of imbalances in a country. Indicators are not
compared between Member States, but are read against thresholds defined ex ante by the
Commission. If thresholds are crossed, an alert is raised. For easy reading, a
scoreboard is drawn up comprising all indicators. The thresholds were chosen arbitrarily,
and Regulation No 1176/2011 explicitly states that the 'crossing of one or more indicative
thresholds need not necessarily imply that macroeconomic imbalances are emerging',
adding that 'conclusions should not be drawn from an automatic reading of the
scoreboard'. This strongly differentiates the MIP from the SGP’s excessive deficit
procedure (EDP) (see box).

If the Commission, in reading the scoreboard, estimates imbalances may exist in Member
States, it carries out an individual in-depth review (IDR) for each of these countries.
Regulation No 1176/2011 stipulates that the 'in-depth review should be undertaken
without the presumption that an imbalance exists and should encompass a thorough
analysis of sources of imbalances in the Member State under review, taking due account
of country-specific economic conditions and circumstances of a wider set of analytical
tools, indicators and qualitative information of country-specific nature'. At that stage, any
aspect of relevance can be taken into account, including spill-over effects emanating from
other Member States and divergences (especially in competitiveness) between countries.
Trade and financial interlinks, institutional settings and different starting positions across
countries are also analysed. Multiple macroeconomic models and datasets are used. Only
once an IDR is completed, can the Commission decide if an imbalance, or even an
excessive imbalance, exists in the country under review. The results of each country’s IDR
are summarised in the alert mechanism report (AMR), which constitutes an essential part
of the European Semester.

Upon a recommendation from the Commission, the Council recommends policies for
countries with imbalances. Simple imbalances trigger the preventive arm of the MIP,
when the recommendations are included in the country-specific recommendations, and
are monitored. Excessive imbalances will trigger the corrective arm of the MIP, launching
an excessive imbalance procedure (EIP), requiring the Member State to submit a
corrective action plan (CAP). Once agreed upon, non-compliance with the CAP may lead
to financial sanctions.
Asymmetric issues

The thresholds associated with the indicators sometimes have both an upper and a lower limit. These are not always symmetrical, e.g. the threshold for the current-account deficit is 4 %, whilst it is 6 % for a surplus. Regulation No 1176/2011 stipulates that when 'assessing macroeconomic imbalances, account should be taken of their severity and their potential negative economic and financial spill-over effects' and informs that 'the need for policy action is particularly pressing in Member States showing persistently large current-account deficits and competitiveness losses', whilst 'in Member States that accumulate large current-account surpluses, policies should aim to identify and implement measures that help strengthen their domestic demand and growth potential'.

A current-account surplus is not expected to be a clear and present danger for stability, and there is no economic reason to achieve bilateral trade balances. The current-account indicator measures a particular country against the rest of the world, and thus gives no indication concerning bilateral trade relationships inside the EU. Although there might sometimes be a degree of correlation, neither the regulation, nor the Commission compendium, nor the AMR imply a causal relationship between current-account surpluses and deficits, where one would mirror the other in the EU.

Also, there is evidence that, prior to 2008, surplus countries' current-account balances rose mainly through increased trade with non-euro-area countries. Nevertheless, large current-account surpluses can bear vulnerabilities, especially in cases of a sudden collapse of world trade (as experienced by Germany, among others, in 2008), and may point to imbalances within a country, which might lead to spill-overs that require correction (e.g. through structural reforms).

Appraisal and outlook

Some consider that, had the current framework been in place from the beginning of the euro area, the EU could have taken corrective measures at an earlier stage, possibly even avoiding the crises. It is estimated that the imbalances of the countries which subsequently required financial-assistance programmes would have been identified in 2003 or 2004, with similar results for other countries suffering from imbalances. However, the identification of imbalances is not synonymous with their correction: a strong political will to act is also needed. Without the courage to take unpopular measures, the crises may not have been averted. The MIP is difficult to enforce and subject to very broad political interpretation, both by the Commission and in Council. The MIP also needs to be assessed in the light of ongoing reforms, such as that of the financial sector, and may require swift adaptation. However, in a conceptual departure from the existing framework, the asymmetrical character of the analysis and the required adjustments has been criticised.

Main references


Gros, D., How to deal with macroeconomic imbalances?, CEPS Special Report, No 69, November 2012.

Understanding the macroeconomic imbalance procedure


Endnotes

1 Leaning on a vocabulary widely used but seldom defined in the academic sphere, the terms 'core' and 'periphery' used in this briefing are meant to differentiate somewhat arbitrarily between two categories: (1) established and economically developed, often large-sized countries, typically part of the European integration process for a very long time, and (2) smaller countries, which were catching up very fast economically in the years preceding the financial crisis and European sovereign debt crisis.

2 A notable exception is former President of the European Central Bank, Jean-Claude Trichet, who, at Eurogroup meetings, warned about macroeconomic imbalances and their possible consequences.

3 There is some similarity with the period before the burst of the 'dot.com' bubble, for which the lack of risk awareness was described as 'irrational exuberance' by US Federal Reserve Board chair, Alan Greenspan.

4 Mechanisms such as the ESM completely replaced private capital as a source of finance for governments who had lost market access. As the financial help was given in the form of loans, conditionality was introduced in order to protect the creditors' interests, to make sure that the countries which got the loans would be able to pay these back after a period of adjustment and recovery.

5 A total of seven EU Member States, three of which were not part of the euro area at the time, were subject to an acute sovereign debt crisis and requested help through a combined EU/IMF financial support programme. Another country obtained support solely aimed at recapitalising its fragile banking sector, bringing the number of Member States requesting external help to eight.

6 Illustrated by ECB President Mario Draghi in a speech: 'Current account imbalances could be justified for any country, including those participating in a monetary union, and they do not necessarily reflect a loss of competitiveness. But increasingly, larger current account deficits have resulted from significant losses of national competitiveness, signalling domestic macroeconomic imbalances and deeper structural problems.'

7 This is not to be confused with the analysis of bilateral flows and stocks carried out to assess spill-over effects in the framework of an IDR.

8 Conceptually, there is quite a difference between correlation and causation. Before 2008, there was certainly a correlation between the saving surplus in the core and the saving deficit in the periphery, but this does not imply there was causation between the saving surplus in some countries and the decisions to use the money inflow for consumption rather than investment. Net debtor countries have now corrected excessive current-account deficits. Data for 2016 show that most euro-area countries have a current-account surplus, or at least a balanced position, thus demonstrating that surpluses and deficits do not automatically mirror each other in the euro area. (The only possible scenario where there would always be a mirroring is when two countries do all their trade between each other, whilst maintaining no economic link with the rest of the world.)

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