

Do we need an macroeconomic imbalance procedure?

Gilles Saint-Paul

Ecole Normale Supérieure (Paris Sciences Lettres) and PSE.

0. Introduction

The macroeconomic imbalance procedure is a device for monitoring the EU member states' economic situation, in order to detect imbalances pertaining to the external sector, competitiveness, asset prices, and the financial situation of the private sector. When the procedure is fully in place, "excessive macroeconomic imbalances" are supposed to be detected and a correction mechanism is supposed to be enforced.

The plan assumes that there is an objective way of detecting an imbalance, that sustainability of such imbalances can be assessed, that it is socially desirable for a supranational entity like the European Commission to impose corrective measures upon member states, and finally that those corrective measures are enforceable.

I believe there is no firm basis in economic analysis or in the record of the European Union to justify such a procedure. I will now explain my reasons for this belief.

1. We do not know what an imbalance is

The notion of an imbalance is not properly defined, and, if it were, it would be unclear why one should fight it as such. An economy can be "balanced" and yet pursue highly inefficient policies; or it could appear as "imbalanced" while any intervention to correct the imbalance would be harmful.

Consider the example of trade deficits. Against which benchmark should we evaluate whether the trade deficit is problematic? In a world with free capital movements, trade imbalances and their counterpart capital flows should not come as a surprise. Trade deficits occur whenever national savings fall short of investment, and this may be for perfectly good reasons, like a surge in investment opportunities, transitory needs for public or private consumption, or a change in the age structure of the population. This is not only a corollary of the existence of a single market for goods and financial assets, but one of its benefits.

Similarly, a country may seem to lose competitiveness, without this being a problem per se. Competitiveness will fall if the domestic price level goes up relative to the rest of the world (that is, the real exchange rate appreciates). This may be just due to the allocative response of prices within the country to a shift in the composition of aggregate demand; for example, the surge in public spending following German reunification had to be matched by a real

appreciation in order for productive resources to be reallocated away from exports and toward the domestic economy. Another example occurs when a poorer country is catching up with the rest of the world in productivity terms. In such a situation, the relative price of non traded goods (such as haircuts) has to go up. If the country is in a monetary union, it will experience more inflation than its neighbors. This necessary adjustment in relative prices may be wrongly interpreted as an imbalance in competitiveness.

Putting these two examples together, a country growing fast because it is catching up will be observed to run a trade deficit -- because its residents borrow against future higher incomes so as to smooth consumption -- and to simultaneously experience a real exchange rate appreciation, i.e. "loss of competitiveness", and yet it will be at an economic optimum.

As a third example, it is quite difficult to distinguish an asset bubble from an appreciation of the fundamental value of the asset. In the case of the Spanish housing market bubble, for example, real interest rates were low, while potential economic growth appeared to be high, and the demand for housing was boosted by immigration. It was perfectly possible to interpret the appreciation of house prices as entirely due to fundamental factors.

This does not mean that worrisome imbalances do not arise, but it does mean that detecting them may be beyond the expertise of either the EU or national institutions. The macroeconomic imbalance procedure may therefore lead to a large number of type I and type II errors (subjecting a sound economy to corrective measures, and ignoring unsustainable developments).

2. We do not know whether an imbalance is "unsustainable".

One central argument in favor of preventive and corrective procedures is that the imbalance may be "unsustainable", and the procedure may avoid future catastrophies. For example, we could imagine that protracted trade deficits in some Eurozone countries might lead to a speculative attack against the euro, or to a critical mass of private defaults that may lead to a wave of contagion. But this overlooks the fact that markets provide self-correcting mechanisms; a country that accumulates trade deficits is depleting its foreign assets, which eventually makes its residents poorer in financial terms. Accordingly, they will cut on consumption which will work toward restoring equilibrium. The opposite occurs if a country accumulates trade surpluses. In recent years, the Spanish trade deficit has been reduced drastically, while Japan has moved from a surplus situation to a deficit one. These episodes illustrate the strength of the self-correcting mechanisms.

3. Some perceived imbalances are consequences of legitimate choices by sovereign governments

A "macroeconomic imbalance" will often be the market response to decisions made by sovereign governments. We can refer again to the German reunification example. In such situations, an injunction by the European Commission or Council to correct the macroeconomic imbalance may amount to a confiscation of sovereignty away from an elected constituency in favor of a supranational non-elected entity.

More fundamentally, to establish the legitimacy of a macroeconomic imbalance procedure, one has to prove that such imbalances exert "externalities" upon the rest of the Eurozone. The effect on interest rates, asset prices, etc, is no proof of such externalities; any action by a market participant affects market prices, and it does not follow that such action is inefficient nor that "corrective" measures would improve welfare.

4. The process may add to economic uncertainty due to ambiguities in enforcement

The record of the European Commission in enforcing its own rules is not encouraging. Unlike national governments, the EC does not have a police force that it can use for the purpose, say, of seizing property as a penalty for noncompliance. To be sure, the EC may reduce transfers to net recipients of CAP or structural funds, but it can hardly impose financial sanctions on net contributors to the Union's budget.

When sanctions are due, national governments may opportunistically collude to block imposing them, as was the case back in the 2000s under the Stability Pact when France and Germany violated it. The EC itself may postpone action, thus behaving in a discretionary way, because it is considering only the immediate consequences of its measures, irrespective of the need to apply rules. For example, during its current excess deficit procedure, France is facing (in my view) considerable leniency on the EC side, because the EC fears that an obvious tough stance vis à vis France could scare markets, raise sovereign spreads, and reignite the Eurozone fiscal crisis.

Because of those shortcomings, the existence of a euro area macroeconomic imbalance procedure may fuel policy uncertainty rather than reduce it, as market participants will be uncertain, in each instance, about the likelihood of sanctions and their nature.