Macroeconomic Imbalances Procedure: has it worked in practice to improve the resilience of the euro area?

Euro Area Scrutiny

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Abstract
The main aim of the paper is to assess the contribution of the Macroeconomic Imbalance Procedure (MIP) to its original objectives. It analyses whether the European Union and the Euro Area are today better equipped to identify and prevent unsustainable macroeconomic developments in the future. It provides an overview of how the MIP has worked in practice. It presents some stylised trends in macro variables and how the procedure tracks them. It provides a counterfactual exercise on how the procedure would have helped to address the underlying problems in those Member States that required financial assistance during the financial and economic crisis. The main policy recommendations of the study are that some re-tooling of the MIP is necessary and that increasing its ownership at the national level is essential.

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EXECUTIVE SUMMARY

After nine years since its introduction, it is time to re-consider the Macroeconomic Imbalance Procedure’s principles, criteria, analytical framework, and take stock of its actual implementation. This paper focuses more narrowly on three aspects.

First, it tries to assess how well the MIP has contributed to its stated and expected objectives and, more broadly, whether the MIP has better equipped the Euro Area to identify and prevent unsustainable macroeconomic developments.

Second, it engages in a tentative counterfactual exercise to see whether the currently upgraded economic surveillance would have helped in preventing the emergence of vulnerabilities and imbalances, namely in those Member States that required financial assistance during the financial and economic crisis, i.e. Greece, Cyprus, Portugal, Ireland, and Spain. It also includes Italy, which at some point was close to experiencing severe financial stability issues.

Third, leveraging on a ten-year experience in the implementation of the procedure, it tries to make some policy recommendations on how to make the prevention of unsustainable policies more effective in the future and whether other supranational policy tools could help complement the current framework.

The paper takes into account the current debate on the reform of the EU and Euro Area governance. While the MIP is for the whole of the EU, the paper focuses on the Euro Area, as the sharing of the single currency makes macroeconomic imbalances even more dangerous and hard to correct.

It concludes that the procedure has substantially improved the macroeconomic dialogue and the policy debate on the best ways to address structural issues and imbalances and, at the margin, has likely strengthened policy response, although imbalances are not directly under the control of policymakers. Spotting the next crisis is a tough exercise, and it is not what the MIP stands for. However, the MIP can contribute to reducing the areas of weakness and the macroeconomic trends that may prove to be unsustainable. The reduction of structural weaknesses through policy action has likely already benefitted the resilience of Member States’ economies and that of the EU/Euro Area to external or internal shocks.

Many issues, however, remain outstanding. The Euro Area and individual countries are still vulnerable and exposed to shocks. Especially the level of public and private debt, and, for some countries, the net international investment position remain a concern. Resilience to shocks cannot be addressed only through changes in the macroeconomic structure of the Euro Area economies. Advances in other areas would be required, and especially in terms of a Euro Area fiscal capacity and the sharing of risk. These advances are linked to the ongoing governance debate and go beyond the scope of this paper.

Some specific changes to the MIP could achieve better results in the near term. These include taking into account the Euro Area dimension more explicitly, i.e. spillovers, complementarities, and trade-offs, as well as the different economic structure of individual countries, due to specialisation and the proper allocation of resources within the area.

Finally, it is of the essence to increase ownership of the process, which can be achieved through increased transparency of methodologies, the setting up of National Productivity Boards in all countries, as well as other ways to make the policy debate more explicit and evidence-based at the level of national governments, parliaments, and public opinions.
INTRODUCTION

The Macroeconomic Imbalance Procedure (MIP) was introduced in the wake of the 2008-2009 European sovereign debt crisis, as part of a comprehensive set of reforms aimed at addressing the flaws in the initial design of the Economic and Monetary Union (EMU), prevent future problems and support macro-financial stability, thereby widening the scope of the surveillance framework beyond fiscal policies\(^1\). Its objective was to identify, prevent and ultimately correct macroeconomic imbalances. If left unaddressed, imbalances may lead to spillovers from one country to the others and compromise the proper functioning of the monetary union. The Procedure is part of the European Semester, which enables the European Union (EU) member countries to coordinate their economic policies, address economic challenges and strengthen macroeconomic surveillance.

The introduction of the euro produced a sharp reduction in interest rates and large capital flows, mostly from the core to the periphery of the Euro Area. Financial flows were accompanied by imbalances in current accounts, divergent trends in price competitiveness, and some financial asset and housing bubbles. In 2008-2009, a sudden stop or reversal in financial flows resulted in the burst of asset bubbles and an economic downturn, which eventually led also to severe public finance problems. It was a typical balance of payment crisis, triggered by excessive accumulation of external and internal imbalances. These trends went largely unchecked and unmonitored until the crisis. Only in 2011, as part of the reform of governance, the MIP was introduced and became then operational in 2012.

It may well be misleading to look at the identified number of macroeconomic imbalances over the years and simply draw conclusions on the increase or decrease of risk and policy reaction, as the qualitative nature of imbalance differs substantially. It may equally be deceptive to look at legislated changes, as assessing actual implementation is of the essence. Even effective implementation may not be enough to correct imbalances, as correcting imbalances may not be entirely under the control of national governments. In some cases, the drivers may be related to much deeper EU-wide or global phenomena. Macroeconomic instability is a multi-faced concept with many dimensions, which may change over time and may be as much country-specific as EU-wide or global. In theory, this characteristic would call for an even stronger policy action to counteract unsustainable macroeconomic developments. In practice, sometimes there is not enough recognition of the seriousness of the imbalance problem and the causal link between policy action and correction of imbalances is somewhat feeble. Relative to the Stability and Growth Pact, which is rule-based and focused on budgetary policies, the MIP has a much broader scope and inevitably introduces much more judgemental elements in its implementation.

The procedure itself has changed over the years, with the introduction of additional indicators to take into account broader implications of adjustment processes, especially related to unemployment and the broader social pillar. The way the procedure is actually implemented has also changed. Linking some or all of the Country-Specific Recommendations (CSRs) adopted by the Council to the MIP should have underpinned its effectiveness, as this could lead to entering a formal procedure, the Excessive Imbalance Procedure (EIP). Prima facie, however, experience suggests that there has been no strengthening in the implementation of recommendations. Despite the European Commission was very close to triggering the EIP in the past, and there were repeated calls by the Council and the European Central Bank to use its full potential, the procedure has not been initiated yet.

2. HOW WELL DID THE MIP CONTRIBUTE TO ITS OBJECTIVES?

The MIP is fully integrated into the European Semester. The Semester starts with the Annual Sustainable Growth Strategy (ASGS), the annual cycle of economic policy coordination, where national policies are reviewed collectively at EU level. The ASGS is the Commission’s primary tool for setting out the general economic and social priorities for the EU for the following year. In this document, the Commission gives Member States focused policy guidance on strengthening the recovery and foster convergence, in line with the EU’s long-term growth strategy Europe 2020. It applies to the EU as a whole and the Member States individually. Its main messages form the basis for the CSRs in spring, which may be linked to the formal MIP procedure, to strengthen their validity and enforcement.

The first step of the annual cycle of the MIP is the Alert Mechanism Report (AMR), usually published by the European Commission in December, with data referred to the previous year. The analysis presented in the AMR is based on a scoreboard of selected indicators, which acts as an early warning device, also supported by a much broader set of auxiliary indicators, assessment tools and additional relevant information.

Headline indicators are associated with thresholds, which were set discretionally and do not constitute legal limits of the same nature as the deficit rules. If trespassed, they may trigger an In-Depth Review (IDR) of the country concerned. The scoreboard and the AMR are the first screening devices to identify Member States with potential macroeconomic imbalances and in need of some policy action for which an IDR is proposed.

Following a discussion with the European Parliament and with the Council and the Eurogroup, the Commission prepares IDRs for the Member States, usually in March. IDRs are analytical documents aimed at identifying and assessing the nature and severity of macroeconomic imbalances. The outcome of the analysis could result in four different categorisations of imbalances: (1) no imbalances, (2) imbalances, (3) excessive imbalances, (4) excessive imbalances with corrective action. These are reported in a specific Commission Communication, to ensure consistency and better take into account systemic Euro Area-wide aspects. For the Member States experiencing any macroeconomic imbalances (2, 3 and 4), most of the CSRs are linked to those imbalances. Recommendations, including those linked to the MIP, are then endorsed by the European Council and formally adopted by the ECOFIN Council in June/July. Since 2015, under the so-called ‘streamlined Semester’, the recommendations tend to focus on the objectives to be achieved, while largely leaving the exact definition of measures to be introduced to the discretion of national authorities.

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4 There are 14 indicators, of which 5 relate to external imbalances, 6 to internal imbalances, and 3 are employment indicators. 28 auxiliary indicators providing additional information on various aspects of the general macroeconomic situation supplement them. For instance, on the accumulation of external imbalances, some additional indicators such as the ‘NIIP excluding non-defaultable instruments’ have been added.

5 With the exception of labour market indicators. On 24 June 2015, the European Parliament urged “these indicators to be put on a genuinely equal footing with the existing indicators, allowing them to trigger in-depth analysis in the relevant Member States and guarantee that their internal imbalances are further assessed, with economic and social reforms being proposed and monitored”.

6 Including when imbalances were identified in the previous round of IDRs.
‘Specific monitoring’ is applied to the Member States with imbalances or excessive imbalances, which is adapted to the degree and nature of the imbalances. It involves an intensified dialogue with national authorities, as well as progress reports. Countries found to be experiencing ‘excessive imbalances with corrective action’ are liable to face the EIP and take corrective actions to address the identified imbalances by submitting a Corrective Action Plan. Non-compliance may lead to a fine (Euro Area countries only).

2.1. Are the objectives of the procedure clearly defined?

Since the MIP introduction, there have been some ambiguities in its objectives. While it is possible to highlight some regularities in past crisis episodes, the next crisis will almost certainly be different from those experienced in the past. This is especially true for crisis determined by financial rather than macroeconomic shocks.

The MIP appropriately focuses on broad macroeconomic trends, which, if left unchecked, may lead to unsustainable developments, rather than trying to spot the next crisis. In other words, the real aim of the macroeconomic imbalance procedure is to build up resilience by identifying and making sure that unsustainable trends do not develop in ways that could undermine the stability of specific countries and the whole EU/Euro Area over time. The impending crisis will come from unexpected sources, and thus limiting the risks and increasing resilience is an appropriate objective for the MIP.

Within these broad aims, from time to time, other interpretations have emerged. Some refer indeed to the spotting of the next crisis, and it is not clear whether the focus would be more about intra-EU or Euro Area tensions, or be related to external shocks. Other ambiguities refer to the balance between identifying risky macroeconomic imbalances that jeopardise the functioning of the EMU, i.e. undertaking policies that are best for the specific countries, to limit imbalances that undermine their stability in their own best interest or forcing countries to do what is best to protect the rest of the EU/Euro Area from a fallout. Both aspects are of course closely intertwined, but at least in principle, they could be seen as separate.

Another implicit objective, sometimes openly recognised, is to make Europe 2020, i.e. the structural reform process, more binding by strengthening the European Semester. This is achieved by linking CSRs to a formal procedure, which may lead to fines, and thus forcing Member States to introduce policy responses. According to the Five President Report, the MIP “should be not just to detect imbalances but also to encourage structural reforms through the European Semester. Its corrective arm should be used forcefully. It should be triggered as soon as excessive imbalances are identified and be used to monitor reform implementation”. It “should foster adequate reforms in countries accumulating large and sustained current account surpluses if these are driven by, for example, insufficient domestic demand and/or low potential growth, as this is also relevant for ensuring effective rebalancing within EMU.”

Moreover, with the strengthening of the social pillar and the introduction of labour market indicators, some stakeholders see the MIP as a way to put forward broad policy objectives, which risks producing a sort of ‘Christmas tree effect’.

Finally, there has probably been too much media and countries’ attention to the developments of headline indicators. Analysing their underlying causes and the complex relationships with the broader economy is more important. A more holistic non-mechanical approach would be beneficial, although by and large, this latter has always been the approach of the Commission.

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7 See for instance Manasse and Roubini (2009).
The implementation (or transposition) of MIP-related CSRs into national policy has been sometimes controversial. In the past, the Commission, in cooperation with EU Council working groups, introduced an enhanced and transparent methodology to assess the economic impact of structural reforms (so-called ‘LAF’, i.e. LIME Assessment Framework⁸). LAF is a methodological tool that compares the performance of EU Member States, and can help underpin the assessment of policy challenges facing Member States in raising growth potential. Building upon the results of an extensive literature survey, it systematically compares the performance of Member States in terms of GDP and twenty policy areas affecting growth, looking at both levels and changes, relative to EU benchmarks. This involves the utilisation of scores calculated from quantitative indicators, which leads to an assessment of relative performance. Additional information on country-specific conditions and circumstances is an integral part of the LAF as a complement to the indicator-based assessment. Evidence-based analytical tools are essential in clearly defining objectives, enhance transparency and convey political support. However, the developed methodology has apparently become a sort of internal tool for the Commission, instead of a set of metrics to support a debate on policy objectives.

2.2. The stand-alone approach

Are imbalances really so bad? Greater integration of product and service markets across EU countries may imply greater sectoral specialisation and different growth models that, in turn, may result in some imbalances. In other words, imbalances may be the by-product of an economic integration that takes advantage of specialisation and proper allocation of resources within the Euro Area.

The MIP considers imbalances as potentially harmful for the proper functioning of monetary union, and thus tries to prevent and address them in a timely manner. To some extent, the logic behind the MIP is based on the fact that European political and fiscal integration is still lacking and, therefore, countries need to be considered as stand-alone entities, and thus imbalances avoided. In a more economically integrated EU, different growth models, implying the presence of some imbalances, would not necessarily be a problem and could instead represent opportunities⁹.

The impact of industrial specialisation and re-allocation of resources within an economic area may produce effects working in opposite directions. The process of integration promotes convergence in income levels and factor endowments, while the elimination of exchange rate fluctuations due to monetary union reduces the uncertainty associated with cross-border transactions. Economic theory has long debated the different implications of these mechanisms and has not yet provided clear answers.

Is specialisation good for the EU and the Euro Area? The benefits of specialisation for a currency union can be assessed in terms of productivity growth and competitive advantages. In the US, where some States specialise in specific sectors, specialisation does not appear to have undermined the strength of the US economy or the proper functioning of the union. Deepening specialisation, instead, could explain the relative strength of the US economy vis-à-vis the rest of the world. To some extent, Europe’s innovation gap relative to the US may be the result of different degrees of regional specialisation of the US industry in high-R&D-intensity sectors. The MIP implicitly supports a more homogeneous economic structure across the Euro Area, which would reduce imbalances, as opposed to a deepening of

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⁹ See K. Hagelstam, C. Dias, J. Angerer, A. Zoppè (October 2019) for a concise comparison to the economic governance framework in United States.
specialisation. Instead, it would be more desirable that each Member State independently develops those activities where there is a comparative advantage.

Is the MIP appropriate for an integrated or would-be integrated economic area? The “Classical Trade Theory” would suggest that economic integration, especially for an area sharing the same currency and an increasingly integrated economic governance, leads to more significant economic divergence and specialisation in economic structures. Other theories, such as the “New Trade Theory” are less straightforward. In fact, under certain conditions, economic integration could determine a process of structural convergence, but the opposite could also happen. The existing empirical analysis is inconclusive. Some studies seem to suggest that the process of specialisation among EU countries has accelerated; others do not provide sufficient evidence. Divergent patterns of sectoral specialisation may contribute to different productivity growth rates and current account balances as well, implying co-existence of different industrial and economic structures and a different pace of employment creation and output generation in different countries. The sectoral composition may also have a substantial impact on total factor productivity growth. Furthermore, greater specialisation could result in some de-synchronisation of business cycles across countries and non-synchronous reactions to common shocks. Different growth rates and output trends across Member States should be expected as a result of integration, and policy should make sure that divergence remains within limits. The more integrated the Euro Area becomes, the less crucial will be to monitor imbalances in the individual Member States, as they would find a natural offset in other parts of the Euro Area. The MIP, instead, tends to treat MSs as though they were stand-alone entities.

Another critical aspect when discussing MIP objectives is the role of structural supply-side policies in dealing with economic shocks. During the sovereign debt crisis, policymakers have learnt a lot about the vulnerability of the EMU. The European institutional framework is not prepared, or at least it was not prepared during the crisis, to cope with large asymmetric shocks. The crisis revealed that the lack of an appropriate overall fiscal stance, or a centralised fiscal capacity, could not be adequately compensated by an effective common monetary policy and a few ad hoc emergency measures. As long as the Euro Area cannot mobilise resources to dampen the short-run effects of shocks on disadvantaged nations, national authorities will have to cope with the difficult mission of adjusting to area-wide shocks without counting on country-specific monetary policy and exchange rates, and without impairing national public finances. The MIP can help to prevent macroeconomic imbalances from getting out of control and contribute to making the economy more resilient. However, supply-side reforms cannot fully substitute for demand management in response to severe demand shocks\(^{10}\).

### 2.3. Tracking policy response and implementation

In the first eight years of application of the MIP (2012-2019), several countries have been subject to an IDR. Counting the number of recommendations or the countries for which an IDR was performed, or the type of final assessment, and trying to describe a trend may be misleading for several reasons:

(1) The sample of countries for which the MIP applied has changed over the years. For countries under an economic adjustment programme, the IDR is not performed, there is no final assessment on imbalances, and the number of countries in and out of adjustment programmes has changed over the years. Most of the times, countries exiting the economic adjustment programme were immediately found to have imbalances or excessive imbalances. Moreover, in 2013 there was Croatia’s accession to the EU.

\(^{10}\) See Codogno and Van den Noord (2019).
(2) Since 2015, with the introduction of the ‘streamlined Semester’, some policy areas are no longer covered by CSR, and thus there is no longer a link to the MIP. Other policy processes, e.g. the Single Market, the European Research Area and the Innovation Union, and the Energy Union, now address them. Thus, the number of recommendations under the MIP has, by default, declined.

(3) The number of scoreboard indicators has changed over the years, moving from 11 to 14 in 2016, and thus the metric for the IDR has changed as well. The number of categories of imbalances in the final assessment has equally changed, i.e. 5 in 2012, 6 in 2013-2015, 4 in 2016-2019.

(4) Criteria for the classification has never been fully explained, and it remains largely under the full discretion of the Commission, giving rise to the suspicion that the process is more political and subjective rather than technical.

However, despite these drawbacks, a few descriptive statistics could provide some insight into the development of imbalances and the related policy response. The number of IDRs rose from 12 in 2012 to 19 in 2016 (out of 19, 6 were identified as having excessive imbalances)\textsuperscript{11}. In 2018, there were 11 countries found to have imbalances, with only 3 countries in excessive imbalances. In 2019, the number increased to 13, of which 3 in excessive imbalances. In 2020, it remained unchanged at 13. Figures A1-A14 in the Annex show the behaviour of scoreboard indicators for Euro Area countries. From graphical inspection, it is possible to draw some conclusions.

First, most of the times, scoreboard indicators have moved in the desired direction, showing a reduction in imbalances that could have become unsustainable and risky for the macroeconomic stability of individual countries and the whole area, and thus increasing resilience. Moreover, the dispersion in macroeconomic indicators has somewhat declined, and this is welcome.

\textbf{Figure 1: Index of standard deviations of scoreboard indicators relative to 2008}

\textsuperscript{11} IDRs are not performed for programme countries as the Memorandum of Understanding and the monitoring of the programme already address the main issues.)
As discussed above, however, some degree of divergence may be tolerated, as it reflects different specialisation of the economies and the search for the best allocation of resources within the Euro Area. Figure 1 presents dispersion trends by showing standard deviations of scoreboard indicators for the 19 countries in the Euro Area, with the base year 2008. They have decreased overtime for 6 out of the 11 variables (the new employment indicators are here excluded). The most significant decline is recorded for private sector credit flows as a percentage of GDP, confirming that most of the unsustainable rise before the crisis deflated afterwards.

Between 2012 and 2019 there were 104 episodes in which the Commission identified some imbalances, of which 28 were classified as ‘excessive’. Being in excessive imbalance tends to be persistent, reflecting the long-lasting characteristic of many imbalances and the difficulties and time lags in the policy response, and sometimes even the lack of implementation.

Moreover, there is a relationship between the number of CSRs and the assessment of imbalances, although this has changed over time. While the content of the recommendation should be what matters, there has been a sort of stigma in receiving a high number of recommendations. Representatives of Member States have spent Council Committee time and effort trying to reduce the number of CSRs before the final Council approval. The European Commission also made explicit the link between the number of CSRs and imbalances.

More recommendations also seem to be related to the number and quality of adopted policy responses and structural reforms, possibly suggesting that CSRs and especially the link to the MIP has been useful in putting pressure on national governments to deliver.

### Table 1: CSRs, summary statistics

<table>
<thead>
<tr>
<th>European Semester</th>
<th>Total number of CSRs</th>
<th>Number of Member States</th>
<th>Minimum number of CSRs per Member State</th>
<th>Maximum number of CSRs per Member State</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>138</td>
<td>23</td>
<td>4</td>
<td>DE,SE</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>ES</td>
</tr>
<tr>
<td>2013</td>
<td>141</td>
<td>23</td>
<td>3</td>
<td>DK</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>ES,SI</td>
</tr>
<tr>
<td>2014</td>
<td>157</td>
<td>26</td>
<td>3</td>
<td>DK</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>ES,HR,IT,PT,RO,SI</td>
</tr>
<tr>
<td>2015</td>
<td>102</td>
<td>26</td>
<td>1</td>
<td>SE</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>FR,HR,IT</td>
</tr>
<tr>
<td>2016</td>
<td>89</td>
<td>27</td>
<td>1</td>
<td>SE</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>FR,HR,IT,CY,PT</td>
</tr>
<tr>
<td>2017</td>
<td>78</td>
<td>27</td>
<td>1</td>
<td>DK,SE</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>HR,CY</td>
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<tr>
<td>2018</td>
<td>73</td>
<td>27</td>
<td>1</td>
<td>DK,SE</td>
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<td>CY</td>
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<tr>
<td>2019</td>
<td>97</td>
<td>28</td>
<td>2</td>
<td>DK,DE,EL,UK</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>CY,IT,RO</td>
</tr>
</tbody>
</table>


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12 As indicated also in European Commission (2020), page 37-38, Member States experiencing imbalances or excessive imbalances have received more policy recommendations than other Member States, “justified by the additional challenges they face”.


However, many factors impinge on the ability of a country to deliver. These factors also include cyclical developments, although they can act both ways. A better macroeconomic situation may facilitate the re-balancing in the economy without policy action, but may also reduce pressure on policymakers to deliver on reforms.

Some studies\textsuperscript{15} suggest that compliance with recommendations has been on average rather weak, and it has even worsened in recent years. This is consistent with the recent more moderate pace of adjustment of the relevant variables of the scoreboard. If we measure implementation rates by the assessment of the Commission (i.e. ‘progress’ or ‘limited progress’), the message is reinforced. Other studies suggest that implementation is frailer when recommendations are not backed by credible enforcement rules or sanctions, when institutions, and public administration capacity are weak, or the political/electoral cycle is unfavourable\textsuperscript{16}.

There is a significant difference between flow and stock indicators. Since the crisis, flow variables have broadly moved in the desired direction, but it has not happened in a way to turn the trends in stock variables. For instance, since 2008 the three-year averages of current account balances as a percentage of GDP have moved from large deficits to deficits well within the lower limit of the scoreboard (-4% of GDP), or even in surplus territory (Figure A1). Nevertheless, in many cases, the net international investment position (the stock variable) has continued to deteriorate (Figure A2). This is especially the case for countries that have benefited from financial assistance programmes, i.e. Ireland, Greece, Cyprus, Portugal, Spain. Figure A16 confirms this tendency.

In the analysis, Italy is associated with programme countries, although it never benefited from financial assistance programmes. It has experienced high levels of public debt-to-GDP together with major structural issues, as also reflected in a high number of CSRs. It was close to experiencing severe financial stability issues in 2011-2012, and assessed to have ‘excessive macroeconomic imbalances’ since 2014. Nevertheless, Italy does not have an external imbalance problem. The three-year average of the current account balance has gradually deteriorated to reach -2.7% of GDP in 2010-2011, and then it has improved moving into positive territory in 2014. The current account surplus is now hovering around 2.5-3.0%, thereby reducing the net international investment position, which is now close to balance. For programme countries, instead, the net international investment position has started to improve only in 2013-2015, and the stock remains well below the threshold of -35% of GDP.

Private sector credit flows and private debt show a similar stock/flow pattern. In 2018, private sector credit was in single-digit growth for all countries. For several programme countries, flows have been in negative territory since 2011. For Italy, again, there was no excessive growth before the crisis, while there has been contraction since the crisis. Ireland and Cyprus show a very high level of private sector debt, as well as the Netherlands (Luxembourg is a special case). In Ireland, however, the decline has been substantial since 2015. Since the crisis, there has been deleveraging in most countries. Both the level of debt and the dispersion among the Member States has increased since 2008 but is now on a declining path (Figure A8).

The same situation holds for general government debt (although the flow variable, i.e. the general government deficit, is not part of the scoreboard). General government debt has remained very high for several countries, although the average of the Euro Area countries has started to decline gradually since 2015 (Figure A9). Figure 1 shows that the dispersion in stock variables in the scoreboard has


increased since 2008, although there has been some reduction in recent years. By contrast, the dispersion in flow variables has steadily declined.

In relation to their thresholds, stock variables (i.e. public and private debt, and for some countries the net international investment position) remain very high and well above the reference values, with only small improvements in recent years. Labour market indicators have steadily improved, although for most countries the situation is still much worse than the one prevailing before the crisis.

Overall, policy action has likely contributed to reducing imbalances, although it remains unclear how much was related to cyclical developments and international trends in macro variables or on effective policy action, and how much of this was triggered by the MIP recommendations. Areas of vulnerability remain, notably the high level of public and private debt, and the net international investment position for some countries. At the margin, the recorded reduction in imbalances has probably made the Euro Area and individual countries more resilient to future crisis.

3. WOULD THE MIP HAVE AVOIDED THE EMERGENCE OF IMBALANCES?

A counterfactual exercise is close to impossible to perform, especially as the MIP is much more than the scoreboard of indicators. Trends in indicators since the late ’90s would have to be translated into CSRs linked to the MIP and recommendations, which would a somewhat subjective exercise. Instead, scoreboard indicators can be used to see whether they would have spotted the trends that led to imbalances.

3.1. Stylised developments in programme countries

In a stylised fashion, all programme countries recorded similar developments in the pre-crisis years. There was a deterioration in price competitiveness, with the real effective exchange rate (Figure A17) and nominal unit labour cost (Figure A19) moving in the wrong directions.

Capital inflows allowed the current account balance to worsen fast, pushing the net international investment position further into negative territory (Figure A15 and A16). Capital inflows went into housing markets, with house prices in some cases growing strongly (Figure A20), and through the banking channel, boosting private sector credit flows that almost everywhere grew at double-digit pace (Figure A21).

Inflows of capital also increased the level of financial sector liabilities (Figure A25) and private sector debt (Figure A22). Developments in public finances are less obvious. In fact, courtesy of economic growth, the rise in asset valuations, and benign labour market developments (all labour market indicators of the scoreboard improved), fiscal revenues got a boost before the crisis. With that, public finances overall improved, and general government debt-to-GDP levels declined in most programme countries (Figure A23). To sum up, a simple visual inspection of scoreboard indicators would have suggested unsustainable trends (with the possible exception of Italy). Table 2 shows the number of indicators that would have flagged in 2007 and 2004. They would have been enough to declare that these countries were experiencing ‘excessive imbalances’. The policy recipe would have been difficult, however.

The correction of macroeconomic imbalances started with tight fiscal policy almost everywhere. All programme countries engaged in a sort of more-or-less-severe internal devaluation, which depressed
domestic demand and increased unemployment. Only with a significant time lag, the reduction in labour costs translated into higher external competitiveness and thus economic growth.

Table 2: Scoreboard indicators for programme countries in 2004 and 2007

<table>
<thead>
<tr>
<th>European Semester</th>
<th>CA</th>
<th>NIIP</th>
<th>REE</th>
<th>EXP</th>
<th>ULC</th>
<th>HOU</th>
<th>PSC</th>
<th>PSD</th>
<th>GGD</th>
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<td>103.1</td>
<td>9.1</td>
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<td>6.2</td>
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<td>67.1</td>
<td>7.1</td>
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</table>

Source: European Commission.

CA=Current account balance (% of GDP), 3-year average; NIIP=Net international investment position, % of GDP; REE=Real effective exchange rate (42 trading partners, HICP deflator), 3 year % change; EXP=Export market share (% of world exports), 5 year % change; ULC=Nominal unit labour cost index (2010=100), 3 year % change; HOU=House price index (2015=100), deflated, 1 year % change; PSC=Private sector credit flow, consolidated, % of GDP; PSD=Private sector debt, consolidated, % of GDP; GGD=General government gross debt, % of GDP; UNE=Unemployment rate, 3-year average; FSL=Total financial sector liabilities, nonconsolidated, 1 year % change; the other labour market indicators of the scoreboard are not included.

The sharp deterioration in domestic relative to external demand produced a U-turn in current account balances. Figure 2 shows the negative correlation between nominal unit labour cost and unemployment, i.e. wages started to decline together with a rise in unemployment. Ireland was the first country to turn the sharply reduced nominal unit labour costs into a positive competitiveness factor, which has eventually reduced unemployment and given a boost to export market shares, although it took several years. Overall, so-called internal devaluation worked in some countries, although with a long lag, and social and political implications.

Figure 3 shows the positive correlation between the sharp increase in unemployment (implying weakness in domestic demand) and the turn in the current accounts balances. Going for such a painful adjustment without a crisis would have been hard to conceive in the pre-crisis period. Probably the best way to prevent unsustainable developments would have been channelling strong capital inflows into productive investments, while keeping growth in private sector credit flows and house price inflation (Figure A21 and A19) under control through macro-prudential measures.
With hindsight, it is evident that scoreboard indicators were growing at an unsustainable pace. However, following the start of monetary union, such growth might have also been perceived as a one-off adjustment to a new steady state, and thus it would have been hard to activate policy responses without a crisis. The bottom line is that spotting the problem with the lenses of the MIP would have been easy; designing and implementing a policy reaction would have probably been difficult and politically challenging anyway.

Figure 2:  Nominal unit labour cost vs unemployment rate, 2007-2018 change.

Figure 3:  Current account balance vs unemployment rate, 2007-2018 change.

3.2. What are the imbalances that really matter?
Italy seems to have performed somehow differently from programme countries, both before the crisis and in its aftermath. Italy never experienced sharp capital inflows or a fast deterioration in the current
account balance and the net international investment position. Private credit flows and financial sector liabilities, as well as house prices, grew less than in programme countries. In 2007, debt-to-GDP was steadily declining, although still in excess of 100% of GDP. The excesses of programme countries were not at play in Italy, and yet the downturn was equally severe and painful.

One lesson, and probably one key consideration for the MIP, is that not only developments in key scoreboard indicators count, but also stock variables that depict vulnerabilities. The most important ones are certainly public and private debt as a percentage of GDP and the stock of external liabilities. These stock variables are also the most difficult to change over the near-term. On the metric of stock variables, the current situation in the Euro Area, and especially in some countries, is at least as vulnerable and fragile as back in 2007-2008.

4. SOME POLICY RECOMMENDATIONS

The developments of the past ten years raise many fundamental issues in dealing with macroeconomic imbalances. Who should decide the best approach to a macroeconomic imbalance? Economic literature? Common principles developed at the EU/Euro Area’s level? Can a sufficiently agreed consensus emerge on specific policy responses? Diversity, experimentation, and country-specific solutions are a value for a large diversified economic area. Still, completely different policies cannot be allowed. What is the limit?

Moreover, the financial and economic crisis has eventually turned into a political and social crisis, and new governments have challenged old policy recipes to the point that agreeing on policy action today may be even more difficult than in the past. This also leads to fundamental questions about the political legitimacy of elected governments versus unelected bodies such as the European Commission and calls for more transparency and national ownership of the process. Furthermore, what is the role of European Institutions? Can the European Commission enter the political debate on macro imbalances and structural reforms with more clearly defined policy recipes? How can reforms and adjustments become socially and politically sustainable? What is the proper balance between national sovereignty and the European dimension?

A comprehensive response to these fundamental issues is hard to envisage without substantial steps in the direction of economic and political integration, and thus the ongoing debate about reforming EU/Euro Area governance is of paramount importance. Structural reforms to prevent macroeconomic imbalances from becoming harmful need to be complemented by a centralised fiscal capacity to address severe turns in aggregate demand or prevent supply-side damage. Fiscal policy should have a role beyond automatic stabilisers, especially when multipliers are unusually high and monetary policy is constrained by the zero-lower-bound. The Euro Area fiscal framework should allow a Euro Area fiscal stance as an extra layer on top of national policies, and adjustments at the national level should be tailor-made to country specificities. For instance, the European Fiscal Board proposed to regulate the speed of adjustment towards the Medium-Term Objective (MTO) in relation to Member States’ macroeconomic imbalances17.

Moreover, risk-sharing mechanisms should be introduced to limit the so-called doom-loop between the banks and the sovereigns, and advance banking and capital market unions to increase resilience of
the Euro Area economy and individual countries. This goes beyond the scope of this paper. There are, nevertheless, also specific ways to improve the effectiveness of the MIP in addressing imbalances.

4.1. Backward vs forward-looking approach and symmetry

The scoreboard and the MIP are mainly backwards-looking exercises, although in the IDRs the Commission also makes forward-looking assessments. The forward-looking part should probably come to the fore and become the most prominent if the procedure wants to play an important role in prevention. While preserving the legal references and the formal approach of the procedure, a more critical role should be given to Commission’s forecasts as a way to better anticipate future potential problems. This could easily be done by introducing a forward-looking scoreboard by using Commission forecasts.

Moreover, more should be done to make sure that the symmetric nature of external imbalances is properly taken into account. The MIP thresholds do not have the same legal validity of the fiscal requirements for good reasons, as the phenomena are not entirely under the control of policymakers and delivering is subject to a much broader set of variables and macroeconomic developments. This is particularly true for external imbalances, and especially current account positions. However, in practice, a lot more emphasis is placed on potentially harmful current account deficits at the national level, with surplus countries disregarding the recommendations, thus affecting the overall position of the Euro Area. To some extent, this is understandable as, the need for policy actions is particularly pressing in countries displaying sizeable current account deficits and competitiveness losses, which threaten the sustainability of their external debt. At any rate, most of the adjustment has happened on one side only, and the whole Euro Area has increasingly moved to a surplus position vis-à-vis the rest of the world.

The rebalancing of current account surpluses and deficits required for the overall area should also take into account the different structures of the Euro Area economies and the imbalances that are the result of economic integration. Figure A1 shows that, in 2007, 9 out of the 19 Euro Area countries recorded a 3-year average of current account deficits in excess of -4% of GDP (Ireland, Greece, Spain, Cyprus, Latvia, Lithuania, Malta, Portugal, Slovakia), with the Euro Area average at -3.7%. In 2018, only Cyprus was below the threshold, while two big countries (Germany and the Netherlands) have consistently recorded current account surpluses above 6% of GDP since 2012. As a result, the Euro Area current account balance has steadily moved towards a sizeable surplus position, reflecting not only a strengthened competitiveness position of Euro Area exports but also weakness in domestic demand.

Policy actions to address the issue of symmetry in the adjustment remain controversial, and the trend has gone unaddressed for several years. Despite the scoreboard has flagged this issue for long, and IDRs and Council’s recommendations sent clear messages, the current account balance in the Netherlands and Germany have continued to rise, driving up the position of the whole Euro Area. Large and sustained current account surpluses can have implications for the smooth functioning of the EMU, and addressing them would help support GDP growth in the Members States concerned, and would have positive spillovers to the rest of the Euro Area.

Another critical aspect that requires further advance is the emphasis on the Euro Area dimension, with spillovers, complementarities and trade-offs. In this regards, there has been significant improvement, including for instance the introduction of a ‘spillover matrix’ in the IDRs, which is now integrated into the country reports.
4.2. Frequency of the exercise

The European Semester process, especially during the spring months, result in very tight deadlines and time constraints that are indeed an obstacle to “full debate and the proper involvement in the process of civil society organisations, social partners, and even national parliaments and the European Parliament, and contribute significantly to the lack of a sense of ownership and implementation”18. The work of the Council Committees (EPC, EFC) is usually severely constrained by the deadlines of the Semester, which again limits the possibility to have a proper debate. Structural variables tend to move very slowly, and both indicators and recommendations do not change substantially from one year to the other. Moreover, policy action tends to bear its fruits typically with a time lag. The draft proposal by one Member of the European Parliament (and others) discussed in the Economic and Monetary Committee of the European Parliament19 to extend “the semester cycle to a biannual or triannual period, with the possibility of revision in case of major economic shocks” appears as very sensible. It would not only improve the effectiveness of the process, but also, and more importantly, increase its ownership at the national level.

4.3. Ownership of the process

Indeed, there is a need to get a stronger involvement of the European Parliament and national parliaments in the European Semester process. The creation of an institutional dialogue with all stakeholders, and especially the Commission, social partners, civil society, both at the European and national level, may provide a boost to democratic legitimacy and increase the ownership of reforms.

Moreover, different legal bases seem to prevent an assessment of structural issues/macroeconomic imbalances in the early stages of the national budget process pre-emptively. As a result, misguided decisions taken in the context of the Budget are effectively left unchecked until they produce their effects on macroeconomic imbalances, and at that time, it may be too late. The Five President Report clearly states that the MIP must be “a tool to prevent and correct imbalances before they get out of hand”. Can misguided policies be corrected once approved in the national Parliament and with the blessing of a democratic process? Is it better to prevent? This would effectively require an assessment of policy plans before national approval, or even before elections.

The Commission has used the MIP framework to favour structural reforms and put pressure on the Member States identified as having excessive imbalances. However, promoting reform actions and exerting peer pressure, without using the MIP to its full potential has been challenging. Although the Commission can put in motion ‘specific monitoring’, policy implementation cannot rely on strict and enforceable requirements. Moreover, there is effectively no way to prevent a legitimate government from rolling back previous reforms aimed to address structural issues and macroeconomic imbalances. Policy initiatives included in the national budget with implications on structural imbalances could not even be blocked in a pre-emptive way through fiscal surveillance. This weak enforcement power sometimes gives the impression that the MIP is a ‘paper tiger’.

Over the years, there has been an effort to link the MIP analysis and recommendations with the other surveillance procedures, which has led to a broader and more integrated approach to surveillance. This has improved the overall consistency of policy advice within the European Semester, and especially the tradeoffs and complementarities between structural reforms and fiscal discipline. However, there are

19 See note 18.
limits to what can be achieved within the current legal framework. Moving towards a comprehensive approach to policy recommendations would effectively require that the Stability and Growth Pact, the Two-Pack and Six-Pack eventually be merged into a new legal text, i.e. a new Pact.

5. CONCLUSIONS

Today, the European Union and the Euro Area are better equipped to identify and prevent unsustainable macroeconomic developments than in the past.

EU institutions have assessed macroeconomic imbalances extensively and in-depth, under the MIP procedures. This has helped to deepen the dialogue between the EU institutions and national policy authorities. The MIP has raised awareness of imbalances and the associated need to introduce preventive and corrective measures among the relevant national policymakers, and although far less, the broader public. Most of the times, national policy decisions take - implicitly or explicitly - into account MIP recommendations. The reduction of structural weaknesses and harmful spillovers through policy action has likely already benefitted the resilience of the economy to future external or internal shocks. Nevertheless, indicators continue to flag vulnerabilities and weaknesses in several Member States and the whole EU/Euro Area.

A tentative counterfactual exercise suggests that a careful examination of pre-crisis macroeconomic trends, in the context of the current upgraded MIP framework, could have spotted the problems. Prompt policy action could have probably helped to prevent, or at least reduce, the effects of the financial and economic crisis in those Member Countries that then required financial assistance.

Some specific changes to the MIP could achieve positive results in the near term. These include taking into account the Euro Area dimension more explicitly, i.e. spillovers, complementarities, and trade-offs, as well as the different economic structure of individual countries due to specialisation and the allocation of resources within the area. Increasing transparency and strengthening the evidence-based analytical process by backing recommendation with stronger analytical tools and transparent methodologies (LAF), and with a forward-looking approach would also be helpful. This may include requiring more detailed policy action and maybe intermediate targets, more directly under the control of policymakers. Deepening analysis and discussion by making the MIP a two or three-year cycle could also help.

Besides, it would be essential to use the MIP to its full potential, including activating the EIP. Member States have avoided entering EIP, and even the European Commission has been reluctant to recommend it, based on its intrusiveness and the perception that it is ‘full programme without the financial assistance’. Merging the MIP and the structural reform process with fiscal surveillance should be pursued in the future by revising the legal framework.

Preventing macroeconomic shocks and making Member States’ economies and the whole EU/Euro Area more resilient cannot exclusively rely on structural supply-side adjustments. It needs to be complemented by a proper policy mix to sustain aggregate demand, and for this, the introduction of a fiscal capacity and a safe asset would be essential, as well as the completion of ongoing reforms such as the banking union and capital markets union.

Finally, increasing the ownership of the process is essential. It can be achieved through the setting up of National Productivity Boards in all countries, as well as other ways to make the policy debate more explicit at the level of national governments, parliaments, and public opinions. The MIP can be very useful in policymaking, but national governments need to take full ownership.
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MIP: Has it worked in practice to improve the resilience of the euro area?

ANNEX 1 – DEVELOPMENTS IN SCOREBOARD INDICATORS

Figure A1: Current account balance.

Figure A2: Net international investment position

Figure A3: Real effective exchange rates

Figure A4: Export market shares

Figure A5: Nominal unit labour cost

Figure A6: House prices
Figure A7: Private sector credit flow

Figure A8: Private sector debt

Figure A9: General government gross debt

Figure A10: Unemployment rate

Figure A11: Total financial sector liabilities

Figure A12: Activity rate

Figure A13: Long-term unemployment rate

Figure A14: Youth unemployment rate
ANNEX 2 – PROGRAMME COUNTRIES’ (AND ITALY’S) INDICATORS

- Figure A15: Current account balance
- Figure A16: Net international investment position
- Figure A17: Real effective exchange rates
- Figure A18: Export market shares
- Figure A19: Nominal unit labour cost
- Figure A20: House prices
This paper gives an overview of the seven aspects of resolvability defined in 2019 by the Single Resolution Board, and then assesses progress in two key areas, based on evidence gathered from public disclosures made by the 20 largest euro-area banks. The largest banks have made good progress in raising bail-in capital. Changes to banks’ legal and operational structures that will facilitate resolution will take more time. Greater transparency would make it easier to achieve the policy objective of making banks resolvable. This document was provided by the Economic Governance Support Unit at the request of the ECON Committee).