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Experiences with the Current EU Economic Governance Framework

European Parliament
Committee on Economic and Monetary Affairs

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1. The Global Context of Current Account Imbalances

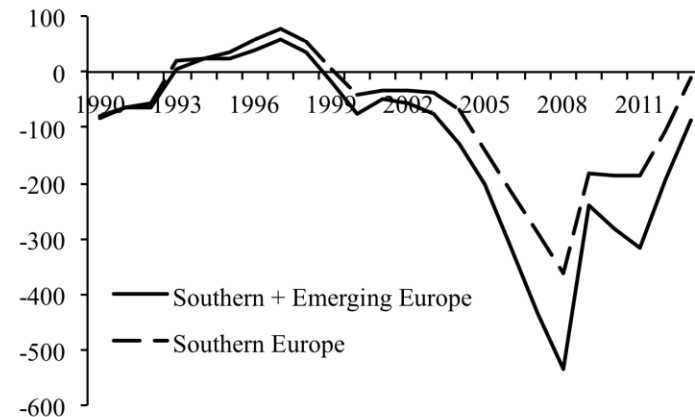
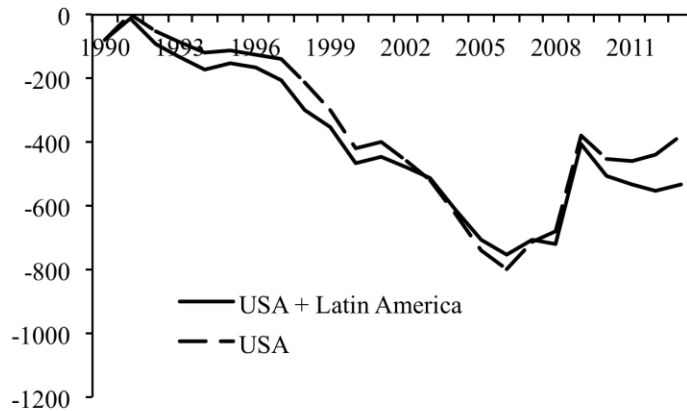
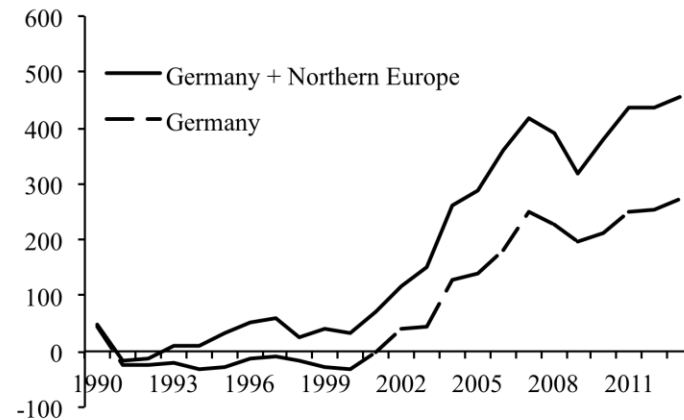
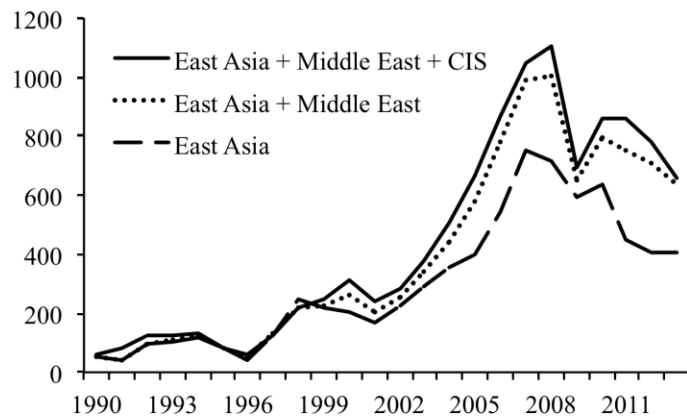
Structural Break in Global Imbalances

- Global imbalances have substantially increased since the late 1990s.
- Regional dimensions (\$, €):
 - US current account deficit (since early 1980s),
 - rising East Asian current account surpluses (since early 1980s),
 - rising current surpluses of oil-exporting countries (since 2001),
 - intra-European current account imbalances (2001-2014).

Determinants of Global Imbalances (Duarte and Schnabl 2014)

- Benign global liquidity conditions (starting from 2001),
- divergent monetary and fiscal policy stances,
- only to a minor extent exchange rates / membership in a monetary union matter.

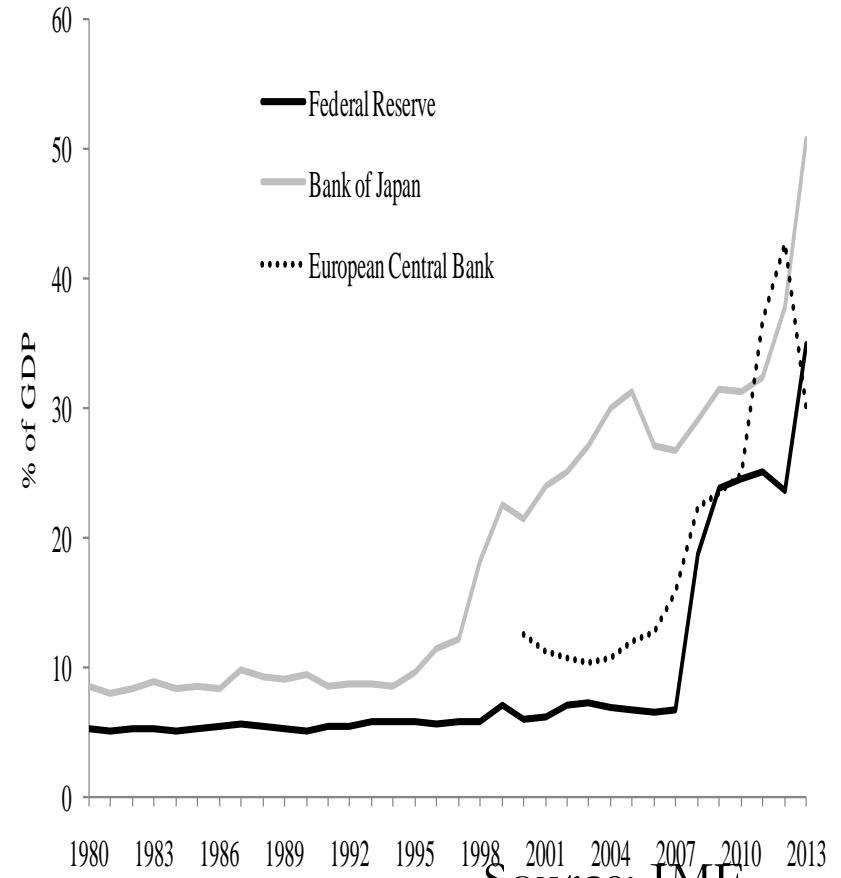
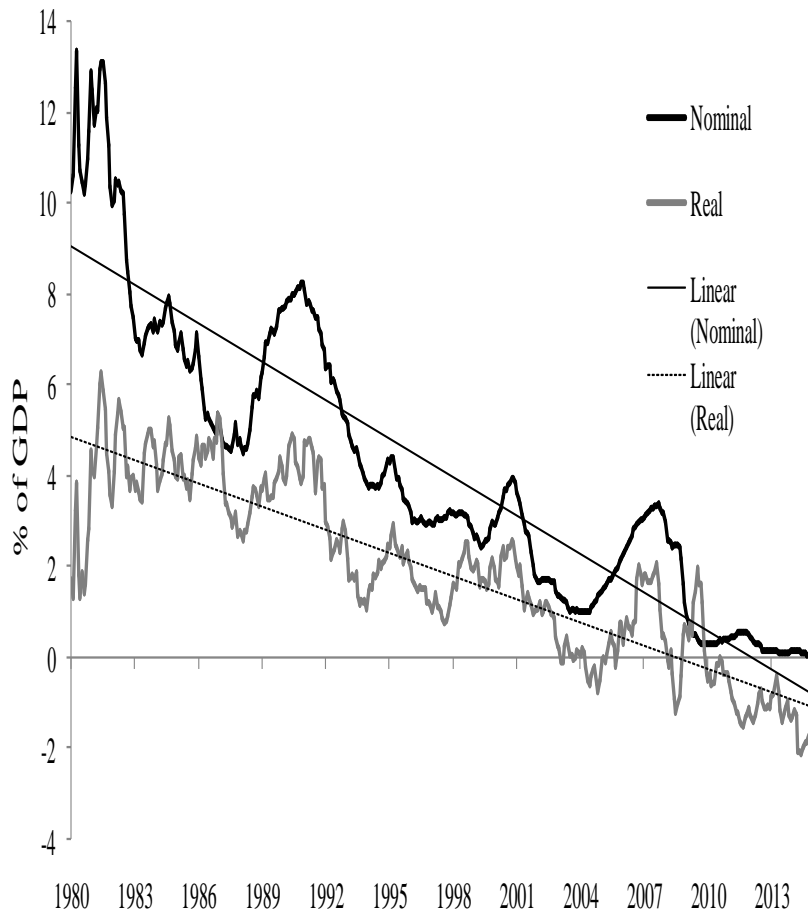
Growing Global Imbalances



Source: IMF. Y-axes indicate billions of dollars.



G3 Interest Rates / Central Bank Balance Sheets



Source: IMF.

2. Crisis Patterns

1st and 3rd Generation of Balance of Payments Crisis Models

- Capital inflows encourage domestic consumption, government expenditure and **current account deficits**, which become unsustainable (Krugman 1979, Flood/Garber 1984).
- Capital inflows are paired with speculative investment and unsustainable international foreign currency-denominated debt positions (Krugman 1998, Corsetti/Pensenti/Roubini 1999).
Overlending, overborrowing, moral hazard path the way into crisis.

Monetary Policy-Induced Boom and Bust

- Ample low-cost liquidity causes boom and bust in financial markets (Wicksell 1898, Hayek 1929, Schnabl and Hoffmann 2008, 2011).
- Ample liquidity paired with negative domestic expectations triggers capital outflows / current account surpluses, which encourage boom and bust abroad (Schnabl and Wollmershäuser 2013).
- Foreign crisis goes along with negative balance sheet shocks for domestic financial institutions (Japan and Asian crisis, US-subprime market and Germany) (Hoffmann and Schnabl 2014).



3. Origins of the European Debt Crisis

Pre-EMU

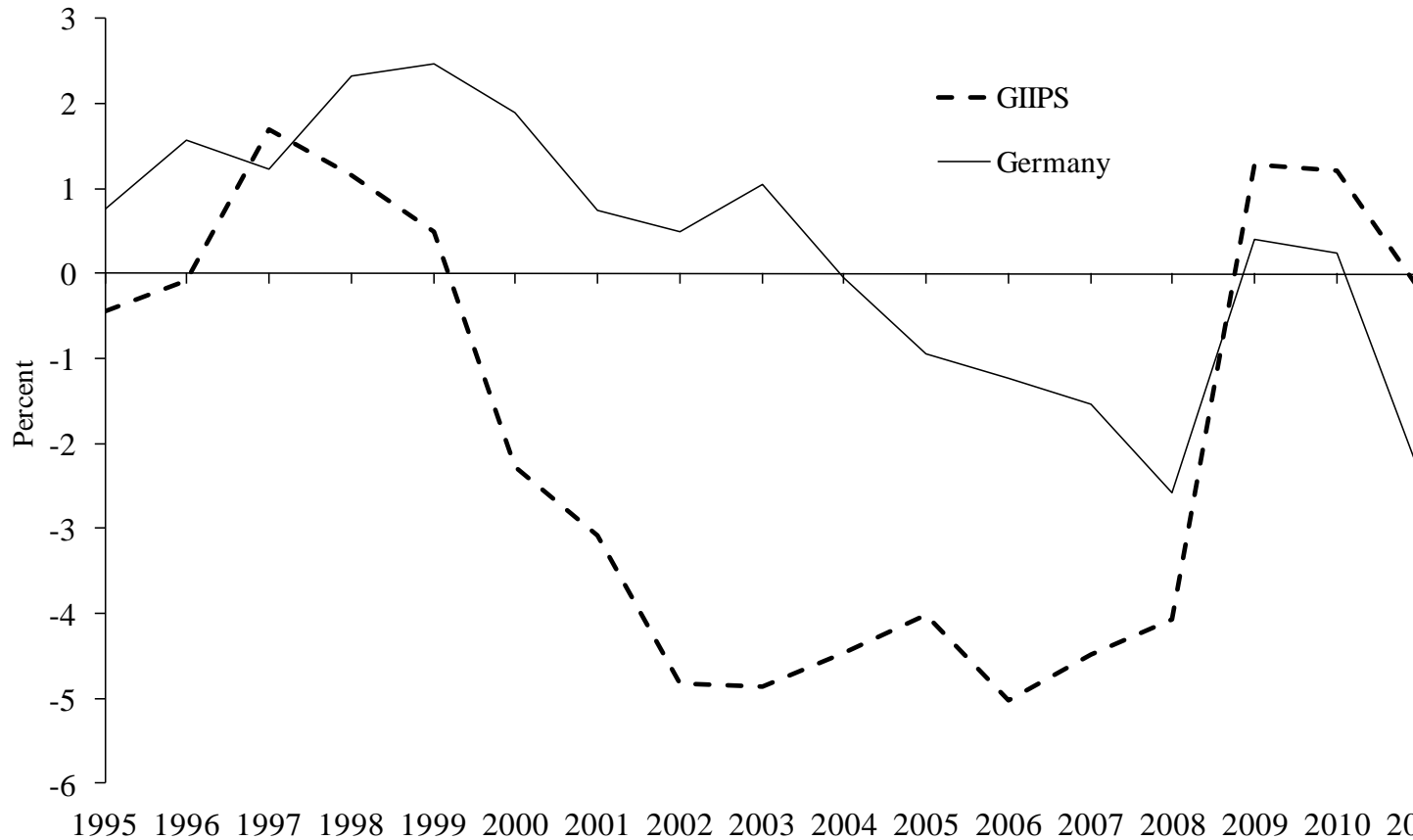
- (Relative) expansionary fiscal policies in the south and west of Europe were matched by relative expansionary monetary policies.
- Current account deficits were constrained by limited foreign reserves, limited credit mechanisms, exchange rate depreciation and risk premiums originating in macroeconomic instability.
- In the north tight monetary policy (led by the German central bank) put a limit on domestic inflation and private capital outflows.

Post-Euro Introduction

- Monetary expansion after the bursting of the dotcom bubble from 2001.
- Tight fiscal policy in Germany is triggered by consolidation efforts after the end of the unification boom (Maastricht, Agenda 2010).
- Capital inflows into southern, western and eastern European countries (**inside and outside the euro area**) lead to fiscal expansion as well as bubbles in financial and real estate markets.
- Current account deficits (and surpluses?) became a key indicator for crisis (MIP).

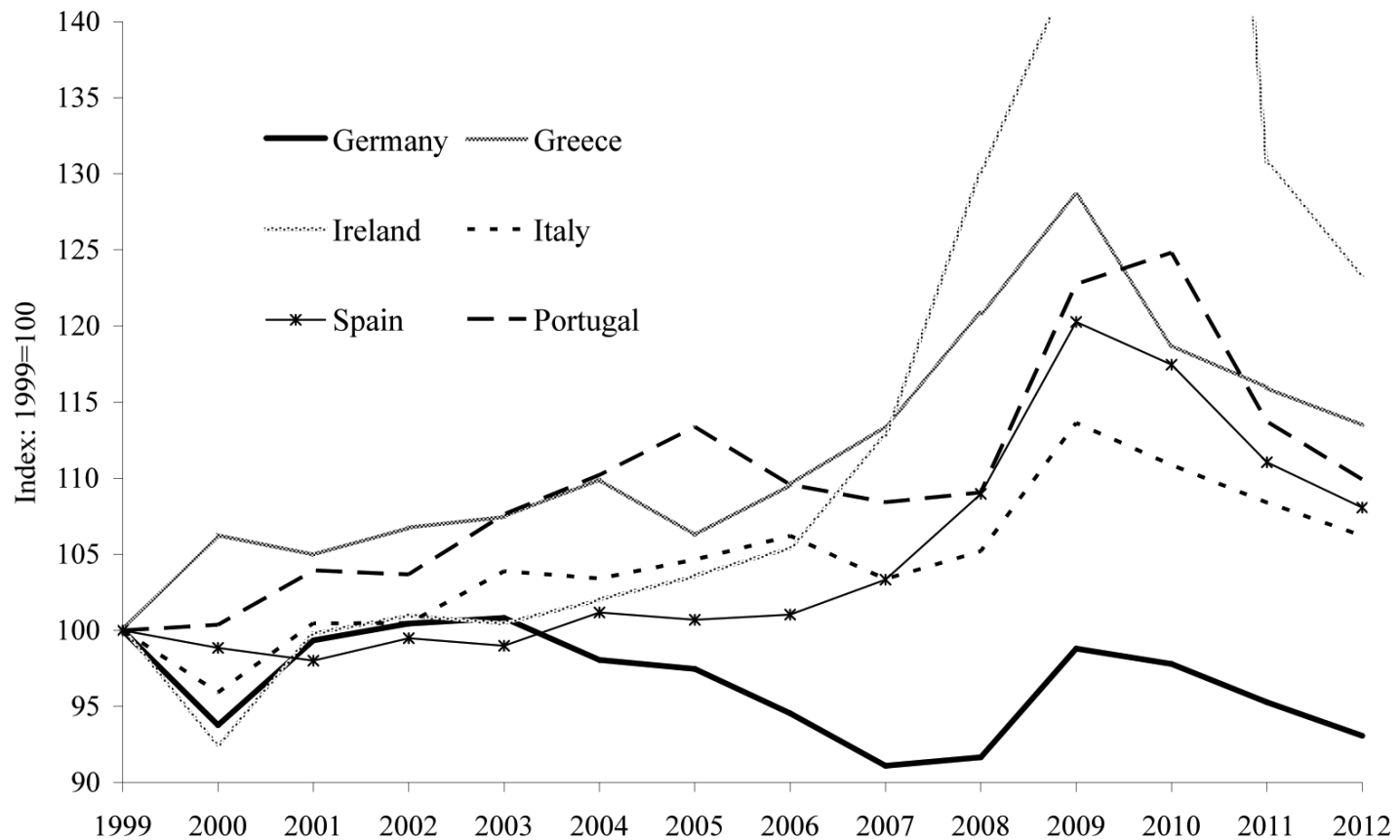


EMU Monetary Policy Beyond Taylor-Target?



Source: Abad et al. 2013.

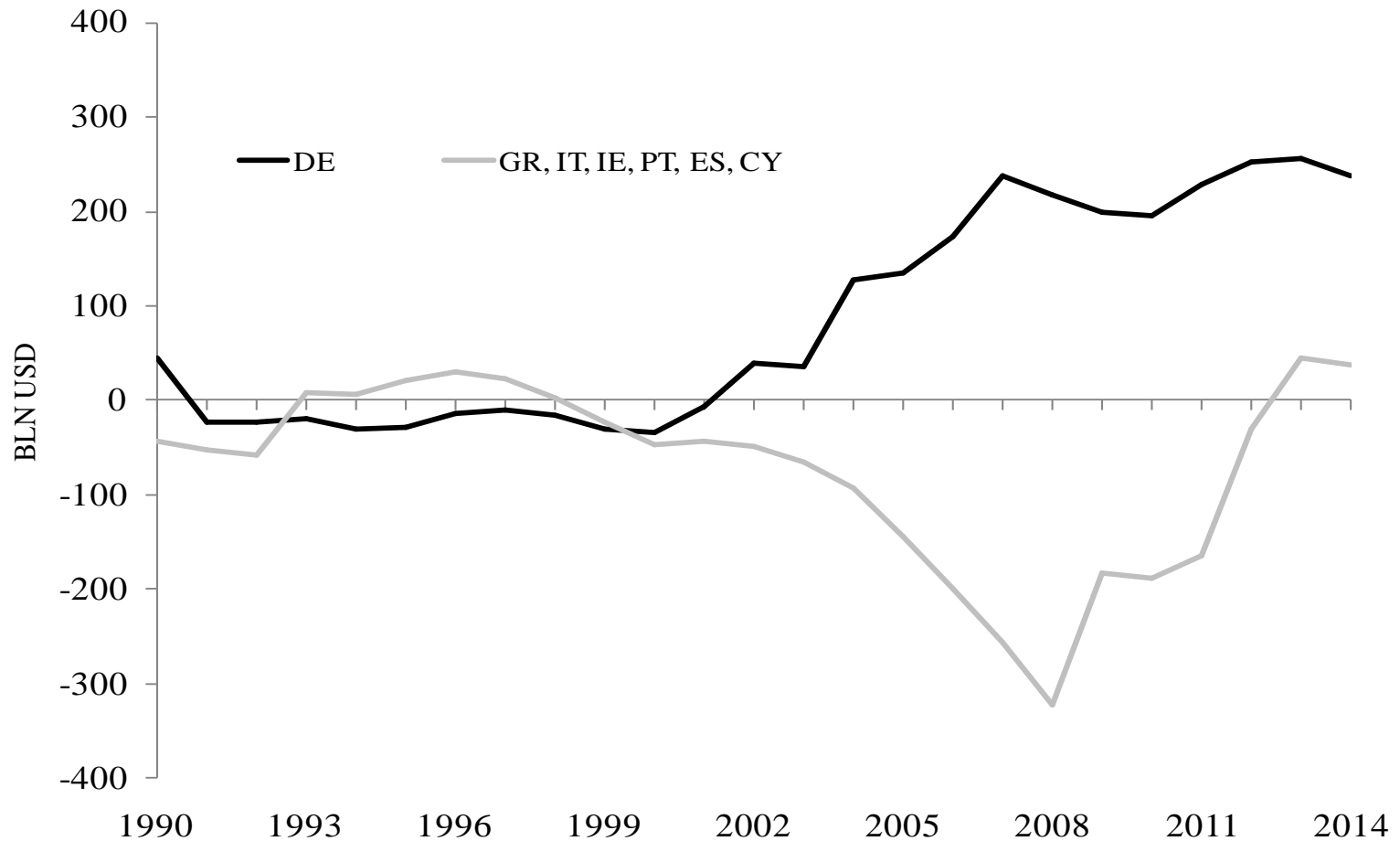
Fiscal Policy Stances in the EMU



Source: Schnabl and Wollmershäuser 2013.



Pre-Crisis European Current Account Divergence





4. Effectiveness of Macroeconomic Surveillance

(Previous) Crisis Countries

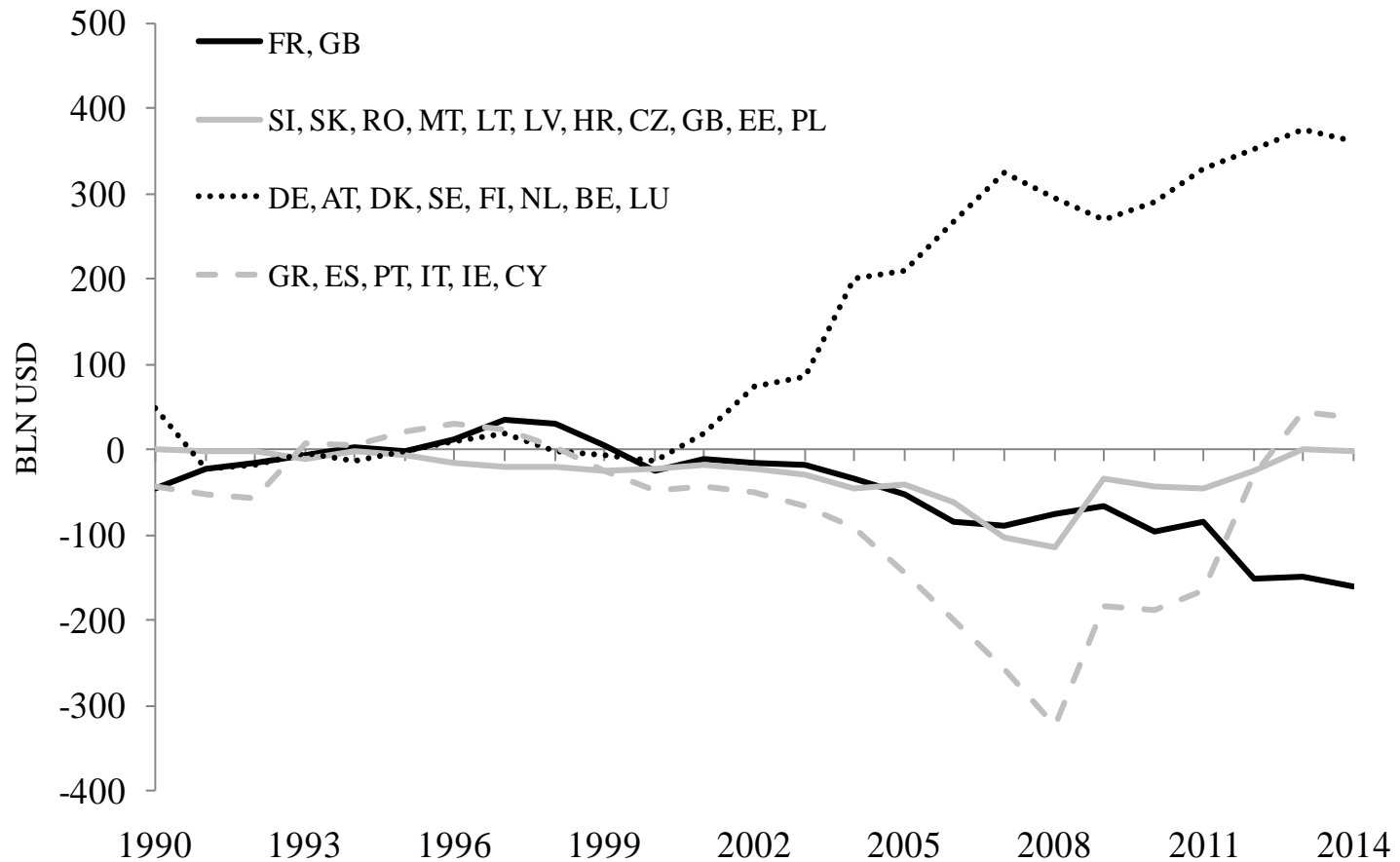
- Fiscal tightening (combined with monetary easing) has contributed to the consolidation of government spending, real estate price dynamics and risks taken in the national financial sectors. (EIP, Adjustment Programs, etc.)
- Current account deficits have become widely consolidated.

The Risk of Growing Current Account Surpluses

- Expansionary E(M)U monetary policy becomes increasingly paired with relatively tight EU fiscal policies.
- Current account surpluses have become redirected towards third countries, in particular UK and US, but also France.
- Depending on the type of risk taken in international capital markets, new crisis potential may emerge for the EU-current account surplus countries and the EU as a whole.



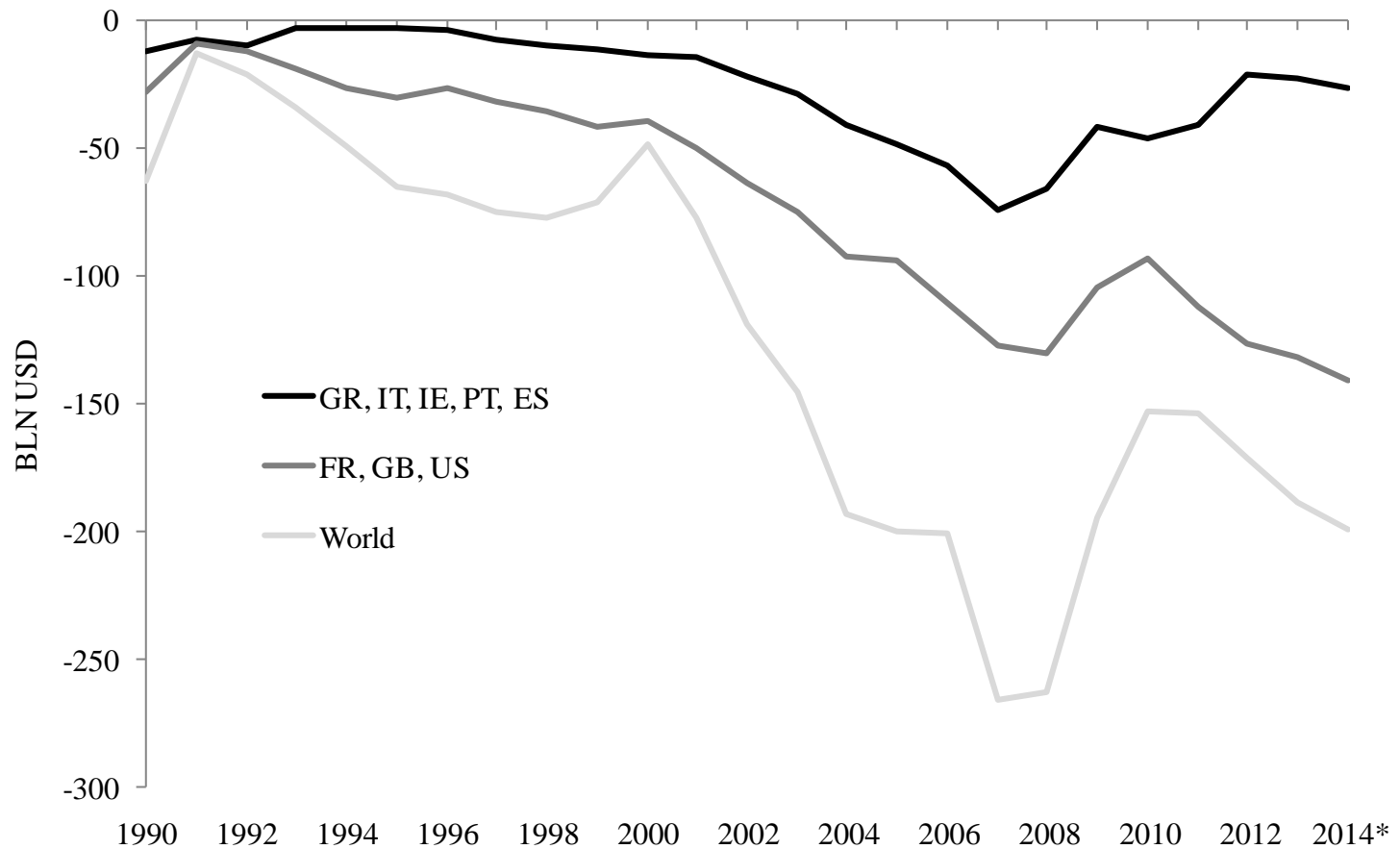
The Consolidation of European Current Accounts



Source: IMF.



The Redirection of German Capital Outflows (Proxy)



Source: IMF DOTS

*estimation from first two quarters



5. Outlook

- Monetary expansion and divergent fiscal policies have been at the root of diverging current account positions in Europe since 2001.
- Since the European debt crisis intra-EU expenditure patterns have tended to converge linked to the macroeconomic imbalance procedure.
- This has contributed to a consolidation of the intra-European current account imbalances.
- At the same time the E(M)U current account surplus is growing.
- Depending on the risks taken in foreign capital markets a new crisis for European surplus countries may emerge.
- The policy implication is a tighter monetary policy stance, more expansionary fiscal policies in the surplus countries or tighter control mechanisms for surplus countries (possibly capital-outflow controls?).
- For the (former) crisis countries, **Japan-type** structural growth rigidities and real wage repression may emerge, which are outside the macroeconomic imbalance procedures (Schnabl 2013).



Thank you very much for your attention!



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