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NEW DEVELOPMENTS AND REFORM PROPOSALS OF THE MACROECONOMIC IMBALANCE PROCEDURE

Summary
The European Union (EU) has had a five-year experience with the Macroeconomic Imbalance Procedure (MIP) that was introduced by the European Commission in December 2011 as a response to accumulation of huge imbalances with the EU and the euro area. This paper evaluates results of the MIP and aims to examine what kind of imbalances have been revealed by the MIP, evaluate the current settings of the MIP and propose reforms that would enhance functioning and applicability of the MIP in practice. Based on results published in Alert Mechanism Reports and In-Depth Reviews and evaluation of the yearly cycle of the MIP, we propose several reforms and changes in the MIP and the scoreboard of indicators in particular. We bring forward a concept of relative thresholds that reflect economic development much better than currently applied absolute thresholds. Moreover, we recommend modification of some of the indicators involved in the MIP and introduction of maximally three flagship indicators that would receive special attention in assessment of the risk stemming from macroeconomic imbalances.

Key words*: macroeconomic imbalance, relative thresholds, scoreboard, economic surveillance*

Introduction

The great financial crisis was the most immense shock to the European economy since 1930s. One can find two particular reasons why the European Union (hereafter EU) and particularly the euro area has been experiencing the crisis and facing difficulties of resolving it. First, major differences between countries in economic development as well as political and social systems. Second, the euro area's inadequate economic

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governance typical of unsystematic discussions and toothless policy actions and responses.

As regards the first aspect, different initial conditions in the core and the periphery of the euro area, mainly in terms of interest rates, led to the credit boom in the periphery financed by capital flows from the core affecting competitiveness (Sapir and Wolff, 2015). As a result, current account balances and net foreign asset positions diverged to an unprecedented degree between the core (in surplus) and the periphery (in deficit). When the financial crisis hit in 2008-2009, private capital flows from the core to the periphery suddenly stopped (Merler and Pisany-Ferry, 2012), leaving behind a mountain of external debt (private and public) in the periphery owed to creditors in the core countries.

In the field of the euro area's economic governance, the European Commission introduced the Macroeconomic Imbalance Procedure (hereafter MIP) in December 2011 as an integral part of the EU economic surveillance framework. Although the MIP is designed and applied to all EU members, the euro area countries with no independent monetary policy are the primary target. The MIP purpose is to identify macroeconomic imbalances and induce remedial policy actions.

This paper is motivated by the fact that we have had a five-year experience of application of the MIP and this is sufficient time to evaluate the outcomes of this economic governance tool. Therefore, the aim of the paper is to examine what kind of imbalances have been revealed by the MIP, evaluate the current settings of the MIP and propose reforms that would enhance functioning and applicability of the MIP in practice. The remaining part of the paper is structured as follows. Section 1 introduces the MIP and its scoreboard of macroeconomic indicators; Section 2 summarizes outcomes of the MIP on individual EU member states and macroeconomic imbalance indicators. In Section 3 we propose calculation of relative version of the MIP indicators and compare their values and development with original indicative thresholds of the MIP indicators. We also bring forward some institutional reform proposals. Final section concludes the paper with summary of the most important findings and results.

1. Characteristics of Macroeconomic Imbalance Procedure (MIP)

The MIP is a macroeconomic surveillance procedure established by the EU in response to the economic crisis and applied by its member states with the aim of improving economic governance. The MIP has two aims – preventive and corrective – with different objectives. While the preventive aim is to adopt good policies the corrective aim is to identify and correct policy failures.

The yearly MIP cycle starts with a comprehensive economic analysis, the Alert Mechanism Report (AMR), which covers all EU member states not benefiting from financial assistance. The analysis is based on reading of a scoreboard of 14 headline indicators in combination with auxiliary indicators. Table 1 summarizes all the indicators along with ways how the data is transformed and the indicators are calculated. Table 1 also reports indicative thresholds for each indicator which specify the accepted range in which the indicator should be preferably found. The scoreboard includes both stock and flow indicators aiming at capturing the accumulation of imbalances over time as well as detecting short-term risks (Bobeva, 2013).

Table 1. Macroeconomic Imbalance Procedure scoreboard and indicators

Indicator	Measure	Accepted range
External imbalances and competitiveness		
Current account balance	3-year moving average, % of GDP	Between +6% and -4%
Net international investment position	% of GDP	> -35%
World export share	In current value, 5-year percentage change	> -6%
Real effective exchange rate	Vis-á-vis 42 industrial countries, based on consumer-price indices, 3-year percentage change	-/+ 5% (euro-area) and -/+ 11% (non euro-area)
Nominal unit labor costs	3-year percentage change	< 9% (euro-area) and < 12% (non-euro area)

Indicator	Measure	Accepted range
Internal imbalances		
Private sector debt	% of GDP	< 160%
Private sector credit flow	% of GDP	< 15%
House prices relative to consumer prices	Year-on-year changes, in %	< 6%
General government debt	% of GDP	< 60%
Financial sector liabilities	Year-on-year changes, in %	< 16.5%
Unemployment rate	3-year moving average, in %	< 10%
Activity rate	3-year change, in p.p.	> 0.2%
Long-term unemployment rate	3-year change, in p.p.	< 0.5%
Youth unemployment rate	3-year change, in p.p.	< 2%

Source: European Commission

After discussions of the AMR conclusions by the Council and the Euro group, the Commission decides for which countries it will prepare country-specific In-Depth Review (IDR). The purpose of the IDRs is to assess whether imbalances and excessive imbalances exist in the member states identified in the AMRs. If, on the basis of this analysis, the situation is considered unproblematic, the Commission will not propose any further steps. If the Commission however considers that macroeconomic imbalances exist, it will come forward with proposals for policy recommendations for the member state(s) concerned. In the preventive aim these are part of the integrated package of recommendations under the European semester. If the Commission instead considers that there are severe or excessive imbalances that may jeopardise proper functioning of the euro area, it may recommend to the Council to open an Excessive Imbalance Procedure (EIP) which falls under the corrective arm of the MIP.

Then, the member state is obliged to present a corrective action plan (CAP) setting up a roadmap to implement corrective policy actions. If the

Council considers the CAP to be insufficient, the Council adopts a recommendation to the member state to submit a new CAP. If the new CAP is still considered to be insufficient, a fine (0.1% of GDP) can be imposed. If the Council considers the CAP to be sufficient, it will endorse the CAP through a recommendation that lists the corrective actions and their implementation deadlines. Then, once a sufficient CAP is in place, the Council assesses whether or not the member state concerned has taken the recommended actions according to the set deadlines. Again, two possible outcomes can be distinguished. If the actions of the member state were insufficient, the Council can impose an interesting-bearing deposit (0.1% of GDP) which can be converted into annual fine if the inability of the member state to correct imbalances continues. If the member state concerned has taken the recommended correction actions the EIP can be closed or placed in abeyance depending on whether the member state is still experiencing excessive imbalances.

2. Outcomes of Macroeconomic Imbalance Procedure application

Five issues of the AMR have been published since the introduction of the MIP. As discussed above, the AMR is the starting point of the annual cycle of the MIP, which aims to identify and address imbalances that hinder smooth functioning of the national economies and EU economy as a whole. Based on findings of AMR the countries potentially facing economic risks are further analyzed by the IDR and classified by the European Commission. This chapter summarizes findings of this process and shows how each EU member state has been evaluated in the MIP and which macroeconomic imbalances have been the most pronounced in the EU during the analyzed period.

2.1. Macroeconomic Imbalance Procedure classification of the EU member states

Table 2 summarizes findings of all AMRs that have been published so far. We apply a streamlined categorization of countries and distinguish four categories of seriousness of macroeconomic imbalances. Any EU member state can be classified as country with no imbalance, country with imbalance, country with excessive imbalance or country under a special assistance program. If the country falls to the last category it is not assessed by the AMR. The European Commission instead uses a more precise categorization that reflects individual phases and settings of the MIP. The configuration of MIP imbalance categories currently appears as follows: (a) no imbalance; (b) imbalances, which require monitoring and policy action; (c) imbalances, which require monitoring and decisive policy action; (d) imbalances, which require specific monitoring and decisive policy action; (e) excessive imbalances, which require specific monitoring and decisive policy action; (f) excessive imbalances, leading to the EIP.

It is evident from Table 2 that eight EU member states did not experience macroeconomic imbalances in any of the years examined. In all rounds of the MIP imbalances were not identified in Austria, Czech Republic, Estonia, Latvia, Lithuania, Luxembourg, Poland and Slovakia. All the countries are small or medium-sized economies and mostly new member states that joined the EU in 2004. Two more countries, Finland and Sweden, show a consistency in categorization that has not changed during the analysed period. However, both countries have been permanently experiencing macroeconomic imbalances, in particular developments related to competitiveness (Finland) and debt and housing market (Sweden).

Table 2. Classification of the EU member states according to MIP

	2012	**2013**	**2014**	**2015**	**2016**
Austria					
Belgium					
Bulgaria					
Croatia	N.A.	N.A.			
Cyprus					
Czechia					
Denmark					
Estonia					
Finland					
France					
Germany					
Greece					
Hungary					
Ireland					

	2012	2013	2014	2015	2016
Italy					
Latvia					
Lithuania					
Luxembourg					
Malta					
Netherlands					
Poland					
Portugal					
Romania					
Slovakia					
Slovenia					
Spain					
Sweden					
United Kingdom					

Source: Author's complication from various issues of AMRs and IDRs.

Note:

No imbalance		Imbalance		Excessive imbalance		Assistance program	

Several countries have improved the ranking as they corrected their imbalances. Whereas some countries reached the "no imbalance" status only in 2016 (Belgium, Hungary, Romania, UK) other countries adjusted the imbalances sooner (Denmark, Malta). By contrast, there are also EU member states where macroeconomic imbalances have accumulated and their MIP ranking deteriorated. Germany and Netherlands were initially evaluated as no imbalance countries but increasing external surplus and strong reliance on external demand induced the European Commission to classify the countries among countries with imbalances. Even more serious economic situation has evolved in Bulgaria, Croatia, Cyprus, France, Italy and Portugal. All these countries have faced or are still facing severe external and internal economic pressures and vulnerabilities. Hence, the European Commission categorizes them as countries with excessive imbalances.

2.2. Macroeconomic Imbalance Procedure assessment of economic developments

Table 3 reports how many EU member states exceeded the reference values of the MIP scoreboard indicators. It should be noted that data evaluated in the AMRs are two years older than the year of the AMR issue. For example, the 2016 issue of AMR is based on data of 2014. One can see significant differences in number of threshold breaches among the indicators. While no or very few countries reported private sector credit flow or total financial sector liabilities above the indicative reference value, the net international investment position, export market shares or general government sector debt seemed to pose a macroeconomic risks in most of the EU member states

Table 3. Number of EU member states breaching the MIP indicators thresholds

	2012	2013	2014	2015	2016
Current account balance	11	10	9	5	6
Net international investment position	15	15	16	16	16
Real effective exchange rate	4	1	9	0	1
Export market shares	15	17	19	17	18
Nominal unit labor cost	8	4	1	5	3
House price index - deflated	2	0	0	2	5
Private sector credit flow	1	1	0	1	0
Private sector debt - consolidated	15	15	14	15	13
General government sector debt	14	14	14	16	16
Total financial sector liabilities	N.A.	1	0	0	1
Unemployment rate	7	9	11	14	12
Activity rate	N.A.	N.A.	N.A.	N.A.	2
Long-term unemployment rate	N.A.	N.A.	N.A.	N.A.	11
Youth unemployment rate	N.A.	N.A.	N.A.	N.A.	13

Source: Author's complication from various issues of AMRs and IDRs.

We can also observe interesting trends in some of the indicators. There are imbalances that have been reduced over the examined period and the number of countries beyond the thresholds decreased from 2012 to 2016. Most notably, imbalance of current accounts, nominal unit labour costs and real effective exchange rate are actually less worrying than they were in 2012. By contrast, other imbalances have remained present in relatively constant number of countries or have spread to even more member states. For instance, large negative net international investment position and general government debt have persisted in 14-16 countries. The imbalance that has remarkably increased its occurrence across the EU is the unemployment rate (from 7 to 12 countries). The remaining imbalances with rising incidence are deflated house price index and export market shares. For proper interpretation of figures presented in Table 3 it is worth to note that exceeding the indicative thresholds does not automatically mean that the country is facing a serious macroeconomic imbalance. Instead, the indicator values only identify the member states which may be affected by imbalances and for which further analysis should be undertaken before concluding on the existence or persistence of imbalances and their nature.

3. Proposed reforms of the Macroeconomic Imbalance Procedure

Although the decision of the European Commission to introduce the MIP has been positively received and the MIP is generally considered as a useful tool of economic governance and surveillance on the EU level, one can reveal several vulnerabilities and bottlenecks that limit applicability of the MIP and credibility of the MIP outcomes. This opinion is also well established in literature.

For instance, Moschella (2014) points out that the MIP is much better placed than the system applied by the International Monetary Fund in identifying imbalances and inducing corrective action. On the other hand, the MIP does not provide mechanisms to prevent political and arbitrary considerations from interfering with the decision to activate sanctions and on how to share the burden of adjustment. Bénassy-Quéré and Ragot (2015) argue that the MIP was built asymmetrically as it uses different thresholds depending on whether the country has an external surplus of deficit. The aspect of built-in asymmetry is stressed also in Sapir and Wolff (2015) as they call for symmetric application of the MIP and for completion of the MIP by national procedures to monitor and correct competitiveness problems. Furthermore, Sapir and Wolff (2015) along with Ederer (2015) and Boysen-Hogrefe et al. (2016) articulate the need for increasing national ownership of the MIP and its outcomes and policy recommendations. The sufficient ownership at the country level is conditioned by transparency and consistency of the MIP with regard to how the results of the scoreboard are linked to the final outcome of the MIP.

3.1. Relative version of the indicators thresholds

In this chapter, we bring forward two kinds of MIP reform proposal. First, propose application of relative version of the scoreboard indicators' thresholds. Second, we recommend several changes of the MIP scoreboard institutional settings that would increase the MIP efficiency.
As Gros and Giovannini (2014) point out, a key point in the MIP and EIP is that it should warn of impending problems within the euro area and the whole EU. It is thus questionable whether one should use absolute indicators thresholds. For example, if all countries had a large external deficit, a sudden stop to capital inflows would affect all of them at the same time. And if most EU countries run external surpluses, a particularly large surplus in any one country should not be regarded necessarily as an "imbalance". Moreover, the loss in export market share is common to all advanced economies due to structural change in international trade imposed by the rise of emergent countries. Therefore, the absolute change of a single member state is not an effective indicator per-se. This consideration applies more in general to almost all indicators included in the MIP scoreboard. Application of a relative version of the indicators' threshold is a methodological response to a common criticism of the MIP that implies that imbalances arise solely within a single country, and not between countries (see e.g. Ederer, 2015).

The relative version of the indicator threshold is calculated as a weighted average of the respective indicator values observed in all countries included in the sample. The weights are determined according to national GDP of the involved countries. Mathematically, the relative indicator threshold is calculated as follows:

$$RT_i = \frac{\sum_{j=1}^{n} \omega_j i_j}{\sum_{j=1}^{n} \omega_j} \quad (1)$$

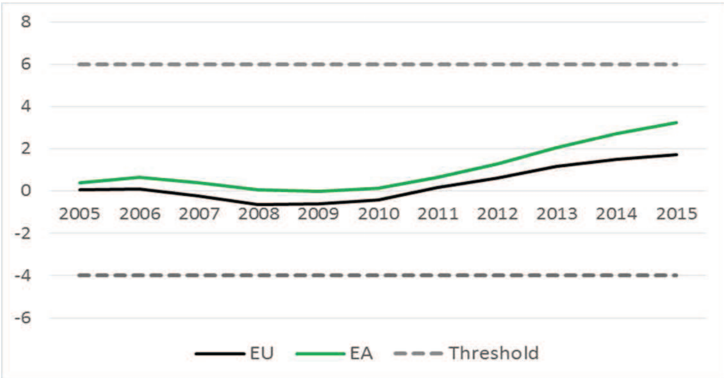
where RT_i is the relative threshold of the scoreboard indicator i, ω_j is the weight of the country j determined by its national GDP and i_j is value of the indicator i in the country j. The relative thresholds are computed in relation to the whole EU and the euro area. Although the relative thresholds are calculated for all MIP scoreboard indicators, the practical applicability is limited for the current account balance and net international investment positions. As it was already discussed above, particularly these two imbalances have evolved in the EU and the euro area to the situation in which one group of countries have surplus and the other one is in deficit (core vs. periphery, north vs. south). Hence, the relative threshold will be, by its definition, oscillating around a constant value far from original thresholds, which makes it difficult to interpret. Fig. 1 depicts development of all relative thresholds as compared with original thresholds given in the MIP scoreboard.

The relative thresholds reflect much better the current economic environment and developments in the whole sample of countries than the original and fixed indicative reference values. As can be seen from graphs in Fig. 1 the relative thresholds diverged from the original ones extensively in most cases and the differences remained present for a long period of time. If we focus on four imbalances whose original thresholds have been breached by most countries (export market shares, private sector debt, general government debt, and unemployment rate) two typical discrepancies between the relative and absolute thresholds are revealed.

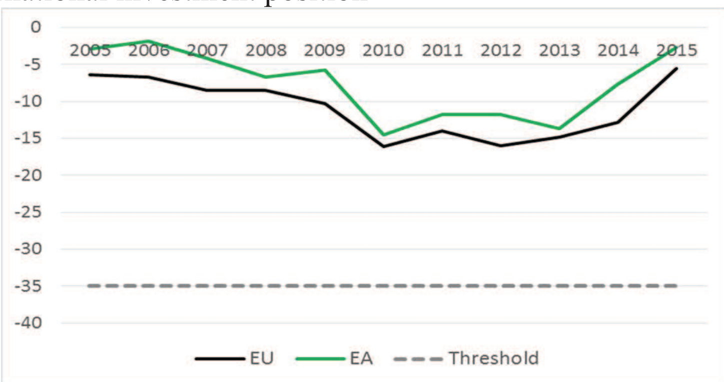
As regards export shares and government debt, Fig. 1 illustratively shows that the original thresholds were very ambitious compared with the general development in the EU and the euro area. In that case many examples of imbalance identified by the absolute threshold did not have to be out of the prevailing economic situation and, therefore, the original MIP rules could be too strict. By contrast, graphs of private sector debt and unemployment rate suggest that the official thresholds might be too permissive and potential risks stemming from imbalances could be hidden behind much lower values of the indicator than the absolute threshold.

Figure 1 Relative and original thresholds of the MIP scoreboard indicators

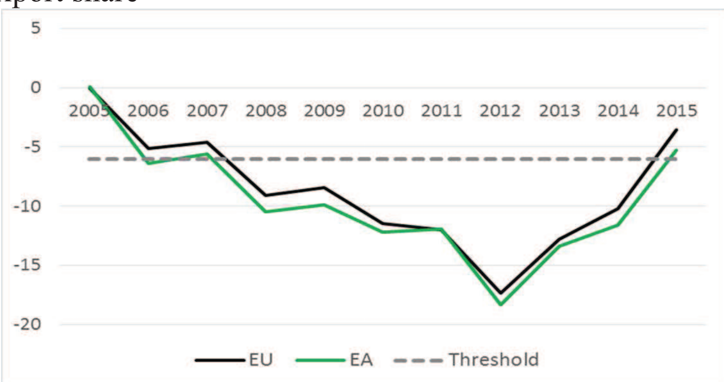
Current account balance



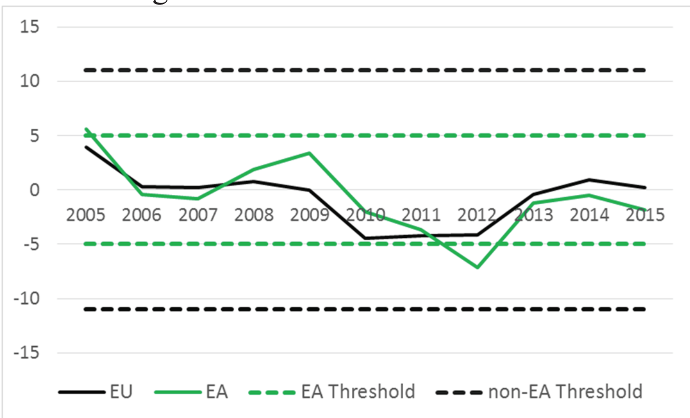
Net international investment position



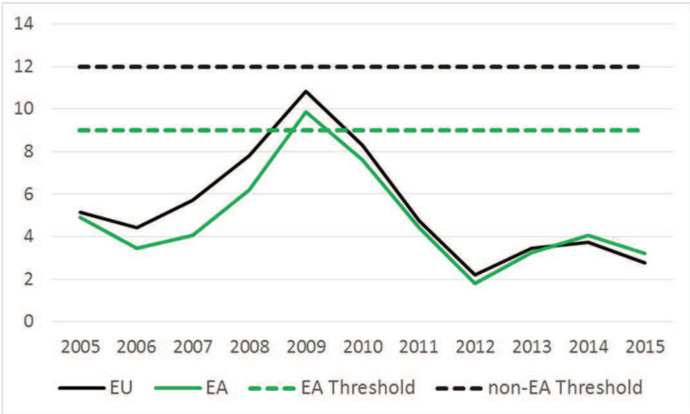
World export share



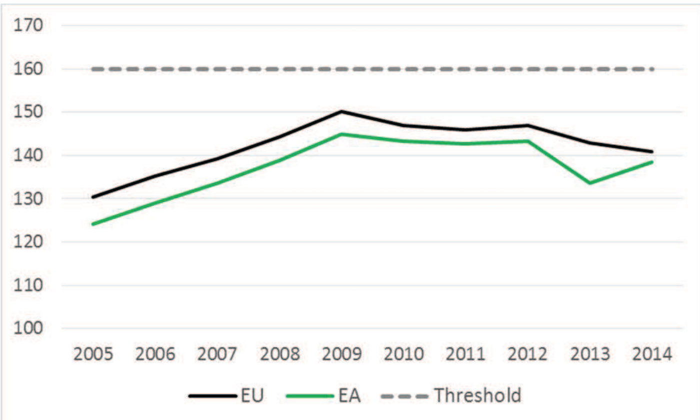
Real effective exchange rate



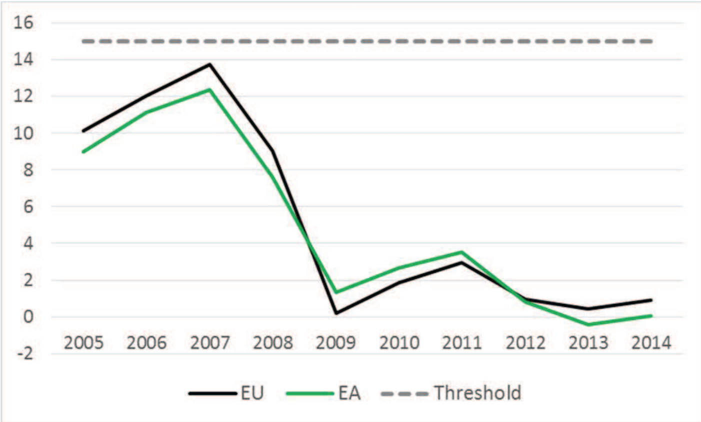
Nominal unit labor costs



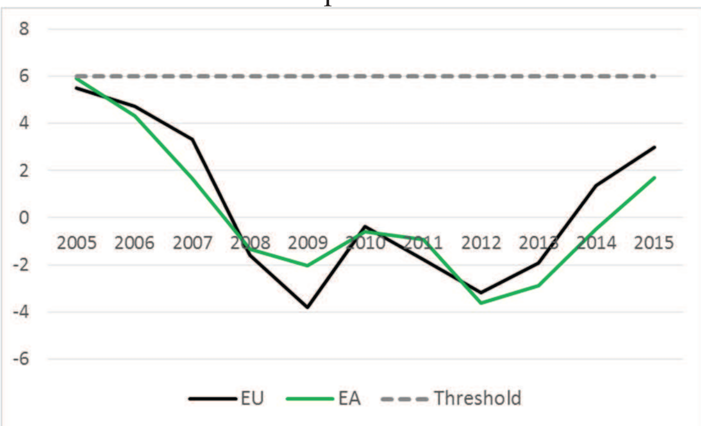
Private sector debt



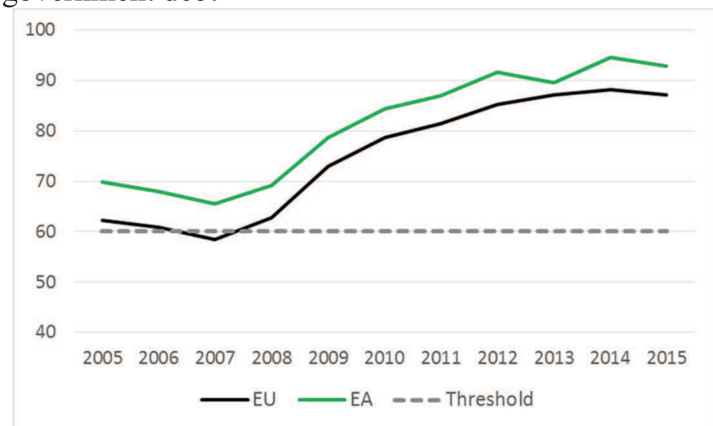
Private sector credit flow



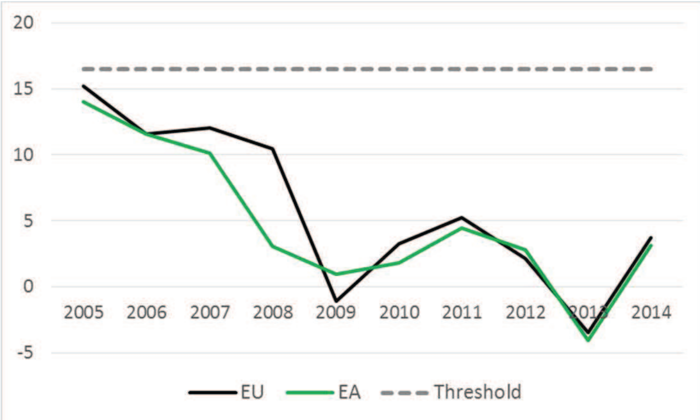
House prices relative to consumer prices



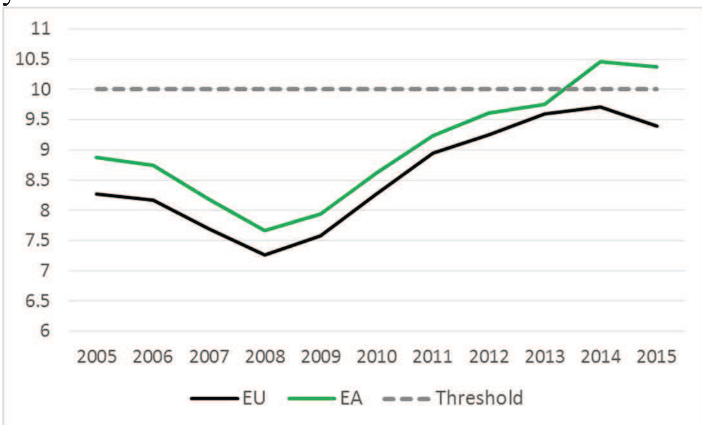
General government debt



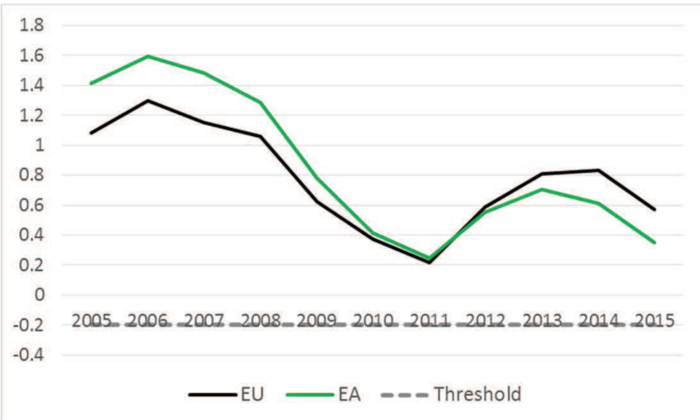
Financial sector liabilities



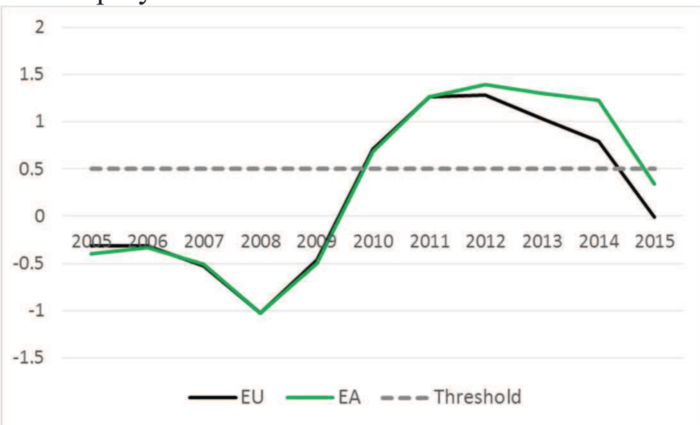
Unemployment rate



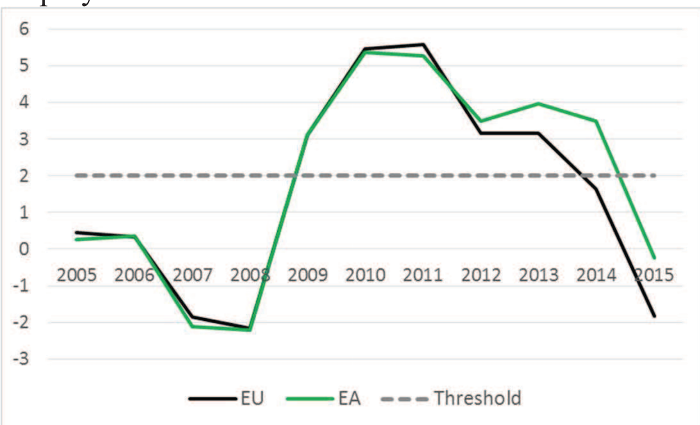
Activity rate



Long-term unemployment rate



Youth unemployment rate



Source: Author's calculations based on data from Eurostat MIP scoreboard database

Hence, the relative thresholds should be actively used in the process of identification of macroeconomic imbalances. Our specific recommendation is to compare national indicator values with the relative thresholds and define a symmetric tolerance zone around the threshold in which the member state would be considered as no-imbalance country. The relative thresholds may completely substitute the current reference values or complement them in order to make the evaluation more accurate. Boysen-Hogrefe et al. (2016) also call for revision of the thresholds to improve early warning properties of most MIP scoreboard indicators.

3.2. Changes of the Macroeconomic Imbalance Procedure scoreboard settings

We continue with further reform proposals that would limit, along with relative thresholds, several problematic aspects of MIP scoreboard institutional design. Moschella (2014) argues that the MIP builds on the application of asymmetric rules. This is evident, among others, in the MIP scoreboard as the indicative thresholds for the current account imbalance refer to +6 % of GDP on the surplus side and -4 % of GDP on the deficit side. Implementation of a symmetrical treatment would increase both effectiveness and credibility of the MIP.

Some of the scoreboard indicators should be revised to increase their relevance and ability to identify a true imbalance risk. As pointed out by Bénassy-Quéré and Ragot (2015) the real effective exchange rate is computed relative to 41 industrial countries, most of which do not belong to the euro area. This binds the indicator to the evolution of the euro, which is outside the control of governments. Similarly, because unit labor costs are given in nominal terms, this measure will vary with inflation, which itself can vary widely across time periods. The crucial role of financial system in economy is not sufficiently reflected in the MIP scoreboard. Although an indicator of the growth rate of the financial sector liabilities has been added to the scoreboard, it does not fully capture the ways how instability of financial sector may give rise to serious imbalances.

The last recommendation we bring forward in this paper regards reforming the MIP scoreboard is introduction of maximally three flagship indicators. Breaching threshold of any of these indicators would automatically call for an IDR. While Bénassy-Quéré and Ragot (2015) suggest application of the current account balance for such a purpose. Our recommendation is to consider export share and private sector debt. The empirical analysis by Boysen-Hogrefe et al. (2016) revealed that particularly these indicators had proven to be useful in providing early warning signals in the financial crisis.

Conclusion

The aim of the paper was to examine what kind of imbalances have been revealed by the MIP, evaluate the current settings of the MIP and propose reforms that would enhance functioning and applicability of the MIP in practice. We found out substantial differences among member states in terms of degree of imbalances faced in national economies. While there is a group of eight countries (mostly new member states) that have constantly achieved a status of no-imbalance country 14 countries have been experiencing imbalances or excessive imbalance for at least three years. If we look on the MIP outcomes from a different perspective we reveal that 12 countries have maintained the same imbalance ranking over the whole period of five years. On the other hand, five countries have improved the classification and four countries received a worse ranking in 2016 than the starting classification from 2012. Whereas no country experienced excessive imbalance in 2012 and four countries were under special assistance program, the figures from 2016 show that six countries faced excessive imbalance and only one country remained with special program and financial assistance.

As regards the MIP scoreboard indicators and frequency how often their thresholds have been breached by the member state, one can also reveal considerable differences among indicators. While export market share, net international investment position or general government debt exceeded the indicative reference values in most of the member states, the total financial sector liabilities or private sector credit flow seemed to pose imbalance risk in very few or no country. Such a finding raises the question whether selection of indicators and structure of the MIP scoreboard are appropriate.

Our key proposal on how to reform the MIP is introduction of the relative thresholds for the scoreboard indicators instead of the current absolute thresholds. We believe that decision on (non)existence of the macroeconomic imbalance must reflect the actual economic development in the examined group of countries. Therefore, the threshold will be probably different in times of economic boom than in period of economic crisis and recession. The current absolute thresholds can be totally replaced by the relative version or they can be applied concurrently for an interim period. Furthermore, we propose to supplement the thresholds reform with several minor institutional changes such as computation of the scoreboard indicators or introduction of maximally three flagship indicators in order to increase relevance and economic rationale of the MIP results.

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