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- The European Systemic Risk Board (ESRB) and the proposed prevention and correction of macroeconomic imbalances regulation (EIP) are designed to avoid imbalances. However, these instruments overlap, and need clarification.
- Both the ESRB and the Commission, which is given certain powers by the EIP, must identify and act early on risks. Acting in the face of strong economic and political pressure is difficult. Complementing the current approach with

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, significant macroeconomic imbalances built up in the euro area. Too low financing costs led to a misallocation of capital. Households and corporations both increased their borrowing and amassed substantial private sector debt. The borrowing fuelled asset price booms, which were particularly striking in those countries with the greatest underlying credit dynamics[1].

The flip-side to the build up of these credit and asset driven imbalances was increased current account deficits and a gradual erosion of competitiveness, together with increases in external debt[2]. The imbalances have proved highly damaging for the cohesion of the euro area, and some imbalances have spilled over to other euro-area economies. Spain, for example, witnessed a housing bubble and a private-sector credit boom, which were essentially sustained by significant capital inflows. These capital inflows were associated with big current account deficits and led to a sharp increase in Spain's external liabilities. The correction of these imbalances has strong effects on domestic demand and growth; it also severely impacts on public finances and on the banking system. Similarly, the bust in the Irish real-estate market undermines the stability of the Irish and euro-area financial systems. The real-estate boom is thus both a macroeconomic imbalance and a significant source of systemic risk.

Until now, the EU has not had effective mechanisms to address macroeconomic imbalances that are not fiscal. In fact, the EU macroeconomic surveillance framework prior to the crisis was almost exclusively focused on fiscal discipline. Recognising the importance of non-fiscal imbalances, the EU is reforming its policy framework in order to prevent similar imbalances from emerging in the future. The new framework is broader and consists of two basic pillars. The European Systemic Risk Board (ESRB), operational since January, is tasked with preventing instability in the financial system. The second pillar is a regulation analogous to the Stability and Growth Pact, which will allow the European Commission, via the Council, to give recommendations to EU member states to prevent and correct macroeconomic imbalances. This regulation, on the prevention and correction of macroeconomic imbalances (known as the EIP regulation), is at the time of writing in the legislative process[3].

The EIP regulation would constitute a significant step towards more effective macroeconomic surveillance in the EU. It is a tool for detecting macroeconomic imbalances early on, and issuing preventive policy recommendations. In case significant macroeconomic imbalances exist, it can result in the issuing of corrective policy recommendations that can ultimately be followed by fines. It remains to be seen which problems and policy areas the Commission will concentrate efforts on once the regulation is in place. Certainly, areas that would jeopardise the proper functioning of EMU would need to be looked at. This could include labour, product and financial markets.

It appears likely that the ESRB and the topics covered by the EIP regulation will overlap in some important areas. This Policy Contribution discusses this overlap and makes proposals for improving the effectiveness of the framework where there are overlaps. Moreover, we draw attention to the fact that discretionary action to prevent future crises is difficult and that both pillars rely mostly on policy discretion. The new framework should therefore rely as much as possible on automatic built-in mechanisms that increase the resilience of the financial system and reduce the pro-cyclicality of credit and asset markets. By doing so, the likelihood and size of macroeconomic imbalances and systemic risk will be

1. Setzer, van den Noord, Wolff (2011).

2. European Commission (2010).

3. The regulation 'on the prevention and correction of macroeconomic imbalances' proposed by the European Commission on 29 September 2010, has been discussed in the Council, with the Council reaching agreement on March 18. The European Parliament's ECON committee agreed on 19/20 April its position on the package. Tripartite discussions between the European Parliament, Council and European Commission are ongoing at the time of writing.

significantly diminished. At the same time, it is clear that considerable discretionary action remains vital to addressing imbalances that are specific to an individual country and would not be addressed by a rules-based framework.

The Policy Contribution is structured as follows. The next section shows that many macroeconomic imbalances and systemic risks are linked, and will often require similar policy action. Section 3 clarifies the policy framework and section 4 makes suggestions for an improved framework.

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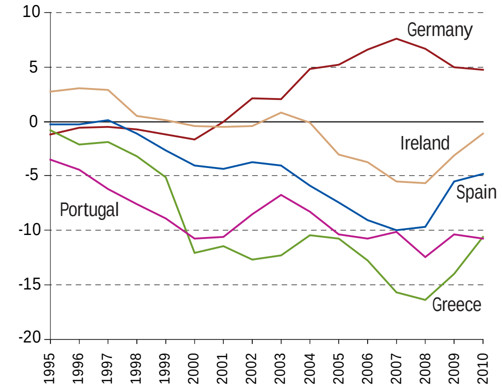
Macroeconomic imbalances are often reflected in the strong and persistent divergence in euro-area current accounts and have led to a build-up of large external debt positions in a number of euro-area countries (see Figures 1 and 2).

The external divergence has been driven by significant differences in national credit developments. Figure 3 shows that between 1999 and 2007 the average growth of private credit in Greece, Ireland, Portugal and Spain was much higher than the average credit growth in the core euro-area economies of Austria, France and Germany. Accordingly, there is a negative correlation between private sector credit growth and current account levels.

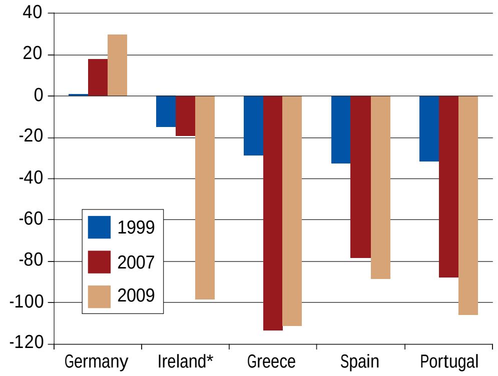
Unfortunately, not all the capital flows have been used productively. In fact, the current-account divergence and the national credit booms have often gone hand in hand with asset price booms, in particular in the housing market. Figure 4 shows that real house-price increases have been much more pronounced in Greece, Ireland and Spain than in the average of the euro area. The European Commission (2009) provides evidence that house price increases have been linked to the current-account developments, and that the link is stronger in European Economic and Monetary Union (EMU). As housing markets often constitute an imbalance of macroeconomic relevance, the European Commission has rightly suggested including a housing indicator in the 'Scoreboard' that it plans to use to detect macroeconomic imbalances at an early stage.

Figure 1: Current account divergence in selected euro-area countries (% of GDP)



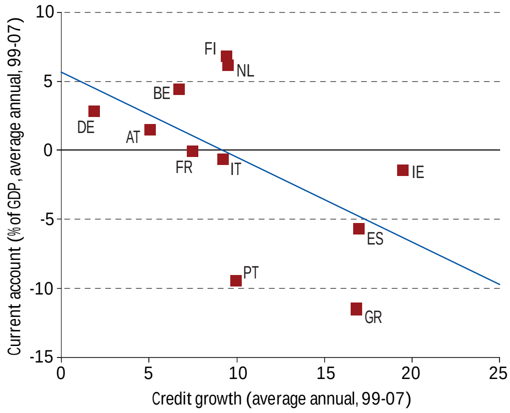
Source: Ameco.

Figure 2: Net financial assets of the total economy relative to the rest of the world (% of GDP)



Source: Eurostat, financial accounts. Note: * data for 1999 for Ireland are from 2001. Valuation at market prices

Figure 3: Credit growth to the private sector and average current account levels*



Source: ECB aggregated balance sheet of euro-area monetary financial institutions, excluding the Eurosystem, loans to 'other euro-area residents'. For current account figure: European Commission, Ameco database.
* Average annual growth of credit to the non-financial private sector during 1999M1-2007M12 and average current account-to-GDP ratio during the same period.

Such rules would, however, not make deep economic analysis superfluous. On the contrary, as

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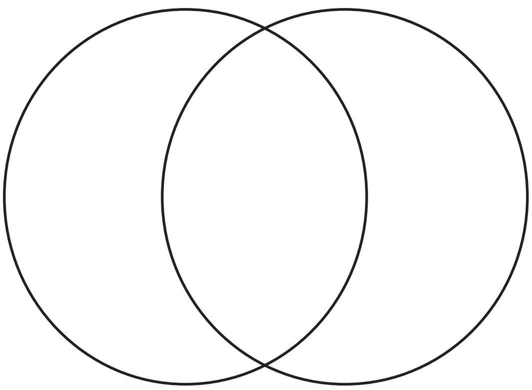
Article 3 of the ESRB regulation defines the mission and objectives of the ESRB: "The ESRB shall be responsible of the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention and mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system and taking into account macroeconomic developments, so as to avoid periods of widespread financial distress. It shall contribute to the smooth functioning of the internal markets and thereby ensure a sustainable contribution of the financial sector to economic growth." (Article 3(1))[10]. The key concept is, of course, systemic risk, which is defined in Article 2 as meaning "...a risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy. All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree." Clearly, this is a very broad definition requiring the new institution to monitor the financial system but also the real economy.

The draft regulation on the prevention and correction of macroeconomic imbalances also provides a definition of its scope. Imbalances are defined as "macroeconomic develoorr(a)] TJarld dee den Imbysten(d d)1i smo.2(diarieo.2ar)16.1(e d)32(en(d d)f6.8(1(e)17(p)14.3 e)12.2(v)12.60(C)1



10. Article 3(1) of the Regulation (EU) No 1092/2010 of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board.

11. European Parliament (2011), Report on the proposal for a regulation of the European Parliament and of the Council on the prevention and correction of macroeconomic imbalances (COM(2010)0527 – C7-0301/2010-2010/0281(COD)), rapporteur Elisa Ferreira.

'The European Parliament should insist that policy recommendations are followed-up. To do so, it should hold Commission, ESRB and national governments accountable, for example by requiring them to testify on concrete policy measures taken.'

3. The EIP procedure is more powerful than the ESRB because the Council can make the Commission's recommendations legally binding with the ultimate threat of sanctions in case of non-compliance. In the ideal and probably most likely case, the assessments of the ESRB and the Commission will coincide in the areas of overlap. In such a case, the Commission could take on board – as a rule – the ESRB's recommendations in the EIP. The main obstacle to this is the exclusive country focus of the EIP while the ESRB can issue recommendations to the Union, member states, the European supervisory authorities and national supervisors. While in practice this problem could be solved by issuing recommendations to all member states, it is worthwhile considering an amendment to the EIP draft regulation to allow for recommendations to parties other than the member state[14].

4. In case of disagreement between the Commission and the ESRB where competences overlap, a choice needs to be made which institution should have the final say. The current set-up clearly gives the priority to the Commission as the Treaty (Article 121) gives the right of initiative to the Commission. A more binding follow-up from the Commission, especially in the area of financial recommendations, when they have implications for macroeconomic imbalances, could be considered[15]. By choosing this option, the weight of the ESRB would significantly increase and systemic risk with macroeconomic relevence would be more forcefully addressed. Such a modification would have to be done in a way compatible with Article 121 of the TFEU.

5. On a working level, it will be important that ESRB and Commission staff closely interact so that information, knowledge and ideas are exchanged early in the process. Such an exchange should go beyond the exchange in the ESRB itself, where the Commissioner is a member. Regular meetings between Commission staff, the head of the ESRB secretariat and the heads of the advisory scientific and technical committees, should take place so that synergies in the assessment and the policy formulation are maximised

6. Finally, The European Parliament should insist that policy recommendations are followed-up. To do so, it should hold Commission, ESRB and national governments accountable, for example by requiring them to testify on concrete policy measures taken. This could be done by, for example, requiring national authorities to report to the European Parliament on if and how they have fulfilled their obligations according to both the ESRB and the EIP. Moreover, the European Parliament may play an important role in case of disagreement between the ESRB and EIP as it holds the Commission and the ESRB democratically accountable.

14. This appears all the more necessary because the EIP draft regulation clearly speaks of the potential of an imbalance to affect the proper functioning of the Union as a whole (Article 2).

15. In the draft EIP Regulation, the Commission must only "take into account" early warnings and recommendations from the ESRB (Article 5(2)). Instead, the Commission could be required to automatically "include" the ESRB's warnings and recommendations in its in-depth study. Should it choose not to do so, it could be required to explain, analogously to Article 17 of the ESRB regulation.

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