Including macro-prudential strategies in Euro-area macroeconomic policy

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[special issue of *Réalités Industrielles*, August 2018]

Abstract:
In the wake of the 2008 financial crisis and especially the euro area crisis, several innovations – including macro-prudential policies and a macroeconomic imbalance procedure – were included in Europe's economic policy structure. However, their coordination and surveillance mechanisms could be better interconnected. The goal, instruments, horizon and summary indicator for each mechanism should be specified, together with the institution responsible for supervision.

Pre-crisis macroeconomic policy in the euro area

The macroeconomic policy architecture introduced at Maastricht was simple. The European Central Bank (ECB) would be responsible for maintaining price stability throughout the euro area and ensuring the liquidity of the European banking system. National governments were responsible for using fiscal policy to respond to specific domestic shocks and for using micro-prudential supervision to maintain the solvency of their banking systems. The Treaty clearly provided that "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council" (Article 121 (formerly 99) of the Treaty on the Functioning of the European Union), leading to "broad guidelines of the economic policies". However, the coordination of economic policies was secondary, with no binding mechanism.

The Maastricht architecture reflected a significant underestimation of financial externalities, both between countries and between macroeconomic policy branches. The global financial crisis, followed by the European crisis, have shown that financial instability in one country can quickly spread to other countries. Moreover, these two crises have called into question the principles of separation between monetary, budgetary and micro-prudential policies:

- The crisis gave the old concept of policy mix – a combination of monetary and fiscal policy – a new lease on life. When interest rates are at zero, fiscal policy takes over and its multiplier is higher than in normal times (see, for example, Christiano *et al*., 2011).

- The crisis also jeopardised the principle of monetary dominance, according to which the central bank must not find itself in a situation where its only choice is to monetise budget deficits. In some European countries, the massive exposure of banks to national sovereign risk has put the central bank in a bind, with banks short of quality collateral to refinance with the central bank (see Bénassy-Quéré *et al*., 2018).

- Finally, the crisis has shown that the central bank cannot ignore micro-prudential supervision, not only for the purpose of preserving its role as lender of last resort, but also because a banking system in crisis cannot pass on monetary policy gestures (see, for example, Draghi, 2017).

Moreover, the crisis has revealed the shortcomings – not to say the adverse effects – of micro-prudential supervision. Not only did capital requirements turn out to be insufficient, not only were supervisors often captives of industrial interests, but more fundamentally, the institution-by-institution approach proved to be ineffective when risks were correlated and cross-exposures suddenly became apparent. More generally speaking, micro-prudential supervision provides few constraints when things are going well and is highly pro-cyclical when they are not.

Reshaping policy and the emergence of macro-prudential policy

The crisis has led to a reshaping of macroeconomic policies in the euro area, primarily along three lines:

- Expansion of Member States' surveillance to include macroeconomic policies (except for fiscal policy), via the Macroeconomic Imbalance Procedure (MIP, see Box 1)

- Heightened regulatory requirements and micro-prudential supervision, with direct supervision of the largest institutions by the Single Supervisory Mechanism, located within the ECB

- Establishment of a macro-prudential policy with an explicit mandate as regards financial stability and specific instruments

Box 1. The Macroeconomic Imbalance Procedure

Just prior to the 2008 financial crisis, Greece was the only one of the nineteen countries in the current euro area with a budget deficit that exceeded 3% of GDP.[1] However, every country that would be seriously affected by a financing crisis had current account deficits in excess of 6% of GDP (Figure 1). These deficits reflected a rapid increase in debt not in the public sector but in the private sector, particularly banks.

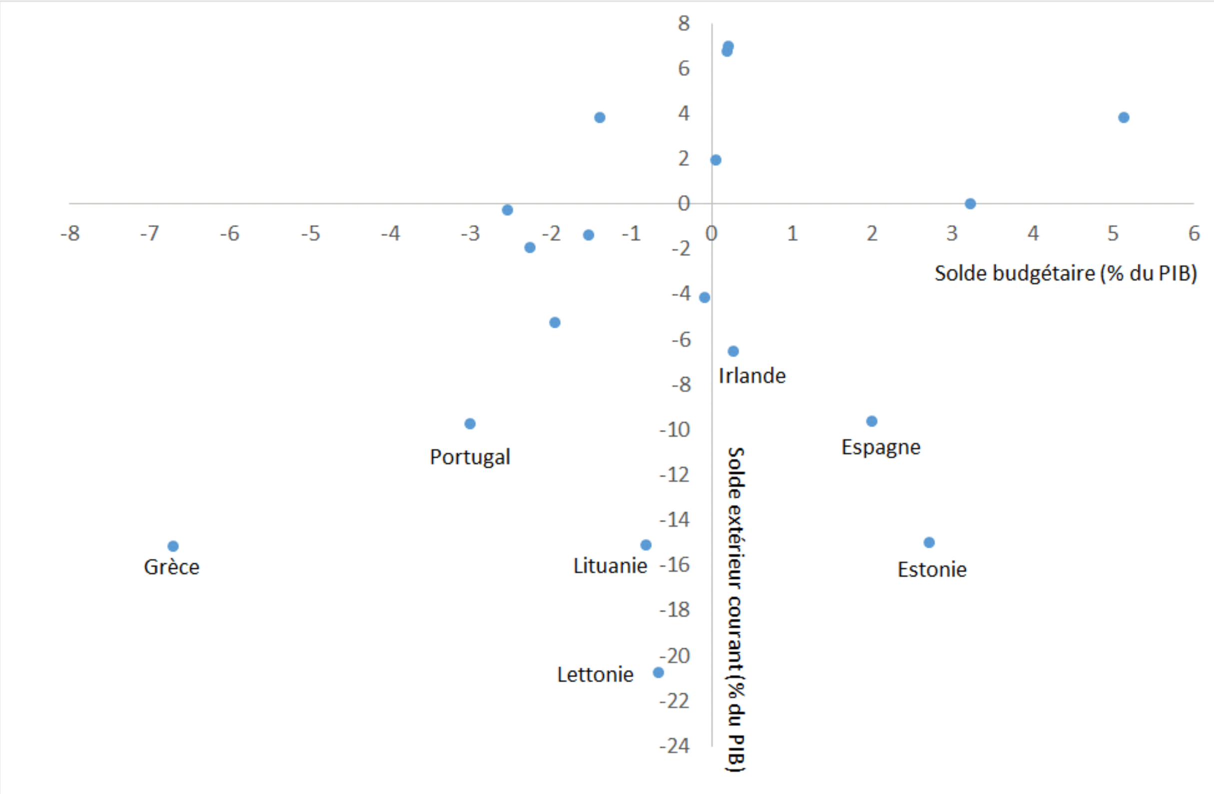

Chart 1. Budget deficits and current account balances of nineteen European countries in 2007
Source: European Commission, Ameco database

Noting that compliance with the Stability and Growth Pact (SGP) was in no way a protection against crises, the European partners, on the occasion of the Six-Pack,[2] introduced a Macroeconomic Imbalance Procedure (MIP) to monitor imbalances other than those in the public sector. Incorporated into the "European Semester", the procedure starts at the end of the year N-1 with the publication, by the European Commission, of an "Alert Mechanism Report" which, based on a set of indicators gathered together in a scoreboard, identifies those countries that are likely to present imbalances. In the spring of year N, the Commission then publishes an in-depth report on each of the countries concerned, which it classifies into four categories (initially five): "no imbalances", "imbalances", "excessive imbalances", or "excessive imbalances requiring activation of the excessive imbalance procedure (EIP)". This fourth category may give rise to sanctions.

[1] This was not known at the time due to statistical problems revealed at the end of 2009.
[2] A "legislative package" consisting of five regulations and one directive that was adopted in October 2011.

From a theoretical standpoint, introducing a macro-prudential policy with specific instruments (counter-cyclical cushions, mortgage market restrictions) is likely to solve problems related to excessive economic policy objectives in comparison to the limited number of instruments (Tinbergen, 1952). For example, in a time of a credit boom and low consumer price inflation, the central bank may keep interest rates low while macro-prudential authorities tighten constraints on bank credit.

Even if there is a lack of perspective, existing research shows that macro-prudential instruments appear to be somewhat effective in addressing credit growth, housing prices dynamics and bank resilience (see Benani *et al*., 2017). Nevertheless, macro-prudential instruments may not be sufficient to ensure that financial stability objectives can be pursued without jeopardising monetary policy.

The second problem is including macro-prudential policy in the macroeconomic surveillance framework. For understandable reasons (independence, access to information from financial institutions), macro-prudential policy has been entrusted to central banks or authorities in which the central bank plays a leading role.[3] In addition, these authorities are coordinated by the ECB, which has the power to impose more restrictive policies than the national authorities have chosen.

However, the EIP, which is also designed to prevent financial crises, is managed separately by the European Commission as part of the European semester. This results in some confusion in the allocation of objectives and instruments between different institutions and supervisory processes.

Clarify objectives and instruments

Surveillance of euro area economic policies is broadly based on four pillars: the Stability and Growth Pact (SGP), the Macroeconomic Imbalance Procedure (MIP), the Europe 2020[4] strategy and the ECB's coordination of macro-prudential policies. The first three schemes, managed by the European Commission, overlap in part (Chart 2). Thus, the country-by-country recommendations under the MIP include elements relating to the SGP, while the same structural recommendation may appear under the MIP for a country considered to be in excessive imbalance, and under the Europe 2020 strategy for another (see Bénassy-Quéré, 2017).

There are two types of economic policy recommendations: one concerns policies "on the fringes" (reducing this or that compulsory levy, limiting rises in the minimum wage); the other is structural (educational or legal reforms, innovation policies, active labour market policies, etc.). It is rare that a financial imbalance can be contained by a structural policy for two reasons. The first is that financial imbalances tend to accumulate faster than the pace of

[3] According to the European Systemic Risk Council (2018), macro-prudential policy in most Member States is conducted by the central bank or by an inter-institutional authority in which the national central bank plays a leading role. In France, the High Council for Financial Stability is chaired by the Minister for Economy and Finance, but the Governor of the Banque de France is the only one who can propose a binding measure (French Monetary and Financial Code, Article L631-2-1).

[4] A European growth programme based on a number of objectives, including investment in R&D, energy transition and education. The programme is monitored country-by-country as part of the European semester, with recommendations for individual countries.

structural reforms. The second is that structural reforms often have an ambiguous or delayed impact on financial imbalances: what is the impact of a more flexible or less dual labour market on the indebtedness of private stakeholders? What is the effect of reforms of vocational training, the courts, or the service market? The only structural reforms that have a direct impact on financial imbalances affect the financial sector: deregulation or re-regulation in banks and other financial players, real estate market restrictions can quickly affect the debt levels of private stakeholders. Even in this case, some instruments can be manipulated on the fringes, such as counter-cyclical capital buffers or limits on debt (or repayment) to income ratios.

To control financial risks in the short to medium term (the MIP horizon), it is better to rely on instruments that can be handled on the fringes. The problem is that some of the instruments available "on the fringes" are located in the macro-prudential sphere, while some are in the sphere of the MIP, and these are two distinct processes.

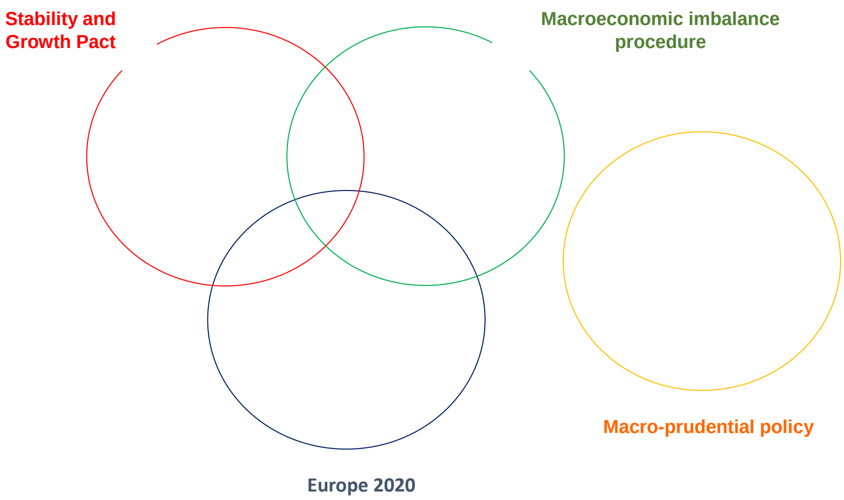

Chart 2. Four partially-overlapping coordination mechanisms

This results in both inefficient risk management and opacity for public decision-makers. The opacity is heightened by the mass of indicators underlying the classification of countries according to the (possibly excessive) imbalances they present, and by the tenuous link between these indicators and economic policy recommendations (Bénassy-Quéré, 2015). In fact, the support of Member States seems limited, judging by the low rate of implementation of country-specific recommendations (Darvas and Leandro, 2015).

Monitoring of macroeconomic policies in Europe would benefit from clarification according to objectives, instruments and time horizons (Table 1).

Table 1. A proposal to clarify surveillance mechanisms

	Objective(s)	Instruments	Horizon	Synthetic indicator	Institution responsible
Stability Pact	Fiscal discipline	Budget balance	Annual	Budget balance	European Commission
Macroeconomic Imbalance Procedure	Macroeconomic stability	Minimum wage, tax policy	Annual	Current account balance	European Commission
Macro-prudential policy monitoring	Financial stability	Counter-cyclical cushions	Quarterly	Basel Gap	ECB
Europe 2020	Growth, full employment, the environment, etc.	Structural reforms	Multi-annual	Growth	European Commission

As mentioned above, the objective of the SGP is budgetary discipline. The goal of MIP, which was introduced in 2011, was to provide a complement to the SGP to avoid the accumulation of non-public risks: corporate, household and banking debt, real estate bubbles, labour cost drift, etc. This is a short- to medium-term objective that takes the institutions of each country as data. The instruments are mainly the setting of minimum wages and salaries of civil servants, tax policies and macro-prudential policies. They are therefore shared with macro-prudential policy. To ensure that these two mechanisms are better connected, it would be a good idea to define them not only by their instruments (which are *de facto* separate), but also by the supervisory horizon (annual for the MIP, quarterly for macro-prudential policy) and by a synthetic indicator to better attract attention, for example the current account balance for the MIP and the Basel Gap for macro-prudential policy.[5] The idea is not to limit monitoring to a single indicator, but rather to highlight an indicator that is easy to understand and explain to the general public, as detailed analysis is based on expert judgement. This does not prevent the European Commission from monitoring the primary balance, the structural balance and the debt, and from making all kinds of adjustments before making its diagnosis. Similarly, macro-prudential supervision proceeds hierarchically, starting with an examination of the Basel Gap before focusing on credit, debt and asset price indicators.

Once each procedure has been defined in this way by its purpose, horizon, instruments and synthetic indicator, a way must be found to ensure that the MIP and macro-prudential policies are in dialogue without making them too cumbersome. As macro-prudential supervision is more frequent, its role would be to report its analyses and action to the European Commission at the beginning of the European semester, relying both on national macro-prudential authorities and on the European Systemic Risk Council.

[5] The Basel gap is the ratio of credit to GDP, deviating from a long-term non-linear trend. Although this indicator is still the subject of discussion in the literature, it is the preferred variable for macro-prudential supervision in Europe.

The EU's growth strategy targets full employment and productivity growth, two long-term objectives. This strategy may result in annual monitoring, but the results of educational or judicial reforms will not be seen for several years. Attempting to resolve medium-term imbalances with long-term reforms is hazardous. Admittedly, the lack of growth in a heavily-indebted country, or the persistence of high unemployment, particularly among young people, pose a systemic risk throughout the euro area. However, this is not a sufficient reason to put structural reforms on the agenda of the MIP, which, overloaded with objectives, becomes unclear and, in the end, ineffective. It would be better to define a specific governance for structural issues, with multi-year objectives and steps that can be monitored by the European Commission. These intermediate steps would allow measures to be tested before they are rolled out on a wider basis. They would also allow ambitious reforms to be broken down. This would not prevent progress from being reported annually as part of country-specific recommendations. But the timetables would be clearly differentiated, with groups of reforms assessed over multi-year periods.[6]

Conclusion

The economic crisis exposed shortcomings in the architecture of macroeconomic surveillance in the euro area. Supplementary supervision was then introduced, but its effectiveness is now limited both by the catch-all aspect of the procedure for macroeconomic imbalances and by its insufficient coordination with macro-prudential supervision mechanisms. These defects are not prohibitive; they can be corrected without changing the Treaty or spending additional resources. However, they attract little attention, precisely because of their complexity, which makes them the domain of a limited circle of experts and bureaucrats.

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[6] It should be noted that such a development would be consistent with the channelling of part of the funds from the European budget towards supporting structural reforms (see the European Commission's proposal, 2018).

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