ISPI Policy Brief

ISTITUTO PER GLI STUDI DI POLITICA INTERNAZIONALE

Carlo Altomonte, Silvia Merler

N. 205 - MARCH 2010

The Strengthened Economic Governance Framework: Some Guidelines(*)

Abstract

The European Council reached an agreement on the economic governance of the post-crisis European Union. It goes well beyond the simple reform of the Stability and Growth Pact as it is intended to avoid new debt crises in the future by taking into account not only imbalances in the national accounts of the Eurozone countries (as in the Greek case) but, more generally, diverging economic indicators including private debt (particularly relevant in the Irish and Spanish cases).

The Policy Brief addresses this topical issues by underlying the importance of both public and debt levels (a matter which prompted a lively debate in the Council) and by showing links with the economic performance of Eurozone countries.

Following months of intense negotiations, the European Council of March 24th and 25th, 2011 has finally endorsed, among other important decisions, a package of six legislative proposals on economic governance. The package is seen as key in the crisis context to ensuring an enhanced budgetary discipline, as well as avoiding the excessive macroeconomic imbalances which ultimately led to the recent turmoil experienced by the euro. The package in particular includes six legislative proposals aimed at reforming the Stability and Growth Pact, thus addressing the 'Greek' type of problems encountered by the euro area in the surveillance of fiscal policies, as well as a new 'Excessive Imbalance Procedure', aimed at the surveillance and correction of those macroeconomic imbalances linked to the evolution of the private sector which, as in the case of Spain and Ireland, ultimately had equally destabilising effects for the concerned countries.

The package will now be left to the legislative negotiation of the European Parliament and the Council, with a tentative final adoption foreseen in June 2011. As these legislative proposals are likely to shape the 'fiscal' leg of the economic and monetary union for the years to come, in this policy brief we try to make sense of the (complex) set of relations linking the evolution of public and private debt and the competitive position of countries (via the current account), with the aim of providing some guidelines to policymakers.

Global and European Imbalances

As the financial crisis has witnessed too well, the last decade has been characterised by persistent global imbalances, often dubbed as the 'saving glut' of Asiatic capital alimenting a large and persistent deficit in the US current account.

The European Union and the Euro-area have not been an exception: the introduction of the single currency has started a period of steady divergence in Euro Members' external positions that has grown uncontrolled. Figure 1 below reports the overall Current Account Balance (as % of

Carlo Altomonte is Associate Professor of Economics of European Integration at Bocconi University, Milan and Associate Senior Research Fellow at ISPI.

Silvia Merler Bocconi University.

(*) The opinions expressed herein are strictly personal and do not necessarily reflect the position of ISPI.

GDP) of the Euro Area 12 between 1980 and 2010, together with the mean absolute deviation in the cross-country distribution of the same variable.

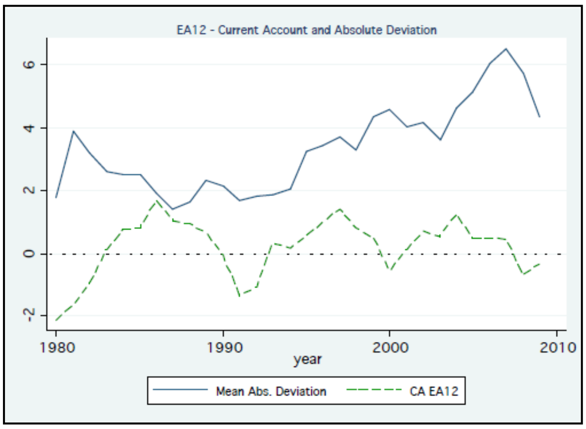

Figure 1 Current Account Balance (% GDP) - EA12

If one looks only at the dashed line – representing the total Current Account Balance of the Area – the EMU seems to have fulfilled its long standing promise to offer macroeconomic stability in an unstable World, managing to keep its overall position more or less close to balance over the last two decades. However, a closer look at the volatility of current account positions *within* the EMU reveals a less comfortable picture, as it suggests that the individual positions of Member States within the EMU have been diverging systematically over last twenty years.

The most striking fact is therefore that the Maastricht Treaty (1993) – with the associated effort to foster convergence – seems to coincide instead with the start of a long period of divergence across Euro Members. Such a co-existence of EMU-level convergence and country-level divergence in the Monetary Union may be striking, but it can be explained in light of what could be defined a “Maastricht Original Sin”. While dealing extensively with the governance public finance, inflation and interest rates – the Treaty blatantly neglected to consider other variables (Current Account and Private Debt in particular) that remained unconstrained. Current Account was denied any formal concern in the building framework of the Monetary Union because imbalances, even if happening, were considered a welcome signal of convergence between rich and poor countries within the Eurozone, and thus were deemed to be transitory. Moreover, given the relative size of financial markets outside the Euro-zone at that time, current account balances of Euro countries were indeed negligible in their magnitude. As a result, the common opinion was that, if any danger was to be expected, it would have come from *within* Euro countries, that is from their public budget position.

This way of reasoning, in principle consistent with the macroeconomic environment existing when the Maastricht Treaty was designed (1990-1992), has nevertheless been made inadequate by two huge openness shocks experienced by the Euro area: first, the increasing implementation since 1993 of the Single Market, which brought about increased capital movements and a massive wave of financial integration; second, the rapid acceleration in the globalisation process, together with the emergence of (much) deeper and more integrated global financial markets. All the latter paved the way for a growing weight of private sector in total indebtedness, which acted as a substitute for the Maastricht-constrained public debt especially in countries lagging behind in competitiveness. A combination of these factors is likely to be behind the drastic explosion in current account positions, and the ensuing instability affecting the euro zone.[1]

Indeed, investigating the standard Current Account determinants for four different groups (OECD, EU27, EA16 and EA12) over the period 1980-2008, Altomonte and Merler (2011) find that the relative income of countries is positively correlated with the current account (consistently with the original Maastricht ‘convergence’ argument) only once Luxembourg is included in the analysis. If the latter country (which is an outlier) is excluded from the data, the relationship disappears completely, regardless from all the macroeconomic controls introduced. Hence, by and large, income is not significantly linked to the current account (for both the Euro

[1] Gros (2010) highlights (and Figure 1 confirms) that the peak in divergences of the Current Account was registered after 2004, namely after the starting of a (private) credit boom, which was fuelled by the low euro interest rates and made borrowing possible even for otherwise too risky borrowers.

Area or the EU27), suggesting that there is no support in the data for the traditional justification of imbalances based on the convergence argument. Less surprising, there is a positive and significant link between the General Government balance and the Current Account. Over the entire period, the link is not strong for the Euro Area, but breaking the analysis between the two sub-periods the relationship is found to be significant only over the second period (1999-2008), whereas it is not over the first. This latter finding suggests that the positive link between public finance and the external balance of Euro Members has started to be relevant only *after* the introduction of the euro. Finally, introducing in the analysis the Households' Net Lending (used as a proxy for private savings), the latter is found to be positively and significantly correlated with the current account in the post-1998 period (as it was the case for public savings).

To sum up, after the creation of the Monetary Union the Current Account starts to be positively and significantly correlated with *both* the General Government Balance and Households' Net Lending, two variables which taken together could be considered a proxy of countries' overall savings. We now link this finding to the competitive position of countries.

Debt and Competitiveness of Countries

When considering the evolution of CA imbalances in the euro area with respect to the current debt crisis, a large part of the debate has often linked the latter to measures of a country's 'competitiveness', but has considered the emergence of sovereign spread differentials as mostly related to a country's government balance, therefore processing the two problems in parallel. However, the latter attitude is only partly supported by the market dynamics, as the Irish and Spanish debt crisis cannot be brought back to public budget misbehaviors (Marzinotto *et al.*, 2010).

To provide some structure to this complex set of interactions, in Figure 2 we thus start by showing the positive correlation existing between the *differential* Real Effective Exchange Rates of the Euro area countries with respect to Germany, a proxy of a country's relative competitiveness, and the spread between the same countries' Long Term Interest Rate (10-years Government Bond) and that of Germany. As shown in the same Figure 2, the GIPS countries (Greece, Ireland, Spain and Portugal) are mostly responsible for the latter positive correlation.

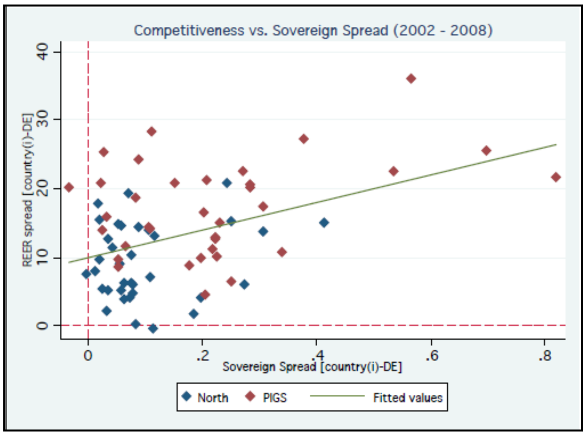

Figure 2 Two kinds of Spread within the Euro Area

Not surprisingly, the same competitive differentials are also strongly correlated with the current account (the correlation implying that countries with higher current account balances also have lower competitiveness differentials with respect to Germany), and not with the fiscal balance. From here, it is therefore natural to check whether a country's sovereign spread differential vs. Germany can be explained by its Current Account position. As the latter is correlated for the Euro area countries with both the public and private levels of debt, the economic rationale for such a relation is that the CA might be considered by financial markets as a synthetic proxy of the overall indebtedness of a country.

The implication of the latter finding, if proven true, would thus be that the strengthened economic governance framework should consider at the same level *both* the public and the private level of debt of a country, as these are both related to the Current Account and, from here, to the sovereign spreads.

Indeed, checking for the latter correlation confirms that after 1998 the fiscal balance has no *individual* role in explaining the pattern of sovereign spreads, whereas the current account is strongly significant. Even more interestingly, neither the fiscal balance nor households lending have a significant correlation with the spread when they are introduced *alone*, suggesting that their sum is actually what matters for the markets. Although results are not reported here, it goes without saying that things are very different for the period 1980 – 1998: over the first period the current account is never found to be significantly correlated with the spreads, which instead are strongly correlated with the government balance. Moreover, over this period the current account remains insignificant also when government balance is excluded.

Current Account and Financial Market Spreads: a Simulation

For those macroeconomic variables available at a quarterly frequency, it is interesting to replicate the above analysis in order to derive a robustness check of the results. In particular, the aim of this exercise is to check the validity of the relationship between the current account and the spreads found in yearly data by understanding whether a prediction of the current account based on the overall indebtedness position of a country would have followed to some extent the pattern of the sovereign spreads. In any case, the analysis contained in this section does not constitute an attempt to *predict* the sovereign spread, but rather to understand the impact (if any) of low frequency macroeconomic determinants on it.

To construct the robustness test, we start with a simple version of the Current Account model estimated over a reduced temporal sub-period (2002Q1-2006Q4), introducing four variables for the PIGS (Portugal, Ireland, Greece and Spain). The obtained fitted current account is then plotted for the entire period (that is up to 2010) against the sovereign spread, in order to check the validity of the positive correlation found in the previous Section.

To construct our Graphs, we took the opposite of the predicted Current account in the model (because the relationship found before was a negative one) and plotted it against the spread. The result is reported in the four panels of figure 3 below, which suggests some interesting considerations. The fitted value of Current account follows the pattern of the sovereign spreads quite well, although it misses many of the oscillation and has a different order of magnitude (which is expected given that we are fitting it with low frequency variables). However, given our goal not to predict the spread but rather to understand its link with the current account, the result is interesting because it suggests once again that such an extremely synthetic fitted measure of the current account is to some extent able to follow the high frequency evolution of the spreads' dynamic.

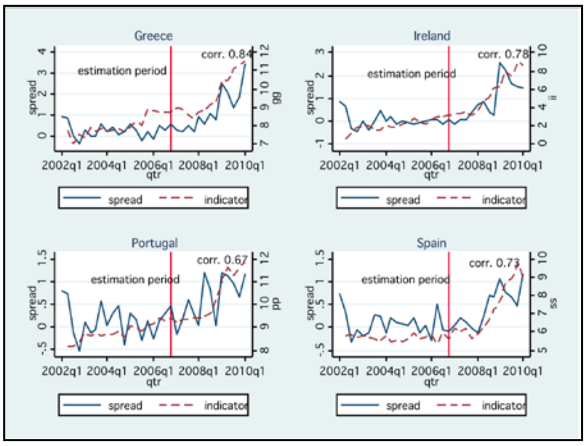

Figure 3 Current Account versus Spread

Conclusions

During the first decade of the European Monetary Union, a number of observers have stressed that playing by the Maastricht rules was an indispensable condition for the survival of the Union itself. Even nowadays, it is tempting to conclude that troubled countries are in trouble because they do not play the game 'by the rules'. Although this might have been the case in the past, and for sure it is the case for Greece, the simplistic equivalence misses a crucial contradiction: Irish and Spain, equally troubled countries, *did* play by the Maastricht rules. If the spike in long-term interest rates of Greece and, to a certain extent, Portugal, would have been predictable within the original Maastricht framework, the one for Ireland and Spain would not, as in the latter case unsustainable (but unchecked by rules) levels of private debt, as reflected in the quality of banks' assets, detonated the crisis.

The rules set in the Maastricht Treaty were not wrong in their own nature, but it is now vital for European policymakers to recognise that they have become short sighted in the current global financial context. To that extent, the most important point that emerges from the analysis presented is evidence that financial markets have widened their horizons to embrace both public and private debt, in so doing shifting their attention onto a variable that after 1998 provides a good proxy of the countries' overall indebtedness, i.e. the Current Account.

This Policy Brief thus provides evidence in support of the recent interest in the monitoring of Private Debt together with the Public one – as advocated in the policy debate – by showing that these two variables are important *together* in explaining the risk associated by financial markets to Euro Members' government bonds.

Second, the evidence exposed suggests that after 1998 the Current Account has become correlated with the sovereign spreads – as an indirect representation of countries' overall indebtedness – thus providing a strong argument in favour of the claim that external imbalances can no longer be ignored.

Le pubblicazioni online dell'ISPI sono realizzate anche grazie al sostegno della Fondazione Cariplo.

ISPI
Palazzo Clerici
Via Clerici, 5
I - 20121 Milano
www.ispionline.it

Per informazioni:
ispi.policybrief@ispionline.it
ispi.policybrief1@ispionline.it