Managing external macroeconomic imbalances in the EU: the welfare cost of scoreboard-based constraints

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ARTICLE INFO

JEL classification: C54
D60
E42
F12

Keywords:
Macroeconomic Imbalance Procedure
DSGE
Welfare
Constrained optimum policy
European Union

ABSTRACT

This paper investigates the consequences of introducing a new economic governance tool in the European Union - Macroeconomic Imbalance Procedure. We focus on the external imbalances and especially on the lower limit of −4% imposed on the current account deficit to GDP ratio. Using a 2-region, 2-sector New Keynesian DSGE model and Woodford’s technique to operationalise inequality constraints, we demonstrate that it is possible to accordingly adjust monetary and fiscal policy. The utility-based welfare loss remains very limited as compared to optimum unconstrained policy, as measured for Poland on the basis of Bayesian estimation, and this result is robust over a wide range of parameter values. The cost is slightly lower i.a. when (i) the monetary policy is autonomous (outside the euro area), (ii) for non-converging economies, (iii) when the limit is relaxed by incorporating positive capital account to GDP ratio. The procedure also envisages lower limits on REER and ULC dynamics, but the latter can be in conflict with the CA constraint, especially in the monetary union.

Therefore, the scoreboard-based evaluation of external imbalances - while not very costly - has definitely some room for fine-tuning in the course of future MIP reforms.

1. Introduction

Macroeconomic imbalances have long attracted the attention of the academia and policymakers. Their external dimension, which manifests itself through current account (CA) figures and real effective exchange rate (REER) movements, usually requires internationally coordinated policy responses. This is especially the case in highly integrated economic areas, such as the European Union (EU), and even more so in currency unions, such as the euro area, where imbalances can develop relatively easily. Potential reasons range from asymmetric transmission of common monetary policy shocks to output (as documented e.g. by Rafiq and Mallick, 2008), through many other dimensions of structural heterogeneity, to the level of development (cf. Bobeva, 2013). Even before the 2009 global downturn, a number of authors noticed deficiencies e.g. in unionwide prudential supervision tools (Granville and Mallick, 2009). The discussion has intensified during the EU economic governance crisis, and especially during the euro crisis that followed. The escalation in the euro area stemmed partly from internal and external macroeconomic imbalances that had built up before in individual countries.

When the euro was launched, external adjustment within the euro area was expected to take place via realignments in competitiveness. Once an asymmetric positive demand shock, say, increased one country’s output gap and inflation rate values, the automatic real appreciation should have first deteriorated its competitiveness, producing a recession, which then would lead to real depreciation (see European Commission, 2006). Obviously, this reasoning also applied to non-EA countries of the EU, but they additionally had autonomous monetary and exchange rate policy as adjustment instruments. However, once internal real devaluations became necessary in the Southern Europe (Greece, Italy, Spain, Portugal) and Ireland, this hypothetical mechanism crushed against massive social and consequently political resistance (De Grauwe, 2012), insufficient rationality of agents or economic inertia (Torój, 2010) and governments contented with the "euro premium" that had afforded a decade of low reform intensity (Bednarek-Sekunda et al., 2010). Sharp external imbalances crystallised themselves along the border between Northern and Southern Europe (see Zemanek et al., 2010; Campiglio, 2015). It was the “core” or “North” of the euro area (Germany, Netherlands, Austria, Luxembourg, Finland) that were depreciating and lending and the “GIIPS” (Southern countries plus Ireland) that were appreciating and borrowing (see Fig. 1a). Over the period 2008–2013, the GIIPS countries have undergone some corrections, which again temporarily aligned their external indicators at the opposite pole to the “core” of the EA (see Fig. 1b).

During this experience, the EU faced critique for concentrating on fiscal imbalances (operationalised in Excessive Deficit Procedure in late 1990s) and ignoring macroeconomic imbalances. The EU’s response...
was first proposed in September 2010 by the European Commission and entered into force in late 2011 in the form of Macroeconomic Imbalance Procedure (MIP, European Parliament, 2011b, 2011a). This procedure replaced the inefficient Broad Economic Policy Guidelines and was aimed to avoid imbalances, defined as "any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the economic and monetary union, or of the Union as a whole".

The application of MIP starts with the analysis of a scoreboard of macroeconomic indicators with their respective, constant thresholds, lower and/or upper, that should not be exceeded. The procedure has generally been welcomed by the European institutions (European Systemic, 2011; European Central, 2012) for transparency and filling an important gap in macroeconomic policy coordination within the EU. Camarero et al. (2015) conducted external debt sustainability analysis for EMU countries and concluded that policy actions in managing external imbalances in Europe are indeed urgently needed. However, a number of researchers have pointed out the weaknesses of the new procedure. The reading of the scoreboard focuses some of the markets’ attention and may adversely affect the sovereign’s financing conditions once the indicators are flashing even though the (later) economic analysis may play down the previous reading (Gros and Busse, 2013). Gros and Giovannini (2014) go even further by questioning whether the absolute or relative indicators for a single country are the valid measures, as long as they add up to euro area indicators (for example, if the absolute or relative indicators for a single country are the valid assessment of a country’s imbalances would be played by the sub-

scoreboard would not run mechanically and the essential role in the analysis may play down the previous reading (Gros and Busse, 2013). While the intertemporal approach to the current account determina-
tion treats deficits as equilibrium phenomena in low-income econo-
 mies, the scoreboard treats all EU Member States homogeneously in this respect. This may imply running into another “one-size-fits-all” problem in Europe. Currently, there are only some asymmetric thresh-
olds for euro area and non-euro-area countries, but the line of division is not the same: the former group comprises a number of NMS (e.g. Slovakia and Lithuania), while the latter e.g. UK, Denmark and Sweden. This is why we reconsider here the choice of indicator against a possible alternative: current account plus capital account (KA), as the latter is at least partly considered as a source of safe, stable financing. Such an approach would leave the scoreboard’s mechanics for the EA-12 group virtually unaffected, but could substantially relax the constraint for small, catching-up economies in a fundamentally justi-
fied way.

It should be stressed that we focus here only on the cost side of MIP, while acknowledging the likely benefits from the tools designed to track of macroeconomic stability in the EU in general. The long-term benefits should materialize themselves if the procedure is effective in limiting the persistent current account deficits that, by Thirlwall’s law, exert a negative impact on long-term growth (Soukiazis et al., 2012, 2014). Meanwhile, our cost-side analysis is rooted in the strand of literature originated by the seminal contribution of Lucas (1987) on the welfare cost of the business cycle. In the context of the European

### Fig. 1. Current account balance and REER corrections in EU countries. Source: author, Eurostat data.
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