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THE EURO AREA'S MACROECONOMIC BALANCING ACT

GUNTRAM B. WOLFF

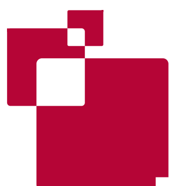
Highlights

- 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 transparent and rules-based mechanisms will reduce this problem.
- The EIP and ESRB can complement each other in terms of analysis and policy, and close collaboration will be vital. The EIP regulation can be used to ensure that ESRB recommendations are followed up. In the area of financial recommendations relevent to macroeconomic imbalances, the Commission should have a more formal requirement to act on ESRB recommendations. The EIP regulation would benefit from a clause allowing recommendations to be addressed not only to member states.
- Conflicts between the ESRB and Commission could arise. In this case, the Treaty requires the Commission to issue a recommendation even if the ESRB issues a negative finding.
- Legally, it might not be possible to exclude the use by the Commission of confidential information obtained in the ESRB.

Guntram Wolff (guntram.wolff@bruegel.org) is a Research Fellow at Bruegel.
Excellent research assistance was provided by Mouhamadou Sy.

Telephone
+32 2 227 4210
info@bruegel.org

www.bruegel.org



THE EURO AREA'S MACROECONOMIC BALANCING ACT

GUNTRAM B. WOLFF, MAY 2011

1 INTRODUCTION

In the run-up to the financial crisis, 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.

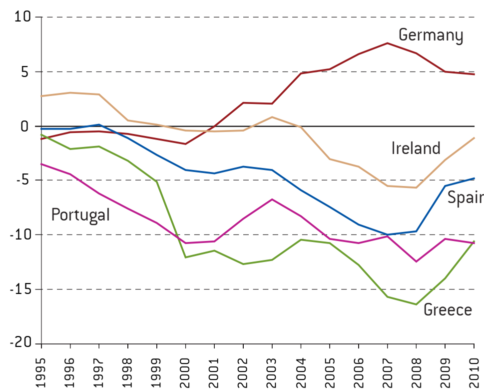
2 MACROECONOMIC IMBALANCES AND SYSTEMIC RISK

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.

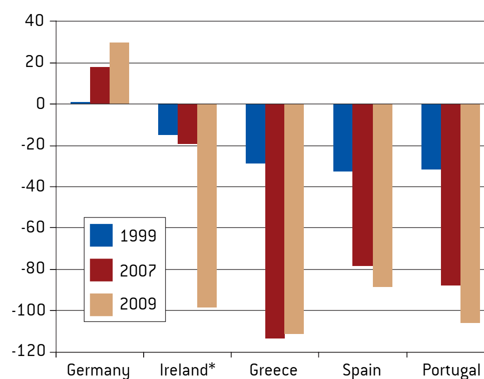
Unfortunately, not all the capital flows have been used productively. In fact, the current-account divergence and the national credit booms have often gone hand in hand with asset price booms, in particular in the housing market. Figure 4 shows that real house-price increases have been much more pronounced 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)



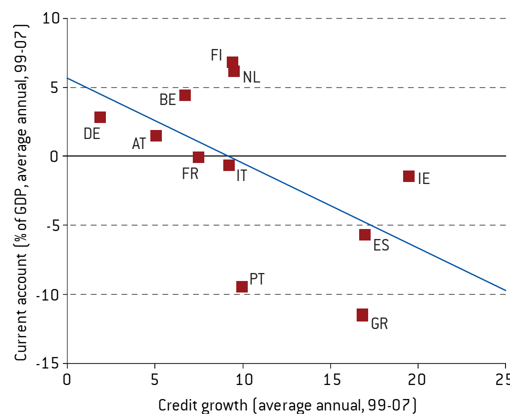
Source: Ameco.

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.

At the same time, it is generally acknowledged that excessive asset growth is one of the core factors behind increased financial sector vulnerabilities (Shin 2010). The turning of housing markets is indeed a major source of financial sector instability and systemic risk, because it simultaneously causes the balance sheets of households to deteriorate and increases non-performing loans (see Figure 5).

Shin (2010) forcefully argues that increased systemic risk from interconnectedness of banks is a corollary of excessive asset growth. This can be understood through the example of a simple stylised financial system with two banks (see Figure 6). Suppose there is a boom in which the assets of both banks double in size while the pool of retail deposits stays fixed. In such a case, the proportion of banking-sector liabilities in the form of deposits must fall, while the cross-claims across the two banks increase in order to finance the lending boom. The proportion of non-core funding to core-funding increases.

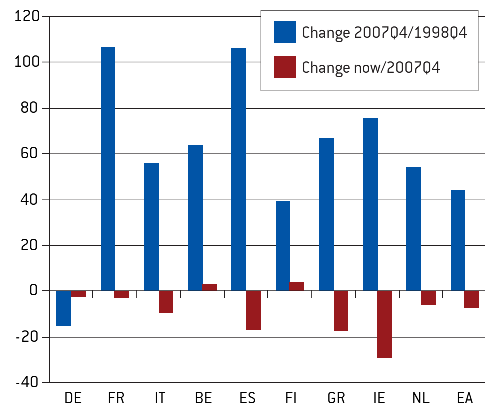
Thus, an asset price boom and bank lending boom will be correlated with increased interconnectedness of the financial system. Systemic risk will increase.

An assessment will have to be made of the extent to which local asset and credit booms in the euro area have led to an increase in interbank lending and/or to an increase in cross-border lending financed directly by depositors. However, it appears beyond doubt that regional asset booms in Europe have contributed to the current financial fragility of the euro area's financial system.

At some stage, the boom comes to an end. This can be triggered by an external event, but can also result from the end of bubble dynamics or simply a growth slowdown. The subsequent bust typically will be characterised by powerful amplification mechanisms that render the downturn steep and deep, and increase the fragility of the financial system. The macroeconomic downturn impacts on many financial intermediaries at the same time through its general impact on asset values and household and corporate balance sheets. The failure of one financial intermediary can have contagion effects on one or many other financial intermediaries, forcing them to sell assets quickly in order to satisfy their payment obligations. This in turn will further erode the value of the assets and put additional strain on the balance sheets[4].

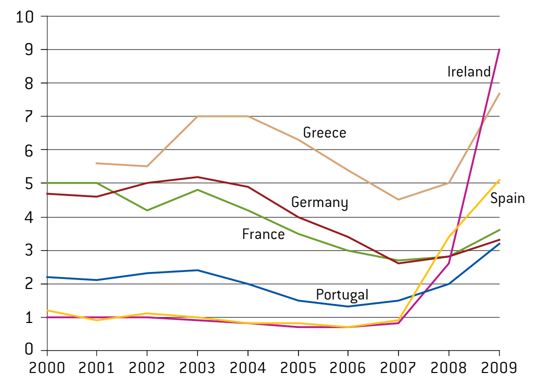
4. For a good exposition, see Trichet (2009).

Figure 4: Real house price increases



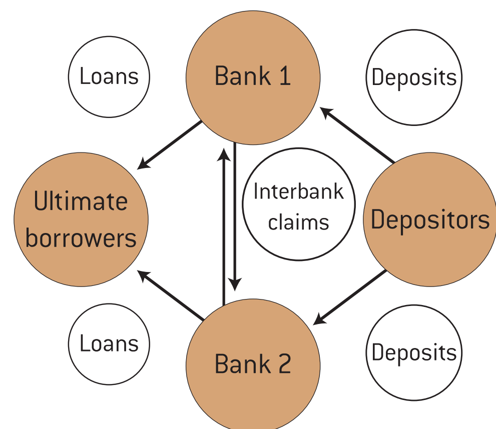
Source: OECD.

Figure 5: Non-performing loans (% of total loans)



Source: Worldbank, WDI database. Note: Bank nonperforming loans to total gross loans are the value of nonperforming loans divided by the total value of the loan portfolio.

Figure 6: Stylised financial system



Source: Shin (2010).

Policy response

It is clear from the description of systemic risk that a macro-prudential policy response cannot rely on micro-policy instruments only. Microprudential policy instruments can make financial intermediaries more resilient. However to prevent systemic risk, one would likely need to rely on instruments that prevent the primary causes of systemic risk: asset prices and the asset side of banks' balance sheets more generally. For example, higher capital ratios help to make financial intermediaries more resilient by increasing their capacity to absorb losses. However, the macroeconomic feed-back mechanisms described above are too powerful: a severe downturn will eventually render even a well-capitalised banking system vulnerable. This can currently be seen in Spain, where the financial system is under severe stress despite the significant anti-cyclical capital rules (dynamic provisioning) that were in place before the crisis.

Addressing systemic risk will therefore often have to involve the prevention of excessive asset price growth and other drivers of macroeconomic imbalances. By reducing asset price booms, the interconnectedness of the financial system typically will also be addressed and systemic risk decreases[5]. Similarly, to prevent macroeconomic imbalances, the structural factors that increase the likelihood of asset price cycles would need to be changed. The European Commission may therefore wish to issue recommendations to the mortgage and credit markets, and on housing taxation, with the aim of reducing real-estate imbalances.

Recommendations to prevent systemic risk could thus be of a very similar nature to the recommendations for preventing macroeconomic imbalances. Both would involve addressing excessive asset price and credit booms, thereby increasing the resilience of the financial system[6].

Asset bubbles: difficult to detect and preventive action will face opposition

There are two central challenges when one wants to prevent asset price and credit bubbles, which both the ESRB and the EIP procedure must deal with. First, an imbalance needs to be detected early on. This is not an easy task. Although significant progress has been made in improving the empirical methodologies suitable for detecting such imbalances, reasonable economists will continue to disagree on whether an asset price bubble is building up. Second, even if a majority of economists agree that a bubble is building up, any institution intending to actually stop the boom will face formidable resistance. This resistance will come from the financial system itself, but there will also be strong resistance from the political side and the electorate at large, as all essentially benefit from the boom.

Rules versus discretion

It is difficult to detect imbalances and it can be hard to act while the party is in full swing. For these reasons, there is a limit to what can be expected from discretionary action aimed at preventing imbalances early on. To overcome the political economy pressures and the informational problems, one should therefore rely as much as possible on rules-based tools that are suitable for reducing the pro-cyclicality of credit, asset prices and the interconnectedness of the financial system. Brunnermeier *et al* (2009) have made proposals on the kind of financial instruments suitable for such a purpose, and more work in this direction should be pursued.

In EMU, such more or less automatic measures are particularly suited to addressing macroeconomic divergences, and will also help to address systemic risk. For them to be effective, they will have to be related to national economic developments, not to the euro-area aggregate. By doing so, the macroeconomic divergence across countries would be dampened and the built up of excessive debt would be reduced. Capital requirements could, for example, be made dependent on the national credit cycle using a simple rule[7]. This would apply to all credit extended to residents of the country, irrespective of the residency of the financial intermediary extending the loan. After-tax interest rate differentials could be reduced by harmonising the taxation of mortgages and credit in general, thereby reducing one national determinant of the price of assets and credit.

5. In the same vein, Mervyn King, the vice-chair of the ESRB, outlined that the ESRB will not only have to rely on supervision but will make recommendations that increase the resilience of the structure of the financial system (public hearing at the European Parliament, 2 May 2011).

6. In fact, the ECB vice president has already made clear statements in that direction: "We could also have warned about housing market bubbles in Spain and Ireland – and about lending in foreign currencies in eastern Europe," Constâncio said. "These are examples of things that the ESRB would have done to prevent crises. If a body such as the systemic risk board, with so many members, issues concrete recommendations of that sort, then something would have to happen". See Financial Times (2011) 'EU authority to head off economic crises', 4 Jan.

7. The Basel III regulation already foresees some steps in the direction of anti-cyclical capital buffers but these remain largely discretionary.

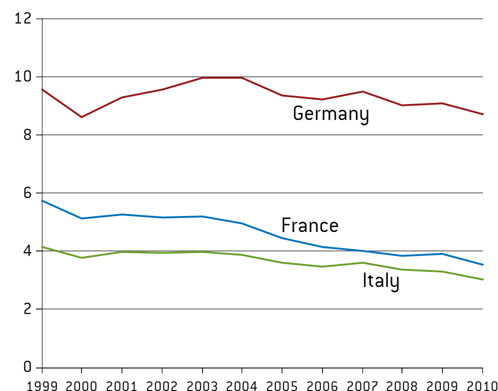
'The EIP procedure is stronger and – as a rule – should adopt the relevant ESRB recommendations and incorporate them in the EIP. This would also help to make these recommendations consistent with the broader macroeconomic strategy.'

Such rules would, however, not make deep economic analysis superfluous. On the contrary, as the economy evolves, new challenges will arise requiring new policy responses. Moreover, some country-specific structural features will require tailor-made policy recommendations that cannot be covered by horizontal rules. In practice, it will therefore be ideal to combine rules that increase the resilience of the system with continuous monitoring. The aspect of using rules has, however, not received enough attention to date. In addition, it should be kept in mind that the EIP aims not only to prevent imbalances but also to correct major existing imbalances. This cannot be done through simple rules, but requires potentially tough and country-specific policy action.

Macroeconomic imbalances can be unrelated to systemic risk

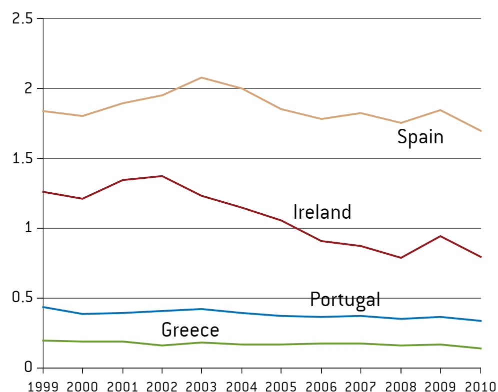
Some macroeconomic imbalances may be unrelated to credit and asset price booms, or to the increasing interconnectedness of the financial system. For example, France[8] and Italy have seen a significant deterioration in their global export market shares, which are not visible to the same extent in Germany, Spain, Portugal and Greece (see Figures 7 and 8). These losses reflect a gradual deterioration in export performance and global competitiveness. However they appear not to be directly related to financial sector vulnerabilities.

Figure 7: Market share developments (% world exports)



Source: Ameco database, European Commission.

Figure 8: Market share developments (% world exports)



Source: Ameco database, European Commission.

3 CLARIFYING THE POLICY FRAMEWORK

Scope

This policy contribution focuses on the areas of overlap between the ESRB and the EIP. Of course, there are important areas where ESRB and EIP do not overlap. The EIP would, for example, be concerned with the gradual deterioration of competitiveness and export performance with little systemic relevance. Also, policy measures in the labour and product markets that help to correct macroeconomic imbalances and ease the adjustment to past imbalances will certainly be part of the EIP but not the ESRB. In turn, an assessment by the ESRB of the systemic consequences of a sovereign debt restructuring would not be of primary concern to the EIP[9]. Similarly, the ESRB might also make supervisory recommendations that have little relevance for the EIP. For example, recommendations addressing the fragility of systemically important financial institutions (SIFIs) would certainly not be part of the EIP but could figure in the ESRB policy tool kit. Figure 9 visualises how the preventive arm of the EIP and ESRB would overlap.

The draft EIP regulation and the ESRB overlap in terms of their scope, which in both cases is sufficiently broad to be interpreted as including financial as well as real economic developments. Box 1

8. See for example, Artus and Fontagné (2006).

9. Wolff (2011).

BOX 1: THE LEGALLY DEFINED SCOPE OF THE ESRB AND THE EIP

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 developments which are adversely affecting or have the potential adversely to affect, the proper functioning of the economy of a Member State or of economic and monetary union, or of the Union as a whole" (Article 2). This definition is also very general.

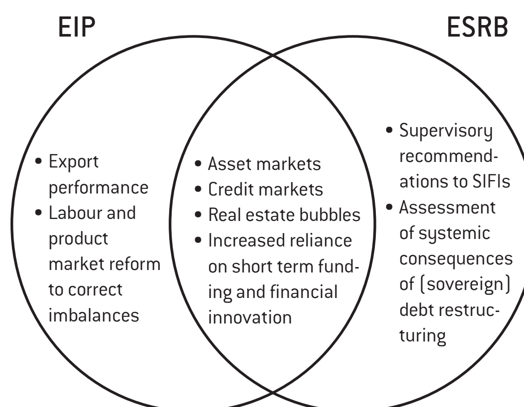
The potential for overlap is to some extent recognised in the Commission's draft EIP regulation as it makes a clear reference to the ESRB. It states that the in-depth reviews shall take into account early warnings or recommendations from the ESRB relevant to the member state under review. In turn, the ESRB regulation does not refer to the EIP, because the EIP is not yet in place. However, the European Commission is a member of the ESRB general board (Article 6.1) and is also represented on the steering committee (Article 11.1).

The European Parliament has proposed amendments to the draft regulation that would require the Commission to transmit information to the ESRB. More importantly, the Commission would be required to take into account the ESRB's warnings to the extent that they are addressed to a member state or are relevant to the member state. The Parliament has also introduced a sentence asking for the confidentiality regime of the ESRB to be respected[11].

presents the details on the legal base. As an example, adverse developments in the financial system can be considered to be harmful for the functioning of EMU. But they would certainly also be a significant risk to the financial system. Accordingly, the EIP and the regulation establishing the ESRB (Regulation (EU) no. 1092/2010) would apply. There is therefore a potential for overlap, producing synergies but also conflict.

An overlap may also be likely in terms of policy instruments. In this respect, there are some areas where the exclusive competence is evident. In other areas, the dividing line is less clear and similar policy instruments could be proposed both by the ESRB and under the EIP procedure: to address a real estate bubble, a number of policy instruments will need to be employed. This may include recommendations in the area of taxes (eg tax deductibility of mortgages), banking regulation (eg maximal loan-to-value ratio) and recommendations curtailing the supply of credit in case of an overheating economy (eg higher bank and borrower equity requirements when price-rent ratios are higher). Policy recommendations could also be given to constrain non-core financing of loans in banks. That would help to reduce the interconnectedness of the financial system and also reduce the availability of credit that is created by moving down the maturity structure in financial intermediation (Shin 2010). Finally, one could also think of macroeconomic policy recommendations in the field of fiscal policy that would help to offset private sector borrowing booms. In these areas, both the ESRB and the Commission would likely issue recommendations.

Figure 9: The ESRB and the EIP: thematic overlap



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.

However, the ESRB and the Commission could also issue different kinds of policy recommendations to tackle similar problems. The ESRB may wish to issue recommendations of a more horizontal nature to the financial system in general (for example in the area of micro-prudential policy), while the Commission would focus on the more structural recommendations.

Potential for synergies between the ESRB and EIP

A number of synergies between the ESRB and the EIP are conceivable in the areas where they overlap. First, the different approaches to tackling the same issues of overlap could be complementary. The ESRB will see the problems more from the side of the financial system, employing detailed data potentially including even bank-level data. The Commission in the EIP will more naturally take a more macroeconomic and structural approach. To maximise the benefits of these two approaches, it will be important that a close contact and exchange between the two institutions at all levels is ensured.

Second, the comparative strength in terms of expertise of the staff of two institutions is different. Naturally, the ESRB would have a comparative advantage in financial issues while the Commission would have a comparative advantage in the understanding of the country-specific problems in the structural and macro area. The competences are thus complementary, and again it will be important that close contacts between the two institutions are maintained. This will allow the assessment by both institutions to be comprehensive and targeted to the specificities of the individual countries.

Third, given the described information and political economy pressures, a close collaboration of the two institutions will considerably increase the leverage of the policy framework. Indeed, ESRB and EIP pulling in the same direction will certainly impress all stakeholders and will thereby help overcoming political economy pressures. The legal enforcement instruments of the EIP may be considered complementary to the less public approach of the ESRB, which can operate in a more confidential manner behind the scenes. The ESRB would also have the leverage of the central banks of the EU and the supervisors behind the scenes.

Finally, the EIP procedure could be used as a powerful tool for increasing the leverage of the ESRB. While the ESRB is to provide warnings and, where appropriate, issue recommendations for remedial action (Article 16(1)), the follow-up to its recommendations is defined in Article 17 and essentially relies on a 'comply-or-explain' principle. Even if the ESRB considers that the inaction is not sufficiently explained, the only possible follow-up allowed by the ESRB regulation is public pressure by making the recommendation public.

In the draft EIP regulation, the follow-up is much stronger. If the Council, following a recommendation of the Commission, comes to the conclusion that an excessive imbalance exists, and it issues a recommendation according to Article 121(4), this recommendation is legally binding on the member state concerned, and the member state will need to present a very stringent corrective action plan outlining in detail what will be done. If it fails to do so, the Council may ultimately impose fines on the member state.

As the EIP procedure is the stronger, it should – as a rule – adopt the ESRB recommendations and incorporate them in the EIP to the extent that these recommendations are of relevance to macroeconomic imbalances. This would also help to make these recommendations consistent with the broader macroeconomic strategy. By doing so, the core ESRB recommendations would be made legally binding and their effectiveness would be increased.

Institutional conflicts are possible

There is the potential for conflict between the ESRB and the Commission. Consider a situation in which the Commission thinks that there is a macroeconomic imbalance in a country's housing market, which risks destabilising the financial system. Then suppose that after a discussion in the ESRB, the majority of the ESRB dismisses this interpretation. This different interpretation could, for example, reflect conflicts of interest between monetary policy and financial stability considerations[12]. The difference in assessment could also

12. See for example, Pisani-Ferry and von Weizsäcker (2009).

reflect different interpretations of what constitutes a harmful imbalance or simply reflect different degrees of risk aversion on the part of central bankers and the Commission.

In such a situation, the European Commission would – despite the ESRB's vote – be obliged to give a recommendation to the Council in the framework of the EIP. This obligation directly derives from the Treaty, which requires the Commission to act, and it is also reflected in the Article 6 of the proposed EIP regulation[13]. Clearly, the EIP procedure gives the European Commission a much stronger position than its role in the ESRB. In the ESRB it is 'just' one ordinary member among many with voting rights. However, in the EIP, both the new regulation and the Treaty require it to act in case it considers there to be an imbalance. Thus the Commission can override the ESRB judgment using the EIP procedure.

The confidentially of information available to the ESRB should not be a relevant dimension in the Commission's assessment. Even if the information discussed by the ESRB is confidential and the Commission comes to the conclusion based on this confidential information that there is an imbalance, it will probably need to use this information and call for a procedure because of its Treaty obligations. As the Commission would be bound by the ESRB's confidentiality agreement, it would not be allowed to publish this information. Nevertheless, it would have to take it into account as clearly stipulated in Article 5(2) of the draft EIP regulation.

Conversely, it is of course also possible that the ESRB concludes that an imbalance with systemic risk is building up and decides to issue a warning, while the Commission does not take this view. In this case, the Commission would not take up the warning or recommendation of the ESRB and there would be no follow-up in the EIP procedure of the ESRB decision.

4 MAXIMISING THE BENEFITS OF THE ESRB AND EIP

1. There is an overlap between the ESRB's responsibilities and the EIP procedure when dealing with the fundamentally important issue of asset-market developments leading to macroeconomic imbalances. Policy action in this area is difficult for both the ESRB and under the EIP because of informational problems and political economy pressures. The current approach emphasises careful economic analysis of the underlying problems leading to tailor-made recommendations. This approach will allow specific problems to be identified. It would be useful to complement the approach with rules-based policy instruments that automatically dampen credit and asset-market cycles in order to reduce the information and political economy problems. First, rules would not require an assessment of an imbalance to be made but would be tied to easily observable headline figures. Second, agreeing on such a set of measures might be easier as it could be done at a very early stage before a boom. This rules-based approach would address some – though not all – of the problems arising from macroeconomic imbalances.

2. It does **not** appear to be advisable to get rid of the overlap by changing the nature of the EIP procedure by requiring it to focus on real economy developments only. One of the central lessons of the crisis is that financial and real economic developments cannot be separated. Narrowing the focus to real developments only would therefore lead to wrong policy conclusions. At the same time, it will be important to keep the focus of the EIP on imbalances. Broadening the scope of the procedure would only water down its effectiveness in preventing harmful developments that cost us so dearly. Conversely, for the ESRB to focus on narrowly defined financial-sector issues only does not appear advisable as it would make assessment and policy recommendation difficult.

'It will be important to keep the focus of the EIP procedure on imbalances. Broadening the scope of the procedure would only water-down its effectiveness in preventing harmful developments that cost us so dearly.'

13. "If,..., the Commission considers that a Member State is experiencing imbalances, it shall inform the Council accordingly." (Art 6(1) or similar in Art 7(1) for the corrective arm). At the same time of informing the Council of the imbalance, the Commission would typically also need to issue a recommendation either for preventive or corrective action.

'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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