The Limits of Surveillance and Financial Market Failure:

Some fundamental issues arising from the euro area crisis

Annexes 1 and 2

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Annex 1

Tensions in the Euro Area: Observations by Key International Institutions -- A Summary

This note provides a summary of observations on tensions in the euro area found in the IMF World Economic Outlook (**WEO**) and OECD Economic Outlook (**EO**) in their half-yearly issues between 2000 and 2012. It is followed by a brief summary of observations made by the BIS in its Annual Report (**AR**).

Observations on the building-up of tensions until late 2008

Observations made by the IMF and the OECD during this period are grouped under the following headings: (1) fiscal balances, (2) housing market imbalances, (3) external imbalances, and (4) inflation differentials and competitiveness.

1.Fiscal balances

Fiscal positions of euro area countries were discussed not only with reference to ceilings under the Stability and Growth Pact (SGP) but often from a perspective of controlling aggregate demand pressure.

In the **IMF WEO**, a general remark on the need to use fiscal policy to deal with divergences in economic developments and inflation pressures in individual member countries of the euro area was made in the May and October 2000 issues (p.19 and p.13 respectively). In the latter issue, the IMF noted that "substantial differences in underlying cyclical positions were likely to persist for a period (p.13)."

In the October 2001 WEO, the IMF noted that some countries—including France, Germany and Italy—would have difficulty reaching the fiscal targets for 2001 set by their respective national stability programs. It then argued that "(F)rom a short-term cyclical perspective, a tightening of fiscal policy would generally be inappropriate at the present stage" and that greater focus should be placed on structural rather than actual fiscal balances (p.28).

In the September 2005 WEO, the IMF warned that five euro area countries (France, Germany, Greece, Italy and Portugal) were expected to exceed the 3 percent limit of the SGP in 2005, in some cases by significant margins. It argued that "with fiscal pressures from aging set to accelerate very shortly, most countries should ideally achieve a broadly balanced fiscal position by the end of the decade—requiring an average improvement in structural balances of about 1/2 percentage point of GDP annually—accompanied by further progress in pension and health reforms. The IMF staff's assessment of present budgetary policies, particularly in the largest countries, suggests they fall far short of meeting this requirement, with most showing little improvement or a deterioration in 2005–06; this would pose a key test of the revised SGP procedures, and that the additional flexibility they allow should not used as an excuse to postpone adjustment altogether (p.13).”

While the IMF WEO did not made country-specific comments on developments in fiscal positions of small euro area members on a regular basis, **OECD EO** provided them for all member countries, small as well as large.

Greece

In June 2000 EO, the OECD advised Greece to offset the expected easing of monetary conditions in the run up to joining the euro area by stepping up the pace of fiscal consolidation through restraints on government spending. To support this argument, it included a figure which showed that the differential between 12-month Greek Treasury bill rate and the ERM central rate had narrowed sharply from late 1999 (p.100). Similar recommendation on the acceleration of fiscal consolidation to restrain domestic demand in the face of monetary easing immediately before Greek entry into the euro area and afterwards was repeatedly made in the subsequent issues of EO (December 2000, p.83, June 2001, P.94 and December 2001, p.90). Later, in December 2006 EO (p.85.), noting that “For the first time in many years the authorities may durably bring the deficit below 3% of GDP”, the OECD argued that “fiscal objectives should now become more ambitious by aiming for a substantial primary surplus, given the high level of debt and favourable outlook for demand. Moreover, comprehensive reforms of the pension and health care systems are needed to ensure long-run fiscal sustainability”. The need for continued fiscal consolidation was repeated in the EO issues of December 2008 (P.141), despite weaker economic conditions.

Ireland

The OECD argued in June 2000 EO that:“(W)ith fiscal and structural policies the only instruments now available, the focus should be on strengthening the supply side of the economy and ensuring effective implementation of the new national wage agreement. The budget surplus needs to be maintained at the current high level in order to contribute to national savings and to finance future liabilities.” This argument was supported by a figure titled “Inflation has accelerated” (p.107). Further specific fiscal policy recommendations were offered in December 2000 EO: “The key policy issue is to ensure that price and wage increases, which have been stimulated by the weak exchange rate and oil price hikes, do not get out of control. The structural budget surplus is set to rise, tightening the fiscal stance. Further tax cuts should be oriented to raising labour supply rather than increasing real wages and cuts in indirect taxes to reduce headline inflation should be resisted” (p.89). Comments in the same vein were repeated in the June and December 2001EOs (p.100 and p.96 respectively).

In June 2002 EO, the OECD warned that “For an economy experiencing a temporary downturn, the shift in fiscal stance from sizable structural surplus to small deficit has been inappropriately large and suggests weakness in the budget system (p.82).”

EO issues afterwards did not include specific comments on fiscal policy for several years until December 2006 EO in which the OECD argued that “Fiscal and regulatory policy should focus on keeping inflation in check. The budget should prioritise spending items that alleviate bottlenecks in the economy, such as investment in human and physical capital, and refrain from fuelling consumption.” (P.91). In June 2007 EO, noting that “the relatively high level of inflation leaves the economy vulnerable to a loss of competitiveness”, the OECD recommended that “Fiscal policy should avoid excessive increases in spending that would further add to demand or reduce the scope to respond to a downturn in revenues” (p.129).

Later in December 2008 EO, as the economic and financial situation deteriorated, the OECD argued that “Fiscal policy should be allowed to support demand in the near term but once the recovery is underway substantial measures will be needed to restore medium-term sustainability (p.150).”

Italy

Italy's fiscal deficit was kept below 3% of GDP until 2004, but in the December 2004 EO the OECD predicted a deficit of just over 3% in 2005 (p.58). A half year later, in the June 2005 EO, it suggested a 2005 deficit of 4.4% and warned that deficit would rise further in 2006 in the absence of new initiatives (p.64). In the December 2005 EO, it gave a new warning that the deficit could rise to 4 ¾ per cent in 2007 (p.62). In the June 2007 EO, the OECD noted that "An impressive fiscal adjustment is being achieved in 2006 and 2007, albeit at the cost of 2 percentage point jump in the tax-to-GDP ratio which, if sustained, could have harmful consequences for growth in the medium term (p.86)." After a substantial budget deficit reduction in 2007, the fiscal stance became somewhat expansionary in 2008. In the December 2008 EO, the OECD argued that the automatic stabilisers should be allowed to work as the economy weakened (P.108).

Portugal

Portugal is another small member country together with Ireland which was advised already in June 2000 EO to rely on fiscal consolidation to contain inflation. Specifically, the OECD argued that "Preventing the intensification of price and wage pressures calls for more ambitious targets for fiscal consolidation (p.127)." In December 2000 EO, the OECD called for fiscal consolidation "given the state of the cycle, the external deficit and the recent intensification of price and wage pressure (p.109)." In June 2001 EO, the OECD stated that "a tight fiscal policy" was required to "raise national saving" and to achieve "a smooth re-absorption of the very large current account deficit (p.121)." In December 2001 EO, the OECD called for decisive measures to contain slippage from the fiscal targets for 2002 and 2003 caused by the cyclical downturn. Essentially the same policy recommendations were repeated in the subsequent EO issues.

In June 2005 EO, the OECD referred to SGP ceilings : "If the new government stands by its decision not to rely on one-off measures to curb the fiscal deficits, the 3% of GDP deficit limit would be overshot by a large margin in 2005 and 2006. In June 2008 EO, reference was again made to SGP ceilings for Portugal: "The budget deficit shrank further in 2007, falling below 3%of GDP. Additional fiscal consolidation and structural reforms are called for despite the weaker external environment (p.174)."

Spain

In December 2000 EO, the OECD called for fiscal tightening for domestic demand management: "In the face of rising core inflation and still relaxed monetary conditions, the fiscal stance should be tightened to damp demand pressures (p.115)." In June 2004 EO, the OECD made a similar argument: "With monetary conditions likely to remain relaxed and output gap closing, the authorities should avoid any fiscal stimulus. This would imply a widening budget surplus over the projection period because of positive cyclical effects (p.111). " The OECD recommendation on fiscal tightening for anti-cyclical purposes was repeated in EO issues of June and December 2005, 2006 and 2007, until Spain started to experience economic slowdown. In December 2008 EO, the OECD noted that "Discretionary fiscal policy easing of around 11/2 per cent of GDP has been supporting growth in 2008. The automatic stablisers should also be allowed to operate in 2009 and 2010. Steps will then need to be taken to curb spending pressures in the longer term (p.179)."

2. Housing market imbalances

In the **IMF WEO**, concern was expressed about the risk of a turnaround in asset prices after sharp increases, particularly for property, in the smaller euro area countries on several occasions (May 2000 WEO, p.18, September 2004 WEO, p.27, and April 2006 WEO, pp.22~23).

Turning to the **OECD EO**, to moderate a housing boom in I**reland**, it was argued that "Tax incentives that boost the demand for housing in an already overheated residential market should be cut" in December 2003 EO (p.89) where the OECD included a figure on developments in house prices. In December 2007 EO, the OECD showed a figure "House prices and building are falling" and warned that "(T)ax revenues partly depend on the property market and will grow more slowly in coming years (P.133)." June 2008 EO also included a figure "House prices and building are declining (P.150)."

As for **Spain**, the OECD included a figure "Housing investment and price increases remain high" for the first time in the December 2006 issue (p.111). In June 2007 EO, the OECD noted increases in household's debt burden and warned that the main risk surrounding the OECD economic projection for Spain lied in a more pronounced adjustment in the housing market, given a high share of residential construction in GDP (p.156). A slump on the housing sector was also shown clearly in a figure included in December 2008 EO (p.179).

Besides short remarks on housing market imbalances in these two countries, the impacts of a common monetary policy of the ECB on housing market conditions in euro area countries were examined in a box in June 2008 EO (p.59). It noted that: "incomplete business cycle convergence within the euro area resulted in a situation where, for some member countries including Ireland and Spain in particular, monetary policy rates were persistently and significantly below what traditional rule-of-thumb would have suggested. Over the 2001-2006 period, the cross-country correlation between various indicators of housing market buoyancy and the deviation between actual euro area interest rates and country-specific rule-of-thumb rates is striking."(1)

3. External imbalances

In the **IMF WEO**, analysis was often made of "global imbalances" between the US, Japan, the euro area and emerging Asia (for example, April 2005 WEO, p.10 and September 2006 WEO, p.17), but it did not develop discussion on divergent external imbalances across individual euro area member countries and their borrowing conditions.(2)

Among **OECD EO** notes on **Greece** from the June 2000 issue onwards, it was in the December 2006 issue that the OECD included a figure on Greek current balances in one of the two supporting figures with a title "The current account deficit has widened." A similar figure was included also in December 2007 EO. In December 2008 EO, the OECD noted that "the current account deficit soared to 151/2 per cent of GDP in the second quarter of 2008, due to the deterioration in the terms of trade."

As for I**reland**, no comments or figures on developments in current balances were offered over years until the November 2011 EO issue where a figure titled "Imbalances are correcting" showed the current account had turn into surplus (p.142).

As will be described below, the erosion of **Italy**'s competitiveness was critically discussed in most of EO issues prior to the outbreak of the euro area crisis, but no specific verbal comments were made about developments in Italy's deteriorating current balances. That said, data on recent developments and prospects for its external trade and current accounts were regularly included in EO statistical tables

Turning to **Portugal**, the evolution of its current balances was a matter of serious concern in EO. Thus, in June 2000 EO (p.127), the OECD showed a figure titled "The current account deficit widens" in the context of its call for more ambitious fiscal consolidation and structural reforms to prevent "the intensification of price and wage pressures." In December 2000 EO, the OECD cited the "external deficit" as well as "the state of the cycle" and "the recent intensification of price and wage pressures" in arguing that "Fiscal policy targets are unambitious" and included a figure on the current deficit which was projected to widen to 12 % of GDP in 2002 (p.109). In June 2001 EO, the OECD stated that "Achieving a smooth reabsorption of the very large current account deficit will require a tight fiscal policy to raise national saving." This remark was supported by a figure on the current deficit which had widened to 10 % of GDP in 2000. December 2001 EO included a figure on the current deficit which had stopped widening but remained large – 9% of GDP in 2001 (p.112). In June 2002 EO, a figure showed that the current deficit had fallen somewhat but remained large – 9% of GDP in 2001 (p.98). However, comments on current accounts were not made in the subsequent EO issues including June 2008 EO in which the current account deficit was projected to widen to 11.6% of GDP both in 2008 and 2009 (see table p.175).

As for **Spain**, June 2005 EO included a figure "Net exports are a drag on activity" together with another "Competitiveness is eroding in manufacturing" (P.111). But in this as well as in the subsequent issues of EO, no strong words of concern were expressed about its current account deficits which continued to increase, reaching 10 per cent of GDP in 2007.

4. Inflation differentials and competitiveness

In some contrast to the September 2003 **IMF WEO** where it was noted that above-average inflation rates of some of the smaller economies were expected to diminish – including sizable falls in Ireland and Portugal (p. 27), concern was expressed in the April 2004 WEO about "substantial and persistent inflation differentials across euro area countries" (p. 26). In this context, the key role of fiscal policy as dealing with inflation pressure as well as the importance of structural reforms (see point 1 above) was stressed (p.26). In the September 2005 WEO, the IMF warned that differences in competitiveness can take a considerable time to reverse, and, partly associated with that, inflation differentials can be very persistent (p.25).

Developments in inflation in individual euro area countries and intra-euro area divergences were more fully reported in **OECD EO** publications.

Among them, a strong warning about the divergence of inflation in **Greece** from the euro area average was a regularly feature of EO since the June 2001 issue, almost always (3) supported by a figure which visibly showed inflation trends in Greece in comparison with the euro area average. In December 2006 EO, the OECD placed the same emphasis on the need to reduce inflation as on fiscal consolidation by noting that "A major question is whether the fiscal targets will be achieved and whether inflation will come down to below 3%. (p. 86)."

On the other hand, the OECD's concern about inflation in **Ireland** was expressed as a stand-alone warning, not in comparison with the euro area average or with reference to competitiveness. In June 2007 EO, however, the OECD noted that "the relatively high level of inflation leaves the economy vulnerable to a loss of competitiveness (p.129)."

Far more systematic comments were made on **Italy**'s relative inflation and competitiveness. Already in December 2001 EO, the OECD was concerned about "inflation inertia" in Italy which "raises costs and affects the exposed sectors, thereby weakening competitiveness vis-à-vis the euro area." In December 2001 EO, it noted that "Inflation, though declining, is likely to remain above the European Union average (p.65)." In June 2002 EO, Italy's competitive position was discussed as a matter of the OECD's particular concern for the first time, noting that "(A) key risk is that competitiveness might deteriorate." A figure titled "Some erosion of competitiveness has occurred" showed trends in relative export prices in manufacturing and nominal effective exchange rates (p.67). In June 2002 EO, the OECD noted that "the core inflation gap is significant", contrasting higher inflation in Italy with inflation records in Germany and France between 1999 and 2002, adding at the same time that "moderate private sector wage settlements underpin the prospects of reduced inflation pressure over the coming year (P. 53)."

Particular emphasis was placed on developments in unit labour costs as a key determinant of competitiveness in December 2002 EO for the first time. Figures showing this particular indicator were maintained in the subsequent EO issues for several years with the exception of December 2004 EO. However, this practice was discontinued in December 2007 EO (4).

On **Portugal**, June 2001 EO included a figure showing the inflation differential with the euro area average was projected to continue to widen (p.121). Similar figures were shown in December 2001 and December 2003 EO. In June 2005 EO, the OECD noted that nominal wages and unit labor costs had continued to decelerate and, after widening temporarily in mid-2004, the inflation differential with the euro area had stabilised at 0.1 percentage point above the area average (p.107). In June 2006 EO, the OECD predicted an improvement in competitiveness as a result of wage moderation (p.118). Unemployment rising to 8 percent in 2007 contained wage pressures and, in June 2008 EO, the OECD predicted the inflation differential with the euro area to be reversed in 2008.

As to **Spain**, in December 2000 EO, reference was made to "rising core inflation and still relaxed monetary conditions" in the OECD's argument for tightening the fiscal stance. It was supported by a figure which showed that the inflation differential with the euro area was projected to widen further. In December 2006 EO, the OECD argued that reducing Spain's inflation differential with the euro area average and preventing further erosion of competitiveness still required structural reforms that foster competition in sheltered sectors and limit the use of indexation clauses in wage agreements. The same argument was made in June 2007 EO.

Observations on heightened tensions in 2009 and afterwards

In the April 2009 **IMF WEO**, the IMF noted that wide differentials in government bond spreads within the euro area had raised particular concern about how to handle a possible loss of market access by a sovereign borrower. It worried that the sovereign debt market turmoil reduced room to use fiscal policy as a countercyclical tool to respond to weakening macroeconomic conditions in the short term, as well as adding to sustainability concerns over the longer term if spreads do not narrow (pp. 23~26).

In the same WEO, the IMF noted that "Many European housing markets also suffered from boom conditions in recent years, and IMF staff estimates suggest that house price misalignments were as large or even larger than in the United States in a number of countries. Although not all national markets were affected, Ireland, Spain, and the United Kingdom are now experiencing major corrections that most likely have a considerable distance still to run (p.19)."

In the December 2009 **OECD EO**, it was noted that sovereign bond spreads in the euro area had come down since their peaks in March 2009 but remained far above the levels prior to the onset of the global financial crisis in the summer of 2007 (p.63). It expressed concern about the interaction between financial market volatility and a high vulnerability of government finances with snow-balling interest payments (5).

It is in a section "Europe is Facing an Uneven Recovery and Complex Policy Challenges" in the April 2010 **IMF WEO** (pp.52~53) that the IMF made a first systematic analysis of the euro area crisis, noting that "sizable fiscal and current account imbalances are constraining recovery in several euro area countries, with potentially negative spillover effects to the rest of Europe." It noted that current account deficits remained substantial and difficult to unwind in a number of euro-area countries, as they cannot use currency depreciation as a mechanism to improve competitiveness.

While intra-euro area imbalances were not discussed in the June and December 2009 **OECD EO** issues, the May 2010 EO contained a box "Addressing imbalances within the euro area" (pp.44~45) in which the OECD noted that "many euro area countries that have lost competitiveness over the past decades are now facing a need to tackle both a sizable structural fiscal deficit and a shortfall of private saving, reflected in a sizable external deficit." It noted that on the assumption that the annual rate of inflation in all euro area countries would be kept at 2%, apart from in Greece, Portugal, Spain and Ireland, where the annual rate will be zero, so that an area-wide inflation rate would be close to 1.6% per annum, the existing competitiveness differential of some 101/2 per cent between these two groups of countries could be corrected in 5 years, given the respective sizes of their economies. It then pointed out that "an adjustment occurring through prolonged low inflation or even some deflation in deficit countries would tend to exacerbate the difficulties some of these countries face in dealing with their high and rising public debt burdens. And deflation could be difficult to achieve, given the high downward nominal wage rigidity in some countries, including Greece."

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(Box)

With the heightening of tensions in the euro area, competitiveness reappeared as a matter of the OECD's concern.

In the country note on **Italy** in June 2009 EO, the OECD re-introduced a figure under heading "Sustained growth in unit labour costs" to add visibility to this issue in Italy.

December 2009 EO included a warning on **Greece**' competitiveness: "The continuous erosion of competitiveness due to persistent inflation differential with the euro area could also hamper the recovery (p.180)." Some two years later, in November 2011 EO, the OECD included a figure titled "Inflation pressures weakened" which showed that inflation in Greece was projected to decline below the euro-area average in 2012 and 2013 (p.113).

On **Portugal**, in May 2010 EO, a figure titled "Regaining competitiveness is a key priority" showed Portugal's relative unit labor cost and export performance for the first time (p.172).

As to **Spain**, May 2012 EO included a figure titled "Export performance has improved" which showed that the divergence of unit labor cost relative to the euro-area average, which by 2008 had widened to about 115 per cent of the 2001 reference level, narrowed down to 105 per cent in 2011 (p.159).

As to **Ireland**, on the other hand, May 2010 EO included a figure "Negative inflation persists, although at a slower rate" (p.148), but without reference to trends in the euro area average and its implication for competitiveness.

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In the Economic Survey of the Euro Area published in December 2010, the OECD argued that:"A new cross-cutting approach to economic and financial management is required to stabilise national economies more effectively. This should rest on a broad range of policies that can tackle the sources of macroeconomic imbalances, including sound fiscal policy and the development of macroprudential tools. Stabilisation would be facilitated by structural policies that help economic adjustment, including ensuring that wage setting mechanisms work well and that housing policies do not exacerbate property cycles. The surveillance of country-level economic, fiscal and financial imbalances by EU institutions should be stepped up (Overview, p.2)."

More recently, in the editorial of November 2011 EO, the OECD issued a warning that "imbalances within the euro area, which reflect deep-seated fiscal, financial and structural problems, have not been resolved. …. Serious downside risks remain in the euro area, linked to the possibility of a sovereign debt default and its cross-border effects on creditors, and the loss of confidence in sovereign debt markets and the monetary union itself (p.7)." In addition to the baseline projections, it argued that "alternative scenarios are possible and maybe even more likely," and presented a downside scenarios, in one of which, without preventive action, the euro area could plunge into a deep recession with large negative effects for the global economy (pp. 41~61).

As to fiscal consolidation in the context of the OECD Strategic Response published in the same EO (PP.63~66), it was stated that: "A small group of countries, consisting of Italy, Spain, Greece, Ireland and Portugal, would not have any scope to buffer the impact of a crisis on the economy, with adherence to planned consolidation targets (in nominal terms or relative to GDP) likely to be necessary to avoid further losses in confidence (p.65)."

At the same time, the OECD stressed the importance of structural reforms "to help with the restoration of appropriate levels of competitiveness and to establish sustainable levels of saving, investment and current account positions (p.59)." In this context, it noted that adjustment was continuing to proceed relatively rapidly in Ireland, partly reflecting the low level of rigidities in Irish labor and product markets. The OECD projected declines in unit labor costs in Greece and Portugal in both 2012 and 2013, and argued that other external-deficit countries in the euro area (including Italy and Spain) also had significant scope to reform labor and product markets to strengthen competitiveness and growth prospects, starting with reductions in labor-market dualism and regulatory barriers to competition (p.60). It added that "some structural reform could boost near-term confidence and even have a direct positive impact on short-term aggregate demand developments, in addition to increasing potential output in the longer term (p.65)."

In the Economic Survey of the Euro Area published in March 2012, the OECD argued that:"The crisis has its origins in the build-up of excessive financial, fiscal and economic imbalances in the euro area and the global credit cycle. The resolution of these imbalances has so far been incomplete, leading to a renewed bout of instability beginning in mid-2011. There is a risk that fiscal consolidation and potential bank deleveraging may restrict economic activity before the benefits of healthier public finances and reforms to boost growth materialise. High risk-spreads and self-fulfilling expectations could lead to unsustainable debt dynamics. There is a risk of global spillovers from these developments. This calls for both short-term action and long-term reforms (Summary, p.1)."(6)

Notes

(1) In the country note on Italy in December 2004 EO, the OECD stated that "real interest rates are lower than elsewhere in the euro area, given higher inflation, though the real exchange rate has been appreciating. Credit conditions are easy, and households continue to increase their borrowing to finance housing investment and durable purchases (p.55)."

(2) It is in the April 2010 WEO (pp.52~53) that the IMF at last expressed serious concern their current account imbalances.

(3) In the June 2006 EO, a figure on the inflation differential with the euro area average was replaced by that on the growth differential, while another regular figure on fiscal balances was retained (Note that EO notes on smaller countries such as Greece are, because of space constraints, supported by two figures only).

(4) A similar figure was reintroduced in June 2009 EO (p.94).

(5) See also Haugh,David, Patrice Ollivaud and David Turner, "What Drives Sovereign Risk Premiums? An Analysis of Recent Evidence from the Euro Area", OECD Economics Department Working Paper No. 718, 2009.

(6) Euro Area, Overview, OECD Economic Survey, March 2012, http://www.oecd.org/eco/49950024.pdf.

Observations in BIS Annual Reports*

Observations on the building-up of tensions until late 2008

(1) Fiscal imbalances

In 2004 **AR**, the BIS noted the overshooting of SGP ceilings, with approving tone as supportive of output (pp 4-5). But, it described this as a "matter for concern" (p.28). It was also disapproving in 2005 AR. Subsequent discussion was largely descriptive. In 2006 AR, it expressed concern about how the SGP would be enforced. From 2008 AR, caution was urged at least where debt ratios were high, e.g. Greece and Italy. Spain was grouped with Germany.

(2) Housing market imbalances

In 2003 AR, a chapter on a review of the financial sector included a figure showing rises in the share of banks' real estate exposure in total lending over the past ten years in Spain (to some 60 per cent in 2002) and Germany (to about 40 per cent) as well as in the United States, Japan, the United Kingdom and Australia (p.137). But no specific comments were made.

In 2004 AR, the BIS noted that house price hikes observable "in only a subset of the euro area economies". In a supporting graph, France, Ireland, the Netherlands and Spain were grouped as euro area countries experiencing house price booms.

In 2005 AR, the BIS observed that regional diversity across the euro area was complicating monetary policy management, pointing out that "anaemic housing markets in Austria and Germany, for example, paled in comparison with the double digit gains in France and Spain."

Noting the ECB's concern about house price hikes in several member countries, the BIS once again simply explained the ECB's position, without expressing its own views: “its mandate only obliged it to react to the extent they affected euro area macroeconomic conditions” and “national financial stability issues naturally fell under the purview of national financial supervisory authorities and euro area central banks (p.62).”

(3) External imbalances

The BIS devoted a great deal of space to global imbalances, but mainly this meant the US deficit and Chinese surpluses. Asia more generally, especially “emerging” Asia, received a lot of attention in these discussions. The euro area received only modest attention in this context and was mostly covered as a single unit. In 2005 and 2006 ARs, however, the BIS noted the large German surplus and Spanish deficit (p.20 in 2005 AR and p.31 in 2006 AR).

The 2006 AR concluding chapter contains a long discussion of risks from imbalances, almost entirely US related. Financial imbalances were held to be “less in evidence” in continental Europe than elsewhere, i.e. US and several inflation targeting countries (p.146).

(4) Inflation differentials and competitiveness

While in reviewing the conduct of euro area monetary policy in the AR of July 2002, the BIS dealt only with relevant economic and financial indicators at the aggregate area level and did not mention complications arising from inflation divergence across member countries (p.62). In the AR published in June 2003, the BIS noted that inflation differentials across euro area member countries remained significant in relative terms though they were much lower than in the past decade. It referred to an allegation that a low inflation target for the euro area as a whole could force countries with low growth into recession and possibly deflation. However, the BIS cautioned against overstating theses risks, while recognizing low labour mobility inside the euro area. It argued that “divergence in both the level and change of prices are relatively common within countries because prices are slow to adjust. In addition, countries with lower costs than their neighbours see an improvement in competitiveness (p.25).”

In the AR of June 2004, the BIS pointed out “large regional discrepancies” the ECB was faced with in monetary policy management. One of them it noted was inflation differentials across euro area economies, and in that context the BIS observed that Germany was close to experiencing deflation, without specifically referring to higher inflation in periphery countries as indicated in the OECD EO country notes reviewed above.

On the management of euro area common monetary policy, the BIS simply explained the ECB position, without making its own recommendations.

“In response to theses challenges, the ECB maintained its positions that changes in the policy rate for the euro area as a whole would not be means for dealing with regional imbalances: raising interest rates in an effort to restrain inflation or excessive house price increases in one region would choke off the recovery in another.” (p.66)

In 2005 AR, the BIS called attention to growth differentials, incentives for migration from new East European members to the west, possible impacts of outsourcing and increased market contestability in containing wage pressure. It noted sharp falls in real unit labor cost in Germany over past two decades. It again noted growth differentials in 2006 AR.

In 2007 AR, the BIS expressed more concern about inflation, as euro area growth strengthened and apparently more generalized across the region, including in Germany, while wage moderation in Germany was noted (p.7). Generally, it drew a positive picture in Europe. In 2008 AR, divergences in domestic demand patterns in the euro area were noted and a deterioration in competitiveness in Italy and Spain was noted (pp.21-22).

Observations on heightened tensions in 2009 and afterwards

In 2009 AR, the BIS Risks and Opportunities chapter related capacity for fiscal expansion to pre-existing debt /GDP relationship. It notes that for most countries these differences have not yet affected the ability to borrow but that this could change going forward.

In 2010 AR, the BIS made numerous references, largely descriptive, to the sovereign debt problems in Greece and some other countries affected by contagion but did not really recognize a "euro area crisis" or provide a section of considered analysis of adjustment issues specific to the euro area. It remained very focused on the sub-prime crisis and the various, mainly Basel III, reforms in process to prevent a repeat.

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* This section is based largely on materials collected by Paul Atkinson.

Annex 2

Determinants of Sovereign Bond Yield Spreads in the Euro Area

This note provides a short summary of econometric findings on the determinants of sovereign bond yield spreads in the euro area.

In a study carried out some years after the start of EMU (1), Bernoth, von Hagen and Schuknecht found that EMU members enjoyed a lower default risk premium than before, but this benefit declined with the size of public debt compared to Germany. Their finding was consistent with the view that markets anticipated fiscal support for EMU countries in financial distress unless these countries had been very undisciplined before. At the same time, they observed that the impact of debt service on interest rates had risen with EMU and noted that monetary union did not seem to have weakened the disciplinary function of credit markets.

After the outbreak of the global financial and economic crisis, several econometric studies focused on determinants of sovereign bond yield spreads in the euro area from 2007 onwards. Among them, Barbosa and Costa focused on developments from early 2007 to May 2010 (2). They found that in the period prior to the collapse of Lehman Brothers, euro area sovereign spreads were mainly driven by the international risk premium. With the deepening of the crisis, factors specific to each economy increased in relevance. Initially, the increase in spreads was largely due to liquidity premiums. However, as the financial crisis spilled over into a strongly deteriorating macroeconomic environment, there was an increase in the importance of country credit risk factors. In the first five months of 2010, the heterogeneity of sovereign credit risk premiums and a further increase in global risk aversion were major determining factors behind the evolution of spreads.

Attinasi, Checherita and Nickel used a dynamic panel approach to explain determinants of widening sovereign bond yield spreads vis-à-vis Germany in selected euro area countries during the period end-July 2007 to end-March 2009 (3).

They found that higher expected budget deficits and/or higher government debt ratios relative to Germany contributed to higher government bond yield spreads in the euro area during the analysed period. More importantly, the announcements of bank rescue packages led to a re-assessment, from the part of investors, of sovereign credit risk, first and foremost through a transfer of risk from the private financial sector to the government.

In line with previous studies, Sgherri and Zoli reported that euro area sovereign risk premium differentials tended to co-move over time and were mainly driven by a common time-varying factor, mimicking global risk repricing (4). Since October 2008, however, they found evidence that markets had become progressively more concerned about the potential fiscal implications of national financial sectors' frailty and future debt dynamics. They reported that the liquidity of sovereign bond markets still seemed to play a significant (albeit fairly limited) role in explaining changes in euro area spreads.

Unlike the studies focusing a fairly short time period, Bernoth, von Hagen and Schuknecht analised determinants of sovereign bond spreads in the euro area for an estimation period of January 1999 – February 2009 (Greece from 2001) for 12 EMU counties. They found that countries with large banking sectors and low equity ratios in the banking sector experienced greater widening in yield spreads, suggesting that financial markets perceived a larger risk that governments would have to rescue banks, increasing public debt and therefore sovereign risk. Moreover, they found government debt levels and forecasts of future fiscal deficits also as significant determinants of sovereign spreads (5).

In a study (6) covering a period from the first quarter of 1999 to the first quarter of 2010, Bernoth and Erdogan found that countries with large banking sectors and low equity ratios in the banking sector experienced greater widening in yield spreads, suggesting that financial markets perceived a larger risk that governments would have to rescue banks, increasing public debt and therefore sovereign risk. More precisely, they reported that the size of the banking sector, as measured by the aggregate balance sheet to GDP ratio, as an important determinant of sovereign risk spreads relative to Germany in the euro area. They also found three-year-ahead government deficit forecasts reported by the national authorities to the European Commission and the debt stock data obtained from Eurostat are significant in explaining sovereign bond spreads.

In addition to a country's financial sector soundness, its price competitiveness was found as an important determinant of sovereign spreads in a more recent paper by Dötz and Fisher (7). Their estimation work was conducted separately for the period prior to and the period since the onset of the financial crisis, using the rescue of US investment bank Bear Stearns as the turning point between the two periods (4 February 2002 to 14 March 2008 and 17 March 2008 to 30 April 2009). Another interesting finding in their work over these periods concerns shifts in the relative importance of explanatory factors: price competitiveness moved into investors' focus as financial sector soundness weakened. Their findings pointed out the importance of fundamental country-specific factors as compared with global factors such as investors' general risk aversion. Risk and liquidity premia generally played a minor part in spread widening of countries with high yield spreads, such as Greece or Italy.

Notes

(1) Kerstin Bernoth, Jürgen von Hagen and Ludger Schuknecht, “Sovereign bond yield spreads in the euro area”, ECB Working Paper Series No. 369, June 2004.
http://www.ecb.int/pub/pdf/scpwps/ecbwp369.pdf.

(2) Luciana Barbosa and Sonia Costa, Determinants of sovereign bond yield spreads in the euro area in the context of the economic and financial crisis“ Banco de Portugal Working Paper 22, October 2010.
http://www.bportugal.pt/en-US/BdP%20Publications%20Research/wp201022.pdf.

(3) Maria-Grazia Attinasi, Cristina Checherita and Christiane Nickel, “What explains the surge in euro area sovereign spreads during the financial crisis of 2007-2009?”, ECB Working paper series No. 1131, 2009.
http://www.ecb.int/pub/pdf/scpwps/ecbwp1131.pdf.

(4) Silvia Sgherri and Edda Zoli, “Euro Area Sovereign Risk During the Crisis”, IMF Working Paper 09/222, October 2009.
http://www.kif.re.kr/KMFileDir/129001476237347500_IMF%20wp09222.pdf.

(5) Stefan Gerlach, Alexander Schulz and Guntram Wolff, “Banking and sovereign risk in the euro area”, Deutsche Bundesbank Discussion Paper
Series 1: Economic Studies No 09/2010.
http://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Discussion_Paper_1/2010/2010_06_07_dkp_09.pdf?__blob=publicationFile.

(6) Kerstin Bernoth and Burcu Erdogan (DIW Berlin), “Sovereign bond yield spreads: A time-varying coefficient approach”,
http://www.diw.de/documents/publikationen/73/diw_01.c.363931.de/dp1078.pdf.

(7) Niko Dötz (Deutsche Bundesbank) and Christoph Fisher (Deutsche Bundesbank), “What can EMU Countries’ Sovereign Bond Spreads Tell Us About Market Perceptions of Default Probabilities During the Recent Financial Crisis?“, Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute Working Paper No.69.
http://www.dallasfed.org/assets/documents/institute/wpapers/2011/0069.pdf.