

## **Views of the ESRB on the Envisaged Scoreboard Indicators Relevant for Financial Market Stability**

Following the agreement reached between the Council and the European Parliament on the legislative measures to enhance economic governance in the EU and in particular the Regulation (EU) No 1176/2011 establishing a surveillance procedure to prevent and correct macro economic imbalances<sup>1</sup>, the European Commission has proposed an initial scoreboard that would provide early signals of potentially harmful macroeconomic imbalances in Member States.

In accordance with this legal background and in particular with Art. 4. 2 (c) of the above mentioned Regulation, the European Commission invited “the European Systemic Risk Board (ESRB) to provide its views regarding the envisaged indicators in the scoreboard relevant for financial market stability”<sup>2</sup>.

The ESRB welcomes the Commission’s invitation. Its views expressed herewith are based on the Commission’s Staff Working Paper that presents the design of an initial scoreboard of early-warning indicators<sup>3</sup>, whose results will be used by the Commission in its Alert Mechanism Report (AMR). The principles underpinning the scoreboard as captured thereby are:

- The indicators focus on the most relevant dimensions of macroeconomic imbalances and competitiveness losses.
- The scoreboard (indicators and thresholds) will provide reliable signals of potentially harmful imbalances and competitiveness losses at an early stage.
- The scoreboard plays an important role in communication.
- The scoreboard should be of high statistical quality.

In its initial design the scoreboard is a compact set of ten indicators that touch upon the main dimensions of imbalances and competitiveness. Thresholds are mainly based on long-term distributions and are not time-varying. The scoreboard helps to identify vulnerabilities, yet, action may be taken only according to the following procedure:

“The economic reading will be based on the results of the scoreboard but there is no automaticity. The overall number of breaches of thresholds, the severity of individual

---

<sup>1</sup> Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances, OJ, L 306, 23.11.2011, p. 25.

<sup>2</sup> Letter from EC Director General Marco Buti to the ESRB, Brussels, “Invitation to ESRB to provide views on envisaged scoreboard indicators relevant to financial market stability”, November 2011.

<sup>3</sup> Commission Staff Working Paper, Scoreboard For the Surveillance of Macroeconomic Imbalances: Envisaged Initial Design, Brussels, 27 October 2011.

breaches as well as the combination of breaches, potentially signalling broad based problems, will all be taken into account. Moreover, the AMR will draw, when appropriate, on other relevant economic and financial indicators with a view to get a more complete picture. Based on the economic reading, the Commission will identify the Member States it considers may be affected by, or may be at risk of being affected by imbalances. Taking due account of discussions in the Council and the Euro group on the AMR, the Commission will determine the list of Member States where further in-depth reviews are needed. It is these in-depth reviews, and not the AMR, which provide the basis for any recommendations to be addressed to countries under the preventive or corrective arm of the new excessive imbalances regulation.<sup>4</sup>

### **The ESRB's views on the scoreboard**

In accordance with the Regulation mentioned above, the ESRB provides hereby the Commission with its view on the financial market stability component of the scoreboard. This includes giving a view on the indicators already in the scoreboard that are relevant for financial market stability, directly or indirectly, the design of the financial stability indicator that will be included by the end of 2012, as well as the possibility of including other indicators deemed relevant from a financial market stability perspective.

In general, the ESRB welcomes the Commission's proposal expressed in the Working Paper that it is important to address the differential performance within the EU stemming from "the specificities of catching up economies", which need to be taken into account when interpreting some of the scoreboard indicators. This also holds for indicators related to financial stability. The specificity of the financial sectors of certain countries needs to be taken into account. In the overall economic reading of the scoreboard, any structural features of catching-up economies or of countries with specific features of their financial structure need to be acknowledged as well. The economic reading should balance carefully the signals given by the scoreboard with a broader set of indicators to reach conclusions about Member States' situation and impact on overall financial stability in an objective and independent way.

The following are specific proposals.

**1. The scoreboard should identify also imbalances that stem from differential performance within the euro area.** The rationale is that imbalances within a currency area create tensions between countries that can not be alleviated by exchange rate movements: therefore structural adjustments should be planned at an early stage in order to preserve financial stability. To this end, the following indicators should be benchmarked not only

---

<sup>4</sup> Ibidem.

against the proposed thresholds, but also against the weighted average of the euro area, calculated over the same time horizon of the indicators: *i)* current account balance, *ii)* nominal unit labor cost and *iii)* real effective exchange rate. This additional benchmark would be used only for euro area countries. As an alternative, comparison with the additional benchmark should be explicitly part of the “economic reading” phase, which is tightly related to the scoreboard.

**2.** It is already foreseen that the scoreboard will add a financial stability indicator by end 2012. **The scoreboard should include short term liabilities (the sum of liabilities maturing within one year) for the unconsolidated financial sector, net of bank deposits, as a share of total liabilities.** Data would be drawn from financial accounts; this indicator would be point-in-time, i.e. would not consider lagged values. The upper threshold would be calculated analogously to the others (quartiles of long-run time series). This indicator measures the market related refinancing needs of the financial sector of a country; the recent crisis has shown that this is a key parameter when evaluating its financial stability. Unconsolidated data reflect the importance of the length of the transactions chain in evaluating risk stemming from refinancing needs. Read in conjunction with the other indicators, the suggested measure would signal the relevance of liquidity given the importance of other possible imbalances; the economic reading of this indicator should consider further disaggregation of short-term liabilities, e.g. with maturity below one month, up to three months, etc. This indicator should be preferred to indicators based on flow-of-funds equity measures, such as leverage or gearing ratios, because since equity is estimated at market values it is very sensitive to movements of the stock market.

**3. The scoreboard should also contain a measure of inflation.** This indicator is very important for financial stability as well as being relevant for competitiveness. Price stability is an anchor of financial stability; among other negative effects, high inflation disrupts the fundamental role of the financial system of allocating resources efficiently and creates uncertainty about fundamentals, thus affecting negatively investors’ choices. Unit labor costs are only one component of inflation, therefore the inflation rate measured via the harmonized index of consumer prices, benchmarked also against the weighted euro area average for the relevant countries, would add useful information to the scoreboard. The harmonized nature of the proposed indicator is also an important advantage. Alternatively, the Commission should state explicitly that inflation, and its divergence with respect to the euro area weighted average for EA countries, will be taken into account in the “economic reading” phase, in conjunction with other indicators such as interest and exchange rates. It is understood that the analysis of inflation is without prejudice to the independence of central banks.

**4.** As stated in the Commission’s Working Paper: “the AMR will draw, when appropriate, on other relevant economic and financial indicators with a view to get a more complete picture.” In this context, **the private sector debt to GDP ratio should be broken down into three**

**indicators: (1) household debt to disposable income; (2) non financial corporations debt to value added and (3) a banking sector solvency ratio captured by the Tier 1 ratio data collected by the ECB for all EU countries.** Alternatively or concurrently, a leverage ratio, defined as in the so-called Basel III framework, could be considered subject to the availability of high quality data for all EU countries such as those used for the other indicators. This would allow early detection of credit bubbles in each of the main sectors, that might be averaged out if they are considered together. In the economic reading phase gross debt ratios should be interpreted in the light of asset holdings and institutional features specific to each country, such as for example the reliance on private pension schemes.

**5.** The Regulation states that, in its in-depth review, the Commission “shall, in particular, take into account [...] any warnings or recommendations from the ESRB on systemic risks addressed to, or being relevant to, the Member State under review.”<sup>5</sup> **Should the Commission so wish, the ESRB stands ready to provide its views on financial stability** in the European Union stemming from imbalances in and across Member States during the “economic reading” and “in-depth review” phases of the AMR, so as to provide a financial, cross-country dimension that can lead to early detection of vulnerabilities and to policy measures that take duly into account spill-over effects.

## Conclusion

When taking into account the views stated above, the ESRB considers that the scoreboard as proposed by the Commission provides overall a useful analytical framework to detect macroeconomic imbalances in order to prevent and correct them.

As the views hereby expressed are an official answer to a Commission request ex. Art. 4, 2 (c) of the Regulation (EU) No 1176/2011 of the European Parliament and of the Council on the Prevention and Correction of Macroeconomic Imbalances, the Commission should feel free to make of this answer any institutional use foreseen by this Regulation, including circulation to third parties and publication, if needed.

---

<sup>5</sup> Cfr. Art. 5.2.(c) of Regulation (EU) No 1176/2011 – See Note 1 supra.