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PARIS

Idiosyncratic shocks, economic governance of the euro-area and the role of member states

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December 2014

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Idiosyncratic shocks, economic governance of the euro-area and the role of member states

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The euro-area was functioning quite smoothly for ten years after the introduction of the euro in 1999. Interest rates and spreads on sovereign debt of euro-area countries declined to a low level, spreads were compressed to near nonexistence, contrary to the economic fundamentals. Inflation was stable and close to target, while seemingly robust growth facilitated real convergence within the euro-area, as was the case with the EU in general. However, beneath a seemingly successful story of monetary integration, external positions of member states sharply diverged driven by eroding competitiveness in peripheral countries. Too low and even negative real interest rates at the periphery following the euro introduction further amplified credit growth and excessive risk taking by financial institutions. As global financial and economic crisis triggered a sovereign debt crisis in the euro-area, not only underlying weaknesses and vulnerabilities of several member states became unveiled, but also many shortcomings in the framework for economic governance of the euro-area. Moreover, adjustment capacity of individual member states to external shocks or materialization of domestic vulnerabilities remained limited as they did not fully accept the policy constraints of being a member of the currency union - fiscal policies have been far from prudent and a lot of structural rigidities in labor and product markets remained in place. Wage and price rigidities and limited labor mobility across countries reduced the ability of a country to adjust to idiosyncratic shocks. Combination of lax fiscal positions and financial weaknesses exacerbated the sovereign-banking link and threatened the very existence of the euro-area.

As a consequence of the sovereign debt/banking crisis in the eurozone a comprehensive reform in the institutional design of the euro-area was undertaken in order to prevent future potentially catastrophic incidents and mitigate their impact. Most notably, a set of fiscal rules was codified in the Fiscal Compact, while ESM took the role of the financial backstop for the euro-area. European Semester introduced the new instrument of country-specific recommendations with the focus on stepping-up growth-friendly structural reform and fiscal consolidation agenda. Regulatory framework for the banking sector of the euro-area in particular went through a major overhaul as the banking union introduced some new elements of fiscal risk sharing in the form of single resolution fund and common fiscal backstop.

Undertaken reforms might be sufficient to avert the worst of the boom-bust cycles that may ignite catastrophic scenario in the future, provide some income support in the event of the crisis and improve debt sustainability for crises-hit member states. But these arrangements clearly fall short of mitigating idiosyncratic shocks that affect member countries in "normal" times. They will most likely not provide for much risk sharing outside of the crises situation nor contribute to consumption smoothing through the business cycle. Therefore, the economic governance framework for the EU will have to keep evolving in order to respond to the remaining policy gaps and arising challenges. Introduction of greater fiscal solidarity will continue, without much doubt, to feature prominently among the reform proposals. The idea of promoting fiscal integration in order to smooth asymmetric fluctuations is not a new one. Already in the "Report of the study group on the role of public finance in European integration" from 1977 there was a proposition to establish a "Community Unemployment Fund" and a "conjectural convergence facility to extend grant finance to economically weak member states in particularly difficult economic times". The scope of the "federal" public expenditure was envisaged to be about 20-25% of GDP, modeled after USA and "Federal Republic of Germany". "One Market, One Money", early vision of monetary and fiscal union envisaged much stronger fiscal integration. In fact, it was never envisaged to advance in the monetary union without the corresponding advances in fiscal integration.

Economic profession has done a lot of work in developing proposals to plug in the flaws in the institutional design of the economic governance of the euro-area. Substantial number of mechanisms for fiscal risk sharing have been proposed, ranging from a limited euro-area budget, direct transfers between the member states, and, up to a certain level, debt mutualisation. Common unemployment insurance is another candidate proposal for fiscal risk sharing, as it is highly centralized in most existing federations (or indeed, monetary unions). It is a mechanism to establish a link between individual income risk (or volatility in the member state) and fiscal transfers between member states. As unemployment is highly related to the cycle, such a scheme would cumulatively reduce volatility of aggregate demand, and may not imply significant persistent transfers between member states in case it is well designed. Still, a number of challenges to design and implementation of such a scheme remain in place. Labor laws and taxation should probably be aligned to a greater extent than what is currently the case. Effective consumption smoothing must discriminate between total cycle component, pertinent for Eurozone as a whole, and country specific cycle relative to this area wide average, as also assumed by Drèeze and Durre (2013). While theoretically clear and intellectually appealing, this type of exercise is plagued by arbitrary assumptions that may render the implementation of such smoothing mechanism difficult.

Comprehensive strategies for prioritization and sequencing of further reforms to the institutional blueprint of the euro-area should benefit from the experiences of monetary unions similar in size to the euro-area. A comprehensive body of research is by now available on ways in which large monetary unions cope with asymmetric shocks. For example, empirical studies show that major channel for consumption smoothing in the United States, where close to 80 percent of local shocks are smoothed, are market-based risk insurance mechanisms[1], most notably capital markets (39 percent) and credit markets (23 percent). On the other side, federal tax-transfer and grant system account for only a minor part of the overall consumption smoothing (only 13 percent). The effectiveness of risk sharing mechanisms among Canadian provinces or German landers is reported by empirical studies to approximately the same tune, with similarly high degree of risk sharing through private channels. Capital markets in the euro area provide much less of an insurance role than elsewhere, in part because cross-border ownership of assets within the euro area remains more limited. Also, this channel tends to break down in periods of severe downturns and financial crisis, when risk sharing is most needed, as evidenced by the freezing of financial markets in the euro-area periphery. Therefore, the largest part of difference in the extent of risk-sharing between the euro-area and other large currency unions does not arise from fiscal transfers, but from (non) functioning of the euro-wide capital market. Main lesson from the empirical literature for the euro-area should be that fiscal union, even if full-blown in scale, will fall short in smoothing idiosyncratic

1 IMF: Toward a Fiscal Union for the Euro Area.

shocks. In the first place, euro-area needs activation of private options for income smoothing, primarily through private capital markets. This role could be played by cross-border ownership of assets and liabilities and intra European credit, which remains limited and suffers even further from widening fragmentation of the euro-area financial system.

More efforts are needed in particular to boost capital markets integration. Still, purely market based insurance also tends to be suboptimal, in particular given the long way ahead of the euro area to reach full integration. But increasing the extent of fiscal solidarity needs to go hand in hand with strong mechanisms for preventing moral hazard. Going forward in building fiscal integration, the Stability and Growth Pact needs to be reinforced with the automatic consequences if 3% deficit ceiling is breached and more emphasis given to debt criterion. To that end, surveillance and coordination of economic policies through the new "Fiscal Compact" should enforce balanced budget as a rule and tough limits on structural public deficit. The new facility for fiscal solidarity, through a federal euro-area budget, national support schemes based on cyclical fluctuations or quotas for the issuance of mutually guaranteed debt, might add to success of stabilization policies and financial stability. Due to political as well as operational constraints, existing discussion foresee limited capacity, mostly in the range of 1-2% of the euro area GDP[2]. While, on the one hand, this level of integration might be politically feasible, on the other hand, it should be clear that only relatively modest level of consumption smoothing can be achieved with that level of fiscal integration.

To conclude, while potential benefits of private risk insurance mechanisms clearly dominate fiscal transfers, a well designed fiscal integration, of which some elements are already in place and others are being discussed, may also help to some extent. The key is to balance the two approaches by boosting income smoothing and risk sharing through capital markets in addition to strict enforcement of budget rules to deal with the issue of moral hazard that may hinder any considerations of greater fiscal solidarity.

2 For example, Wolff (Bruegel Policy Contribution) estimates resources needed to counter asymmetric shocks at 1% of the area's GDP.

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