A FISCAL CAPACITY FOR THE EURO AREA

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Prepared for the panel: "Can a Euro Area Budget Stabilize the Eurozone?"

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1 Why is it needed a fiscal capacity in the euro area?

2 Fiscal capacity: critical issues to be defined

3 Fiscal capacity: some proposals

4 Conclusions

1. Why is it needed a fiscal capacity in the euro area?

- Lack of risk sharing in the euro area
- Room for a fiscal risk sharing channel in a monetary union

Source: ECB Economic Bulletin, Issue 3/2018, Article “Risk sharing in the euro area”.

Lack of risk sharing in the euro area …

DEFINITION

The concept of risk-sharing refers to the notion that economic agents try to smooth out changes in their consumption or investment levels in the face of adverse shocks.

PRIVATE MECHANISMS OF RISK-SHARING

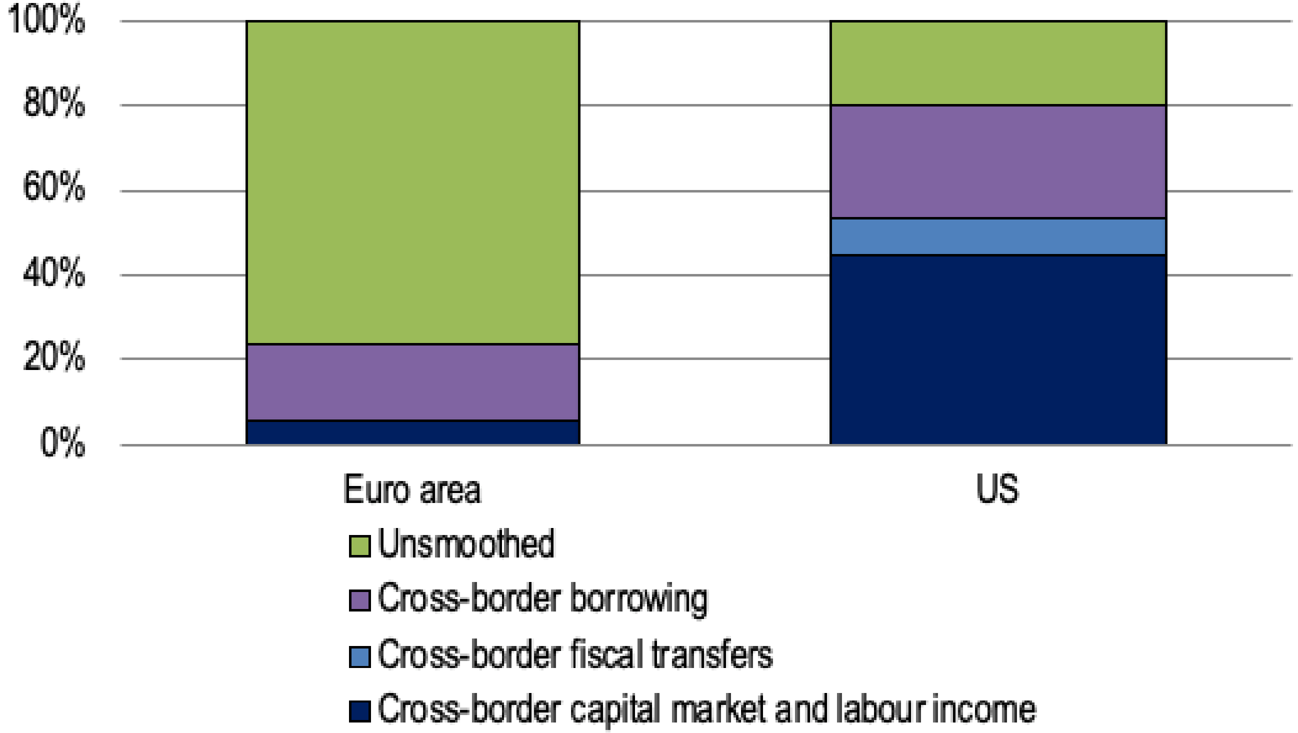
- The "**savings" channel** (also referred to as the **"credit channel"**) operates via cross-border saving/borrowing, i.e. economic agents may borrow internationally to sustain consumption or investment levels in the face of adverse shocks;
- The **"capital market"** channel runs via internationally/inter-jurisdictionally diversified private investment portfolios.

PUBLIC MECHANISM OF RISK-SHARING

- The "public" channel relies on cross-regional fiscal transfers.

Lack of risk sharing in the euro area …

Figure 2 Cross-border risk sharing (% of output shocks)



Source: Buti et al (2016), "Smoothing economic shocks in the Eurozone: the untapped potential of the financial union", VoxEU.org, 25 August 2016.

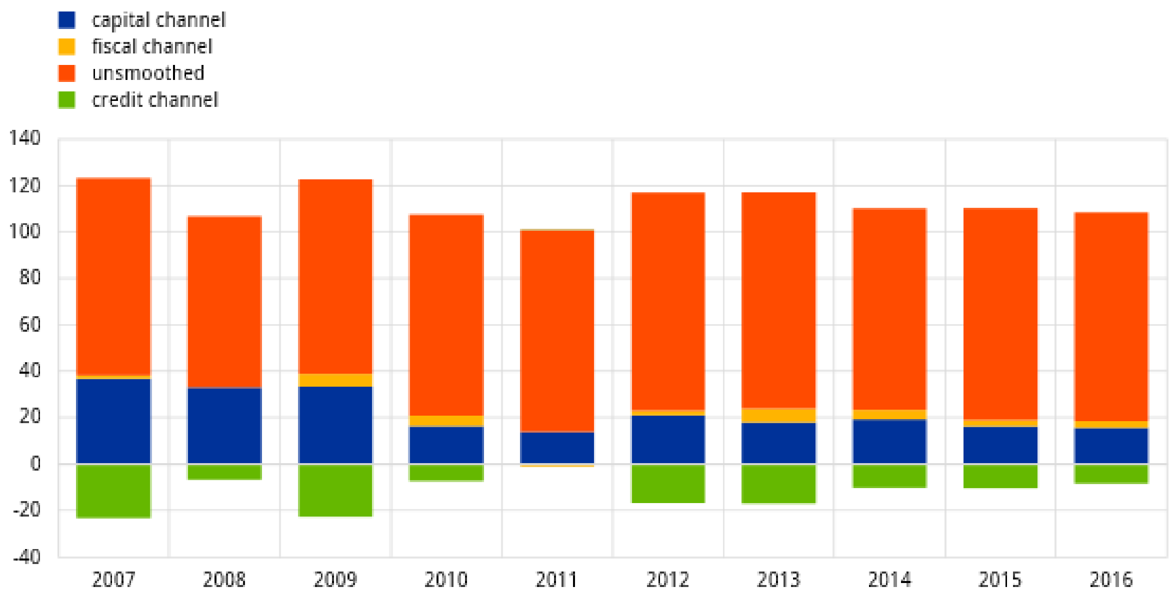
Lack of risk sharing in the euro area …

Risk sharing in the Euro Area

Chart 3

Consumption risk sharing in the euro area and its channels

(percentages)

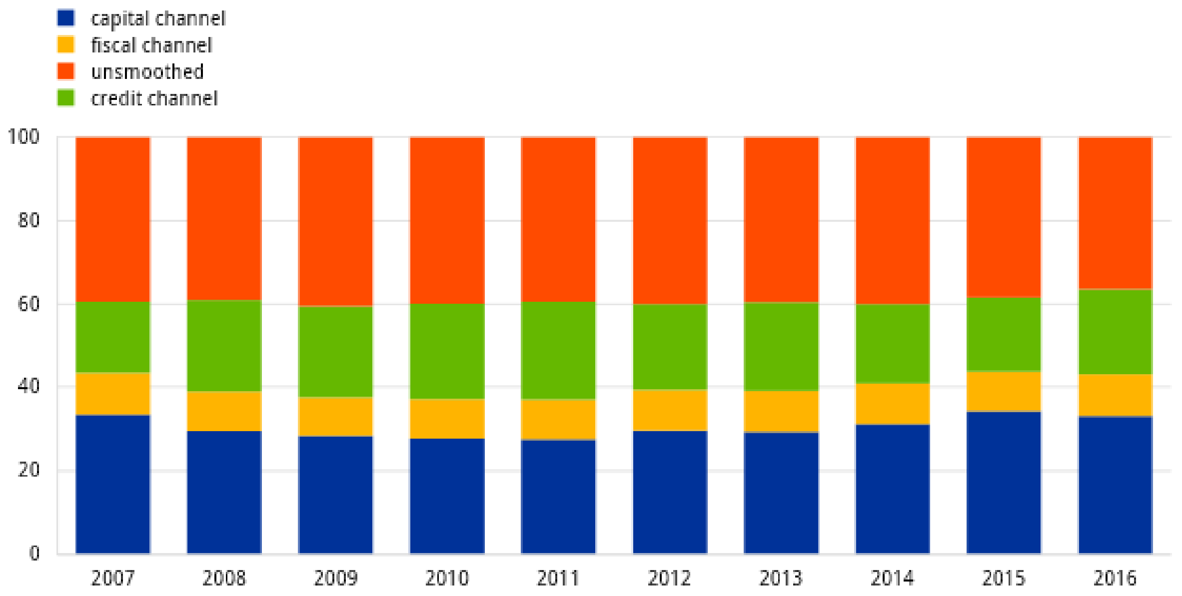


Risk sharing in the United States

Chart 4

Consumption risk sharing in the Unites States and its channels

(percentages)



Source: ECB Economic Bulletin, Issue 3/2018, Article “Risk sharing in the euro area”.

Lack of risk sharing in the euro area …

KEY STYLISED FACTS:

FACT 1: The evidence shows that in the US the three channels of income smoothing across states (public transfers, capital markets income and credit) are able to smooth around 60-80 per cent of economic income shocks, whereas in the euro area that number decreases to 20 per cent

FACT 2: Higher shock absorption in the US results mainly from more effective private risk sharing via credit and capital markets (at a much larger scale than in the euro area)

FACT 3: Risk sharing is reduced in periods of severe downturns as a result of the quasi disappearance of the credit channel (IMF, 2015 WP)

FACT 4: In the euro area the fiscal channel contribution is negligible, whereas in the US plays a visible role.

1. Why is it needed a fiscal capacity in the euro area?

- Lack of risk sharing in the euro area
- Room for a fiscal risk sharing channel in a monetary union

- Incapacity of national fiscal stabilizers to smooth large economic shocks
- Limits to discretionary fiscal policy within the SGP
- Cross-border spillovers are too small to be effective

Source: ECB Economic Bulletin, Issue 3/2018, Article “Risk sharing in the euro area”.

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- Complementarity between additional fiscal and financial integration

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- Complementarity between additional fiscal and financial integration

- A fiscal capacity facilitates a better mix between fiscal and monetary policies in the event of an area-wide shock
- Potential important role for macroeconomic stabilization in a situation in which monetary policy interest rates face an effective lower bound

Source: ECB Economic Bulletin, Issue 3/2018, Article “Risk sharing in the euro area”.

2. Fiscal capacity: critical issues to be defined

- Size of the Budget
- Ex ante conditionality to have access to the fund
- Scope of the fund: asymmetric shocks only or also symmetric shocks?
- Scope of the fund: only large shocks or also relatively smaller ones?
- Should the fund be allowed to borrow?
- “Trigger” mechanism to access the fund
- Use of fund’s resources: freely used or limited to particular types of expenditures?
- Options to reduce the risk of permanent transfers

References: European Fiscal Board, 18 June 2018, “Assessment of the fiscal stance appropriate for the euro area in 2019”;

3. Fiscal capacity: some proposals

	CEB (2017)	CEPR(2018)	IMF(2018)	OEDC(2018)
Scope	Country-specific and area wide shocks	Large downturns affecting one or several member states	Country-specific and area wide shocks	Country-specific and common shocks
Trigger for pay-out	‘Double condition’ on both the level and the change in the unemployment rate	Employment-based indicators: changes in the unemployment rate, employment, or the wage bill	Unemployment above 7-year moving average	Unemployment rate above 10-years moving average and increasing
Contributions (annual)	0,5% of GDP for each p.p. decline in the unemployment rate	0,1% of GDP	0,35% of GDP	0,1% of GDP
Pay-out size	0,5 % of GDP for each p.p. increase in the unemployment rate	One-off payment of 0,25% of GDP per each p.p. of unemployment above the relevant threshold	0,5% of GDP for each p.p. increase in the unemployment rate above the relevant threshold	1% of GDP for each p.p. increase in the unemployment rate above the relevant threshold

Source: Carnot, N. et al, CEB Working PAper No. 17, October 2017.Bénassy-Quéré, A. et al, CEPR Policy Insight No. 91, January 2018; Arnold, N. et al, IMF Discussion Note No. 3, March 2018; Stráský, J. and G. Claveres, OECD Working Paper 40, July 2018

3. Fiscal capacity: some proposals

	CEB (2017)	CEPR(2018)	IMF(2018)	OEDC(2018)
Borrowing	Yes	No	Yes	Yes
Moral Hazard mitigation	Implicit compliance with fiscal rules	Compliance with the SGP and the recommendation of the European Semester	Ex-ante compliance with fiscal rules	Ex-ante compliance with fiscal rules
Reducing the risk of permanent transfers	Usage premium (bonus)	'First loss' borne at national level; Usage premium	Usage premium; Limits on cumulated net transfers	Usage premium; Limits on cumulated net transfers

Source: Bénassy-Quéré, A. et al, CEPR Policy Insight No. 91, January 2018; Arnold, N. et al, IMF Discussion Note No. 3, March 2018; Stráský, J. and G. Claveres, OECD Working Paper 40, July 2018.

3. Fiscal capacity: some proposals

	CEB (2017)	IMF(2018)	OEDC(2018)
Simulation Period	1985-2016	1990-2017	2000-2016
Stabilization	Yes (significant)	Yes, in particular when monetary policy is constrained	Yes (significant)
Permanent transfers?	No	No	No

Source: Bénassy-Quéré, A. et al, CEPR Policy Insight No. 91, January 2018; Arnold, N. et al, IMF Discussion Note No. 3, March 2018; Stráský, J. and G. Claveres, OECD Working Paper 40, July 2018.

4. Conclusions

The EMU is incomplete…

A fiscal capacity would bring risk-sharing among Member States…

A fiscal capacity would reinforce macroeconomic stabilization…

A fiscal capacity would complement financial integration…

A fiscal capacity would complement monetary policy…

A well-designed fiscal capacity would not introduce permanent transfers …

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