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A central public risk-sharing capacity

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Reforming EU frameworks or EU countries?

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The issue: a central fiscal capacity as risk-sharing instrument for the Euro area (EA)?

- I intend to examine the rationale of a central fiscal capacity in the EA with respect to the unique character of the monetary union, which is not a single state or federation of states with a central government.

- The great challenge in this issue is to reconcile an EA wide fiscal risk-sharing instrument with the sovereign fiscal responsibility of EA member countries and the wide-spread mistrust against a redistributive transfer union.

- My favored solution is a central stabilization fund, completed by a European unemployment insurance system; both mechanisms can be introduced without changes of the EU treaties.

- The central fiscal capacity would be an overlay over the existing system, completing it according to the distinct features of the EA.

Theoretical backgrounds for policy conclusions

My reasoning prominently roots in the most relevant achievements of the literature on financial networks & risk-sharing:

- **Franklin Allen and Douglas Gale**: „Financial contagion", *Journal of Political Economy,* vol. 108 (2000), No. 1.

- **Stefano Battiston, Domenico Delli Gatti, MauroGallegati, Bruce C. Greenwald, and Joseph E. Stiglitz**. "Liaisons dangereuses: Increasing connectivity, risk sharing, and systemic risk", in *Journal of Economic Dynamics and Control*, vol. 36, 2012 no. 8.

- **Daron Acemoglu, Asuman Ozdagla, and Alireza Tahbaz-Salehi**. "Systemic Risk and Stability in Financial Networks". MIT Working Paper 1303, 2013.

....and on the theory of fiscal federalism:

- **Wallace E. Oates**. "An Essay on Fiscal Federalism", Journal of Economic Literature, Vol. 37, No. 3, 1999.

What is ‚risk-sharing'?

Risk-sharing means the sharing of the individual and systemic risks of individual and aggregate consumption losses after various kinds of unexpected output shocks .

- Private risk-sharing happens via capital and credit markets and involves techniques like securitization or the issuance of derivatives, covered bonds etc.
- Public risk-sharing happens via fiscal operations and may involve transfers, grants, credits.
- Cross-border risk-sharing means the lifting of restrictions to the issuance and trading with the instruments; an example is the project of a capital markets union. But it means also the establishment of fiscal tool across the member states of a single state, a federation or a monetary union like the eA.

The next picture informs about the channels of risk sharing and their strength in different federations according to comparable computations . These computations follow the methodology developed by **Asdrubali et al.** from 1996.

Risk Sharing in Different Federations

(Percent of regional income shock smoothed by channel)

100
80
60
40
20
0
-20

European Union: 33 (total); 34; 1; -3
Economic and Monetary Union: 38 (total); 25; 11
Canada: 80 (total); 24; 29; 27
United States: 81 (total); 19; 48; 14
Germany: 79 (total); 18; 51; 11

Fiscal Transfers
Capital Markets & Capital Depreciation
Credit Markets
Total Smoothed

Source: Allard et al. 2013, with further literature references.

Why EA-wide public risk-sharing might be necessary? 4 major contentions underlying the Maastricht-Treaty and their shortcomings

Contention I:

Expanded and cross-border private risk-sharing would reduce systemic risks and their real economy fallouts

This seems to be the broad consensus among politicians, economists and the press. The best expressions are the recent position papers of the EU institutions (presidents reports, EU Commission, and above all the ongoing project of a capital markets union. There is no convincing need for a permanent fiscal institution of the EA (economists), at least not now (Commission).

Critique

- Experience: despite increasing domestic and international risk-sharing – financial crises gained severity (contagion) – there is no indication that a severe financial crisis is a temporary exception.
- Theory: **Battiston et al.** (2012) and **Acemoglu et al.** 2013 have shown that with complete financial networks the systemic risks might increase.

Contention II:
Centralized monetary policy disposes of all instruments to deal with common shocks

Critique

However, it in the Euro area it turned out that monetary and fiscal policies are not complete substitutes, at least not at the the zero lower bound and 'diminishing returns to unconventional monetary policies'. Centralized monetary policy becomes ineffective. And: The ECB excaped to unconventional monetary policies, because national fiscal policies were not ready to act responsible. That meant, the ECB resumed quasi-fiscal responsibilities, because there was and is no central fiscal player.

Country traditions and recent country reforms of the social and tax systems caused the cyclical sensitivity of public budgets in member countries to differ (see next figure). **A common shock to all transforms into asymmetric shocks with feedback effects to the common level.**

Contention III

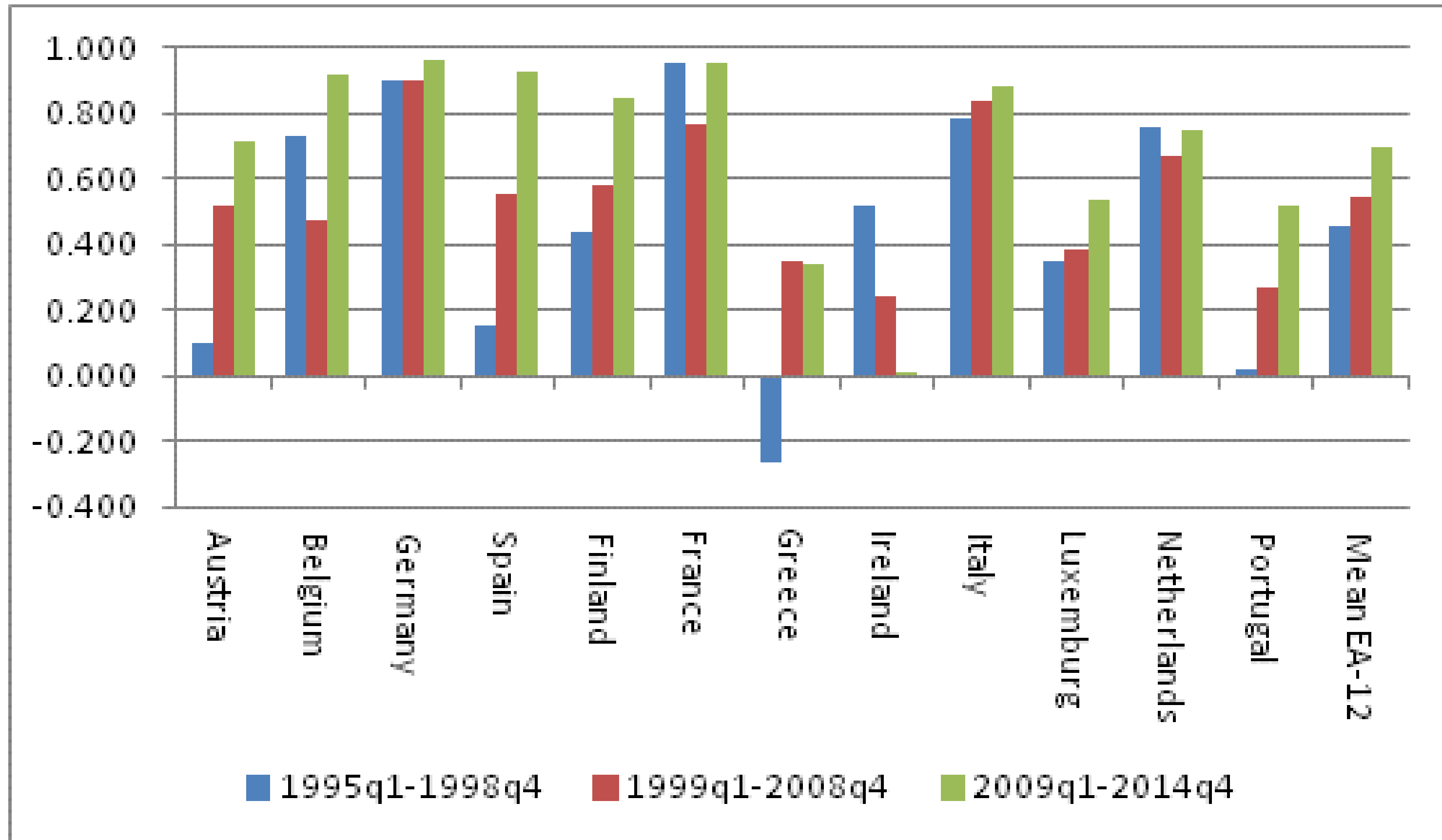
The existing fiscal framework (SGP, Fiscal Compact etc.) provides all the rules to use national fiscal policies to deal with shocks that have an asymmetric and cyclical character.

Critique

However, isolated asymmetric shocks, justifying a country-specific reform approach, have lost its earlier importance (see next picture): A one percentage point deviation from the trend rate of GDP in the euro area is correlated with a 0.65 percentage point deviation on average in each country. **Asymmetric shocks become common shocks.**

In addition, severe shocks have the unpleasant property to to transmute into a persistent shock. Different country reforms can induce more structural and sector divergences between the member countries, decoupling trend growth rates of potential output (picture after the next).

Business cycle synchronization in the EA (coefficients of correlation with the EA)



Own calculations and illustration based on Eurostat quarterly GDP data

Structural synchronization in the EA (coefficients of trend correlation with the EA)a

calculations and illustration based on Eurostat quarterly GDP data

Contention IV:
Normal shocks have a cyclical character, and national fiscal automatic stabilizers can sufficiently compensate for ups and downs of the cycle.

However, country traditions and recent country reforms of the social and tax systems caused the cyclical sensitivity of public budgets in member countries to differ (see next figure).

There are many cases, where the cyclical budget improved when GDP decreases – mainly in the period 2013-2014 (inter al.: EA, Austria Belgium, Germany, Greece, France). This includes strongly different income multipliers of automatic adjustments. Simply reverse the ratios in this figure!).

National reforms undermine risk-sharing.

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Income sensitivity of the cyclical component of national budgets (28 EU countries (2010-2016)

1.0
0.8
0.6
0.4
0.2
0.0
-0.2
-0.4
-0.6
-0.8

European Union, Euro area, Belgium, Bulgaria, Czech Republic, Denmark, Germany, Estonia, Ireland, Greece, Spain, France, Croatia, Italy, Cyprus, Latvia, Lithuania, Hungary, Netherlands, Austria, Poland, Portugal, Romania, Slovenia, Slovakia, Finland, Sweden, United Kingdom

mean 2008-2016 mean 2013-2014

Ratio of a 1 percentage point change of the cyclical component in terms of GDP to a 1 per cent change of the GDP

Author's compilation and presentation based on Ameco and Eurostat data.

Is a central fiscal capacity possible?

• Member states shall maintain their fiscal sovereignty - there is no voice among economists to be taken seriously that questions it. The community might want to protect against negative spillover effects of reform actions unilaterally undertaken by one or some countries. How to establish a central fiscal capacity without a transfer of national sovereignty (no treaty change)? The legal way: intergovernmental contracts. The institutional solution:

• Introducing the central fiscal capacity as an overlay over the existing Maastricht system, completing it according to the distinct features of the EA. Leaves country responsibility for sound fiscal policy unaffected. Might be
• bombined with a **sovereign insolvency regulation**

Both makes the SGP, the Fiscal Compact and the bail-out clause reliable.

How to implement a central fiscal capacity?

EA Unemployment insurance? Some pros, many cons, mainly:
- Would a member benefit from the system, when it follows a competitive wage policies and accepts unemployment? Democratic legitimacy?
- How to avoid steady transfers in case of persistent shocks?
- Unemployment is a late indicator of an output shock.

EU Stabilization funds: Some cons, many pros:
- ‚rainy day funds', will be mobilized if necessary – demokratic legitimation
- no transfers, but grants
- can be focused on public and private investment
- can be financed by own resources (taxes, member contributions) and bonds
- bonds are riskless (financed from own taxes), and support banking sector stability.

EA budget: might be the far future vision and the logical result of an unemployment insurance system and a stabilization funds).