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FISCAL RISK SHARING IN THE ECONOMIC AND MONETARY UNION

Abstract:

The economic, debt and banking crises had strongly asymmetric effects on euro area countries and revealed the vulnerabilities in the institutional setting of the EMU and created significant risks to the single currency. In the aftermath of the crises there were significant changes in EMU aimed at increased risk sharing but they did involve the introduction of supra-national macroeconomic stabilization function. It is suggested in the paper that deeper fiscal integration is necessary to complement the currency union and strengthen the economic integration in the EU. The paper outlines the theoretical background of risk sharing and examines the main alternatives for a common fiscal capacity in the euro area.

Keywords:

Fiscal Policy, Economic Integration, Fiscal Federalism

JEL Classification: E62, F15, H77

Introduction

At the onset of the Economic and Monetary Union (EMU) the creation of a supra-national fiscal capacity was not envisaged. It was believed that the increasing trade and factor mobility after the introduction of the common currency would naturally lead to better synchronization of the Member States' economies. This confidence was enhanced by the convergence of public debt levels and long-term interest rates at the time. However, the economic, debt and banking crises had strongly asymmetric effects on euro area countries and revealed the vulnerabilities in the institutional setting of the EMU. The increasing sovereign debts, failing banks and divergence of long-term interest rates created significant risks to the single currency. Thus, the series of crises gave an impetus for deeper fiscal integration in the EU, including the introduction of more rigid rules for fiscal discipline and new mechanisms for financial assistance.

Against this background, the present paper is devoted to fiscal integration in the euro area. The purpose is to examine the alternative options for the establishment of a supra-national macroeconomic stabilization in the euro area through some type of a risk sharing mechanism. Three main channels for risk sharing are defined in the economic literature. The paper is structured as follows: the first part presents the theoretical fundaments of fiscal risk sharing and outlines the main arguments for deeper fiscal integration in the EMU; the second part examines the main options for the creation of a common fiscal capacity in the euro area; and the third part concludes.

1. Theoretical background of fiscal risk sharing

The theory of optimum currency areas (OCA) has focused on several criteria which must be met for a group of countries to share a common currency: strong trade ties, high labour mobility, similar business cycles and availability of a risk-sharing mechanism (Frankel & Rose, 1996, p. 3). Theoretically, if the first three requirements are fully met, there is no necessity of a fiscal capacity. These conditions, however, are not entirely fulfilled in any existing currency union in the world, including the Economic and Monetary Union (EMU). Even mature federations, such as USA, Canada and Germany, are not characterized by perfect labour mobility and completely synchronized business cycles among the regions comprising them. Hence, some type of a risk sharing mechanism is necessary to mitigate the negative effects of asymmetric economic shocks.

The economic literature does not provide a single, universally accepted concept of fiscal risk sharing. Generally, it can involve a variety of mechanisms, including a supra-national stabilization fund, common unemployment insurance, deposit insurance, or a combination thereof. Cimadomo defines risk sharing as the willingness of economic agents, such as households and firms, to insure their consumption streams against fluctuations in the business cycle of their country (Cimadomo J., 2018, p. 85). In an empirical study Sorensen and Yosha (1996) suggest the following channels for fiscal risk sharing within a currency union:

- *Capital markets* – this channel can contribute to the mitigation of asymmetric economic shocks through portfolio diversification of market participants.
- *Central (federal) government* - central fiscal authorities can smooth the economic cycle with transfers and taxes.
- *Credit market* – another possibility for market participants to smooth consumption during specific shocks is through changes in lending and borrowing (D'Imperio, 2015, p. 5).

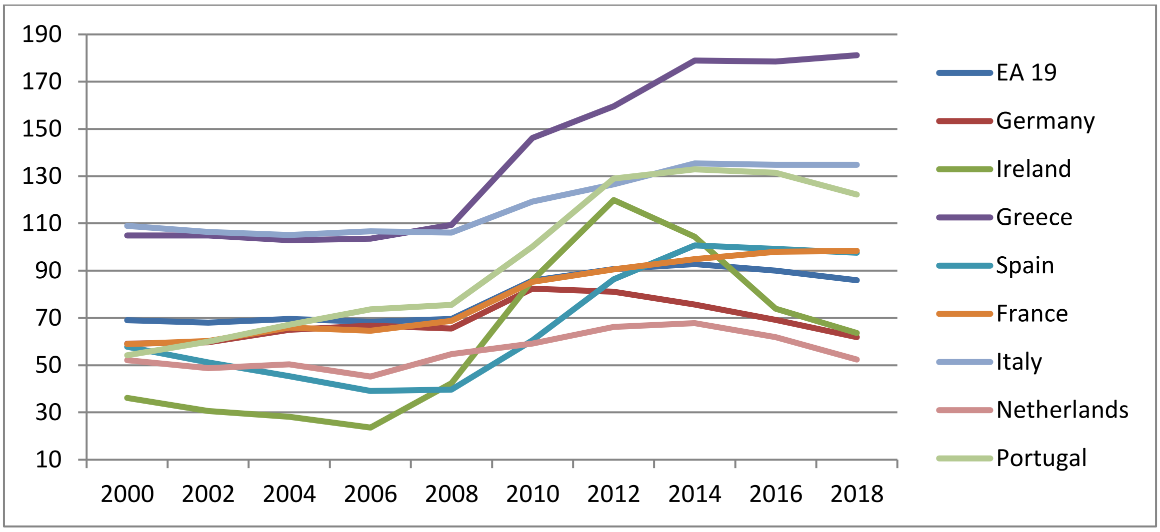
Regardless of its specific form, the objective of fiscal risk sharing is not only to serve as an anti-crisis tool, but also to guarantee the stability of the single currency in the long run. Empirical evidence suggests that the existence of risk sharing mechanisms is a crucial element of a currency union. In 1991 Sala-i-Martin and Sachs presented the results of a study on the role of federal government for macroeconomic stabilization in the United States. Their main conclusion is that the successful performance of the single currency in the US should be attributed to the existence of a Federal fiscal authority which insures against regional shocks. In a more general context, these authors suggest that a mechanism for interregional fiscal transfers within a group of countries with fixed exchange rates could offset the low labour mobility and allow for mitigation (although not full elimination) of asymmetric shocks. Such a risk sharing system could involve direct transfers among the regions of the currency area, or introduction of tax changes in the regions according to the business cycle phase (Sala-i-Martin & Sachs, 1991, p. 4).

With respect to the EMU, the results are mixed, as some studies have indicated increasing fiscal risk sharing after the introduction of the euro, while others suggest a decline. All studies, however, conclude that fiscal risk sharing in the euro area remains lower than in other monetary unions with common fiscal policy (Cimadomo J., 2018, p. 89). Another important conclusion of the empirical research is that among the three channels mentioned above, capital markets integration is the most important mechanism for risk sharing among the members of currency unions. Although on a smaller scale, the fiscal channel also has an important role for macroeconomic stabilization in federal countries.

Krugman et al. (2012, p. 578) argue that EMU's current combination of rapid capital migration with limited labour migration raises the cost of adjusting to product market shocks without exchange rate changes. If a Member States suffers an unfavourable shift in output demand, its capital can flee abroad, leaving even more unemployed workers which could result in severe and persistent regional depressions. Therefore, fiscal federalism can help offset the economic stability loss due to fixed exchange rates. In the United States, there is such possibility because the states experiencing difficulties receive support from the federal government in the form of welfare benefits and other payments that are financed through taxes. These authors recognize, however, that EU's limited powers in the tax field allow it to practice fiscal federalism only on a very small scale (Krugman, Obstfeld, & Melitz, 2012, p. 578).

According to Berger, et al. (2018) the risks of idiosyncratic shocks are especially relevant in the EMU countries with high levels of public debt and little room to respond with national fiscal policy. In addition, the euro area banks own large amounts of domestic sovereign debt (the so called sovereign–bank nexus). This results in a vicious cycle in which sovereign and financial difficulties reinforce each other (Berger, Dell'Ariccia, & Obstfeld, 2018). The dynamics of the public debt of EMU Member States in 2000-2018 can be divided in two sub-periods (Figure 1). In the early years of the common currency, from 2000 to 2007, the average debt-to-GDP ratio fell by around 3 percentage points, to 65.9% of GDP. This decline can be attributed to the discretionary measures taken in relation to the implementation of the Stability of Growth Pact after 1997. In the second sub-period, from 2008 to 2018, the public debt of many euro area countries increased, most significantly in Greece, Spain, Cyprus, Ireland and Portugal. In 2014 the debt-to-GDP ratio reached a peak of 92.8%. Despite the relative improvement in the state of public finances, overall in 2008 - 2018 the average debt-to-GDP ratio in the euro area rose by 16.3 percentage points and reached 85.9% of GDP.

Figure 1: Public debt of selected euro area countries in 2000 - 2018 (as a share of GDP)

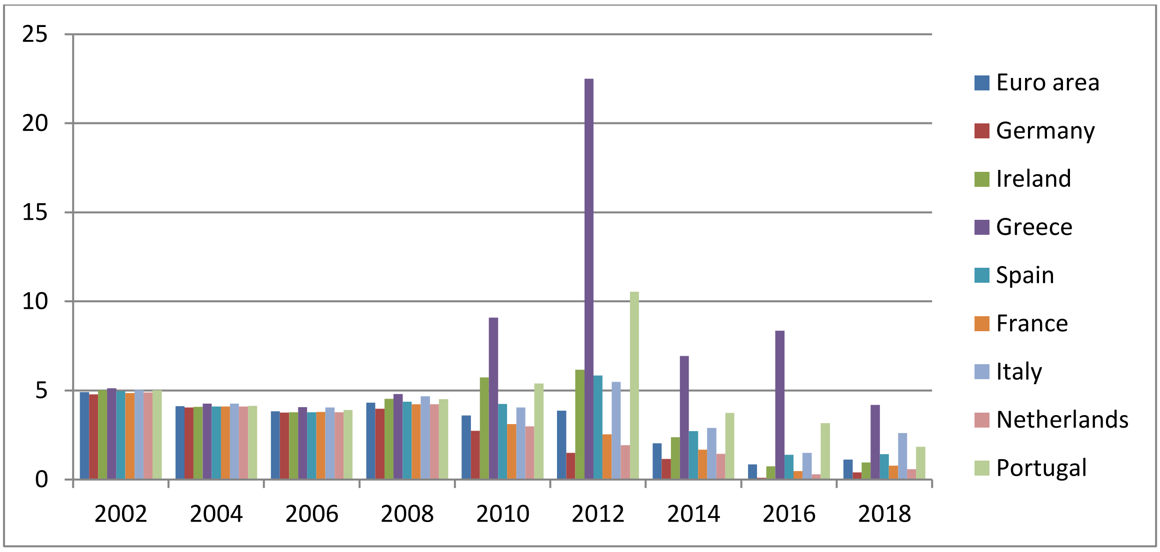


Source: Eurostat

Furthermore, during the euro area sovereign crisis it became clear that some Member States cannot cover their financing needs in capital markets due to the high default risk. This in turn exacerbated the economic crisis because these countries were not able to conduct counter-cyclical policies. Greece was the most extreme case with its temporary capital markets access loss. Other euro area countries, including Italy, Portugal, Spain, faced similar problems in the form of strong temporary increases of their government bond yields (See Figure 2).

Thus, the sovereign debt crisis led to significant divergence in the financing costs of EMU countries. In 2018 the average yield on 10-year government bonds in the EMU was only 1.1% against 4.9% in 2000. The decline in long-term interest rates can be attributed mainly to the strongly expansionary monetary policy of the ECB after 2012, as well as to the establishment of the European Stability Mechanism. However, these low levels do not reflect adequately the risks to the public finances of euro area countries.

Figure 2: Long-term interest rates in selected euro area countries (EMU convergence 10-year government bond yields)



Source: Eurostat

Thus, the arguments for further fiscal integration in the euro area can be summarized as follows:

- low labour mobility and high capital mobility among the Member States,
- high debt levels in some Member States,
- significant bank holdings of debt and
- inadequately determined risk premiums.

2. Alternative options for the creation of fiscal capacity in EMU

At the onset of the Economic and Monetary Union (EMU) the establishment of a common fiscal capacity was not envisaged. The common fiscal framework was represented mainly by the EU budget and the Stability and Growth Pact (SGP). Moreover, an explicit no bail-out clause was included in the Treaty on the functioning of the EU. At the time it was generally believed that the introduction of the common currency would boost the cross-border movements of goods and production factors, thus contributing to the synchronization of Member States' economies. The convergence of public debt levels and long-term interest rates of EU countries at the turn of the century was a confirmation for the successful implementation of the SGP in its initial years. In the aftermath of the euro area sovereign debt crisis, however, it was recognized that the stability of single currency requires further political and economic integration in the European Union. The European Commission (2017, p. 1) has acknowledged that although the crisis did not start in the EU, it revealed some of its institutional weaknesses.

In response to the crisis, the past decade has seen significant changes in the EMU's architecture with the purpose to address these weaknesses and enhance the resilience of the Member States to large economic shocks. Along with the adoption of stricter rules for fiscal discipline, these changes involved also the introduction of elements of fiscal risk sharing. In particular, the foundations of a banking union were laid.

Figure 3: Main pillars of a fiscal risk sharing system in the EMU

Although the establishment of a banking and capital union is important for absorption of economic shocks, the nature of national fiscal policy in a monetary union suggests that an ex-ante fiscal insurance could yield important benefits in the medium or long run, especially in case of large shocks and events potentially resulting in the loss of market access (Thirion, 2017, p. 28).

One of the most important institutional reforms in the EMU was the establishment in 2012 of the European Stability Mechanism (ESM) with the objective to support euro area Member States with low-interest rate loans, in case they lose access to the financial markets. In certain circumstances it can also be used for the direct recapitalization of banks. Since its establishment, the ESM provided financial assistance to several euro area countries and contributed significantly for the mitigation of the sovereign debt crisis and bank crisis. Despite its positive impact on the euro area financial stability, the ESM is not a fully-fledged fiscal risk sharing mechanism. In the first place, its financial resources of EUR 500 billion are not sufficient for addressing a potential crisis in a large EMU Member State. In addition, the ESM is mainly a tool for ex-post consumption smoothing which is activated under strict conditionality. Finally, the ESM was not established under the EU legislation, but instead took the form of an intergovernmental treaty (European Parliament, 2019, p. 2). A genuine fiscal risk-sharing mechanism should come into action before a country is forced to implement a programme of macroeconomic adjustment. An automatic ex-ante fiscal risk sharing instrument could mitigate the need for a fiscal consolidation driven by financial market panic, potentially reducing the probability of the need to request a bail-out ex-post (Thirion, 2017, p. 15)..

The European Commission has recognized that an automatic stabilization function at the euro area level was necessary to improve the cushioning of large macroeconomic shocks (European Commission, 2017, p. 12). Although most Member States have expressed their support for the establishment of some form of fiscal risk sharing mechanism, there are significant differences among them with respect to the specific form of such mechanism, as well as to the amount of the financial resources that should be devoted to it. The proposals include a separate large euro area budget, a dedicated EMU stabilization fund within the existing EU budget, a European Monetary Fund and a common European unemployment insurance scheme. The main characteristics of these alternative options are presented below.

- **Separate euro area budget**

The creation of a separate budget of sufficient amount is the most far reaching option for fiscal integration in the euro area, but it would enable the EMU to mitigate the adverse effects of asymmetric economic shocks. For example, the reliance on cyclical revenues (e.g. corporate income tax) and countercyclical spending (e.g. unemployment benefits) would contribute to automatic stabilization at the EMU level. In addition, one could foresee discretionary elements which could further foster stabilization properties (Carnot, Mourre, & Schmitt-Nilson, 2018, p. 92).

In recent years, France has been the main supporter of a euro area budget, but most other Member States have opposed, due to several reasons. In the first place, a fully-fledged euro area budget requires significant financial resources. This in turn would imply a transfer of taxing and spending powers from the Member States to supra-national institutions. Currently, the EU budget amounts to around 1% of Member States' Gross national income and this is insufficient for the smoothing of large country-specific shocks. Moreover, most EMU Member States, however, are not willing to renounce their sovereignty in the field of fiscal policy as this is the only available tool for national macroeconomic policy. Additionally, there is the risk that a EMU budget would lead to permanent transfers to some countries and thus would become a mechanism for income redistribution. Against this background, a dedicated EMU budget of sufficiently large amount is not likely to be introduced in the foreseeable future.

- **Macroeconomic stabilization fund within the EU budget**

A more feasible and politically acceptable alternative is the creation of new budgetary instruments devoted to the euro area within the existing EU budget. A stabilization instrument works by effectuating transfers between a central fund and national budgets with the specific aim of absorbing shocks (Carnot, Mourre, & Schmitt-Nilson, 2018, p. 92). There have been several projects in this respect. In 2017 the European Commission presented a Roadmap with several measures for completion of the Economic and Monetary union by 2025, including the introduction of macroeconomic stabilization function. It was emphasized that the creation of any new budget instrument should not lead to permanent transfers to Member States and that any bew budgetary mechanism should be a part of EU budget (European Commission, 2017, p. 8). As part of the preparation of EU's long-term budget (Multiannual Financial Framework) for 2021 – 2027, the European Commission proposed the creation of a European Investment Stabilization Function (EISF) as an instrument targeted particularly at EMU member countries experiencing large macroeconomic shocks. The EISF was envisaged as a back-to-back instrument, which means that the Commission would borrow funds on the capital markets and then would lend these funds to a Member State in difficulty, possibly at a zero-interest rate. The Commission has asked all Member States to subsidize the interest payments through direct transfers from their national budgets to a Stabilization Support Fund. This mechanism would be available only to EMU countries and would be open to the countries participating in the Exchange Rate Mechanism II (European Parliament, 2018, p. p. 1).

During the negotiations on the next long-term budget, several Member States, led by the Netherlands, expressed their disagreement with transferring more powers to the EU in fiscal policy. These countries (referred to as the New Hanseatic league) expected the EU budget to focus instead on supporting structural reforms (European Parliament, 2019, p. 3). Thus, at the end of 2018, the Member States agreed on the introduction of an Instrument for Convergence and Competitiveness (BICC) in the next long-term budget, which will be dedicated to the euro area, but it will not perform stabilization functions. As the name suggests, its main objective is rather to enhance economic convergence of the euro area economies through financing of public investments and structural reforms. The new instrument is expected to increase the effectiveness of monetary policy and, in so doing, to ease concerns about the need for permanent fiscal transfers (Council of the European Union, 2019).

- **European Monetary Fund**

The creation of a European Monetary Fund was suggested for the first time by Germany during the Greek sovereign debt crisis of 2010. Several years later, the European Commission elaborated a proposal for the establishment of a European Monetary Fund (along with the EISF). The Commission's intention was for the EMF to replace the European Stability Mechanism. It was foreseen that the new European Monetary Fund would continue to provide financial stability support to Member States in need, to raise funds by issuing capital market instruments and to engage in money market transactions. The decisions taken by the European Monetary Fund would be subject to endorsement by the Council of the EU (European Commission, 2017, p. 5). Unlike the ESM, the proposed European Monetary Fund could automatically activate countercyclical resources to be offered to Member States without conditionality. The EMF would also perform the functions of a fiscal backstop to the Single Resolution Fund, which means that it would serve as a lender of last resort to banks in euro area countries providing them credit lines or guarantess. However, there were disagreements among Member States and the European Commission with respect to both the necessity of establishment of an EMF and its potential place in EU's institutional setting. The European Commission intended to incorporate the new EMF into EU law and increase its powers, whereas most Member States preferred that ESM keeps its intergovernmental character (European Parliament, 2019, p. 2). As a result of these differing views, the project for EMF was not included in the EU long-term budget for 2021 – 2027.

- **Common unemployment insurance scheme**

Alternatively, fiscal risk sharing in the EMU could take the form of common unemployment insurance. Unlike a supra-national budget, such mechanism directly targets individuals in the countries affected by economic shocks. The ideas for the creation of a common unemployment insurance fund in Europe, as a method for macroeconomic stabilization, date back to the 1970's and 1980s. The academic discussion in this field was resumed after the financial and financial crisis. In a study examining the possible introduction of a European unemployment benefit scheme, Beblavy, et. al. outline its main advantages in comparison to other possible stabilization mechanisms in the euro area. In the first place, such a system is countercyclical per se and is automatically activated in case of economic downturn. Furthermore, it provides income support directly to individuals affected by a recesion, thus reducing the social cost. Another advantage of a common unemployment insurance system is its in-built multiplier effects, which allow households to sustain their consumption levels (Beblavy, Marconi, & Maselli, 2015, p. 10). Different options have been suggested for the financing for the scheme, including through payroll tax, corporate income tax, GDP-based contributions by Member States and debt.

According to Thiron (2017, p. 28) a practical difficulty to the implementation of a common insurance system in the EMU is that unemployment rate is a second-order measure of the cycle which comes with varying degrees of lag according to national labour market institutions. The ability of such a system to provide a timely response against large shocks therefore depends on labour-market rigidities and on the reaction of unemployment to the cycle. This suggests that a significant degree of convergence in labour market policies may be a necessary pre-condition. National unemployment benefit schemes across Europe present very different characteristics so complete harmonization could prove very difficult to achieve.

Each of the alternative risk sharing mechanisms presented above has significant advantages and could potentially increase the capacity of the EMU to contribute to the absorption of country-specific shocks. Nevertheless, neither of them can obtain the necessary consensus among EMU

Member States. The implementation of any of these approaches involves specific financial, technical and organizational issues. In particular, the potential of a risk sharing mechanism to mitigate large asymmetric shocks depends on the availability of sufficient financial resources. In particular, it should be given the possibility to run deficits and borrow money. Another important practical issue is the clear definition of the conditions under which Member States could resort to the stabilization funds as well as the provision of tools for avoiding moral hazard. Efficient supra-national stabilization requires distinguishing between risk sharing and redistribution. In principle, risk sharing should include any type of shock (transitory, persistent, or permanent) provided the underlying risk is indeed random and has the potential to affect all EMU members. At the same time, it can be difficult to determine the underlying nature of observed differences in income or other economic variables in real time (Berger, Dell'Ariccia, & Obstfeld, 2018, p. 31). One of the most important arguments against the establishment of an automatic ex-ante fiscal capacity in the euro area is the probability that its existence would decrease the incentives of the recipients for fiscal consolidation and structural reforms.

3. Conclusion

Although the EMU already has many features of a fiscal union, it still does not have a common macroeconomic stabilization function and as a result the Member States are still subject to specific macroeconomic shocks. The availability of some type of fiscal capacity is necessitated by the imperfect factor mobility among the members of the currency union and the incomplete synchronization of their economies. The series of crises of the past decade gave impetus for significant changes in EMU’s institutional architecture. Elements of fiscal risk sharing were introduced, including the foundations of a banking union and the establishment of the European Stability Mechanism. Despite its important role, the ESM is not a sufficient tool for the absorption of large country-specific shocks. In recent years, there have been several proposals for the creation of some type of fiscal capacity in the euro area, including a separate budget, a dedicated fund within the existing budget, a European monetary fund, and a common unemployment insurance scheme. Each of these alternatives has its advantages, but neither can obtain the necessary consensus of the Member States, due to the complex financial, technical and organization issues involved. Thus, at the present juncture the discussion of the introduction of a common fiscal capacity remains mainly in the academic realm. Nevertheless, there is an increasing awareness among policymakers both in the European institutions and Member States the long-term stability of the single currency will require further steps towards deeper integration in the euro area.

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