Shock absorption in the euro area

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The future EMU Fiscal Governance: Stabilization, rules and spillover effects

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Outline:

1. Background: fiscal governance, shock absorption and risk sharing;
2. Shock absorption in the euro area – US as benchmark;
3. Focus on fiscal policy;
4. The role of financial markets in smoothing shocks;
5. Summary and policy insights
1. The background

Shocks and the response to shocks in a MU: Fiscal policy stabilization, the structure of the economy, market mechanisms and the governance framework

How to deal with shocks

- Reduce the probability of (fiscal) shocks
  - Fiscal Rules
  - Mobility of labour
  - Political issue?
  - CMU & BU

- Market mechanisms
  - Mobility of Capital
  - Goods & services

- Structural reforms
  - Wage flexibility
  - Price flexibility

- Fiscal policy stabilization
  - Domestic
  - Fiscal union

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1. The background

• When the crisis came and few issues emerged
  – Financial shocks more detrimental than fiscal
  – In the EA role of rules limited by low enforcement
  – Adjustment in relative prices can be as painful as inevitable
  – Stabilization function of fiscal policy: Still possible?

• But also another lesson: comparison with the experience of federations, US in particular
  – Asdrubali et al. (1996): In the US international risk-sharing (IRS) is high

• IRS reduces correlation between domestic consumption and domestic output – different from stabilization of GDP

• Risk-sharing vs. consumption smoothing
  – Capital Markets and fiscal transfers: cross-border movements of private income (no borrowing/lending) or transfers of fiscal money=>IRS: spatial dimension
  – smoothing through savings (households, governments, firms): intertemporal dimension
Shock absorption capacity in the euro area (I)

• First main contribution:

Based on Asdrubali et al. (1996) – GDP variance decomposition - 3 channels for absorbing the impact of a GDP shock before it affects consumption

Compare euro area to the US: We build a dataset with fully comparable data– corporate savings (retained earnings) and K-depreciation are part of the capital markets channel
1. (Asymmetric) Shock absorption in US & EA
US-EA-11 comparison by sub-periods, 1998-2013

Source: Alcidi et al. (2017)

Consumption smoothing: HH savings and domestic fiscal policy
Fiscal transfers means federal/central transfers
How to explain the poor performance of the euro area?

• **Weak role of capital markets:**
  – In the EA poor performance of the market channel is due to financial integration not contributing to risk-sharing as expected
  – It overlapped with the financial cycle

• **Core versus periphery: large differences in performance**
  – Mostly due to corporate savings

• **Higher persistence of shocks in the EA, relative to the US, combined**
  – Larger variation within the group of countries – in terms of asymmetric shocks
1. (Asymmetric) Shock absorption the EA: core vs. periphery

**Euro area core**: Austria, Belgium, France, Finland, Germany, Netherlands

**Euro area periphery**: Greece, Italy, Ireland, Portugal, Spain

Consumption smoothing: HH savings and domestic fiscal policy

Fiscal transfers means federal/central transfers

Source: Alcidi et al. (2017)
How to explain the bad performance of the euro area (I)

• Weak role of capital markets:
  – In the EA poor performance of the market channel is due to financial integration not contributing to risk-sharing as expected
  – It overlapped with the financial cycle plus “bad” integration

• Core versus periphery: large differences in performance
  – Mostly due to corporate savings

• Higher persistence of shocks in the EA, relative to the US, combined
  – Larger variation within the group of countries – in terms of asymmetric shocks
1. Average shock persistence in the US

US: average duration of asymmetric shocks by State (1965-2013)

Source: Alcidi et al. (2017)
1. Average shock persistence in the EA

EA: average duration of (asymmetric) shocks by state (1990-2014)

Source: Alcidi et al. (2017)
Shock absorption capacity in the euro area (II)

• Second main contribution: fiscal policy
• We compare the role of domestic fiscal policy in EA and US federal budget in absorbing shocks
• We find:
• In the EA, national fiscal policy is an important tool for absorbing the impact of shocks on consumption
  – but this has been limited in size during the crisis in some countries
    • Most likely to be induced by markets pressure than fiscal rules
• In the US the role of federal stabilizers against asymmetric shocks is largely overstated:
  – discretionary character of US fiscal federal policy makes it better suited for symmetric (US –wide) shocks
  – US unemployment benefit schemes seem to be less powerful than in EA
  – In the US co-existence of private and public risk-sharing mechanisms (e.g. FDIC) difficult to measure may lead to under-estimation of the role of interstate risk-sharing
3. The role of markets: Risk-sharing and financial integration

- Literature focussing until 2008: EA financial integration improved IRS
- During the crisis financial integration showed no risk-sharing properties
- What went wrong?
  1. No capital mkt integration but cross-border debt, i.e. no risk-sharing
  2. Common underlying factor which prevented cross-country diversification
- Estimates (Alcidi, 2017) of the degree of market risk-sharing (and fiscal policy smoothing) suggest pro-cyclicality relative to the financial cycle, which behaves similarly to financial integration indicators
- RS is high when credit and house prices are booming, low in the downturn phase of the financial cycle
  - Amplification effect in peripheral MS which were borrowing
- Financial integration – at least the broad measure – does not necessarily lead to risk-sharing
Concluding remarks

• Capital markets in the US are the main channel for shock absorption, while in the EA, domestic fiscal policy is a key tool to smoothing the effect of shocks

• Higher persistence of asymmetric shocks in the EA, relative to the US

• Policy options to improve shock absorption
  – CMU goes in the right direction, but will take time
  – Prevention of large swings (in business and financial cycles) is crucial: Banking Union and macroprudential policies
  – Improve mitigation:
    • Role of official lending and ESM
    • Rationale for common insurance mechanism?
“Old things are always in good repute, present things in disfavor”
Publius Cornelius Tacitus

“The grass is always greener on the other side.

“Look forward and water your grass!”
Thank you for your attention!

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Asymmetric shocks and business cycle fluctuations

• Important insights from the analysis above:

• Crucial to distinguish:
  – Asymmetric shocks: deviation from the average of the Union
  – Business cycle fluctuations: what domestic fiscal policy targets for stabilization
  – Union-wide (symmetric) shocks – it probably requires common borrowing capacity

• Point to importance of different tools in particular of market mechanisms