Shock absorption in the euro area

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FIRSTRUN Final CONFERENCE
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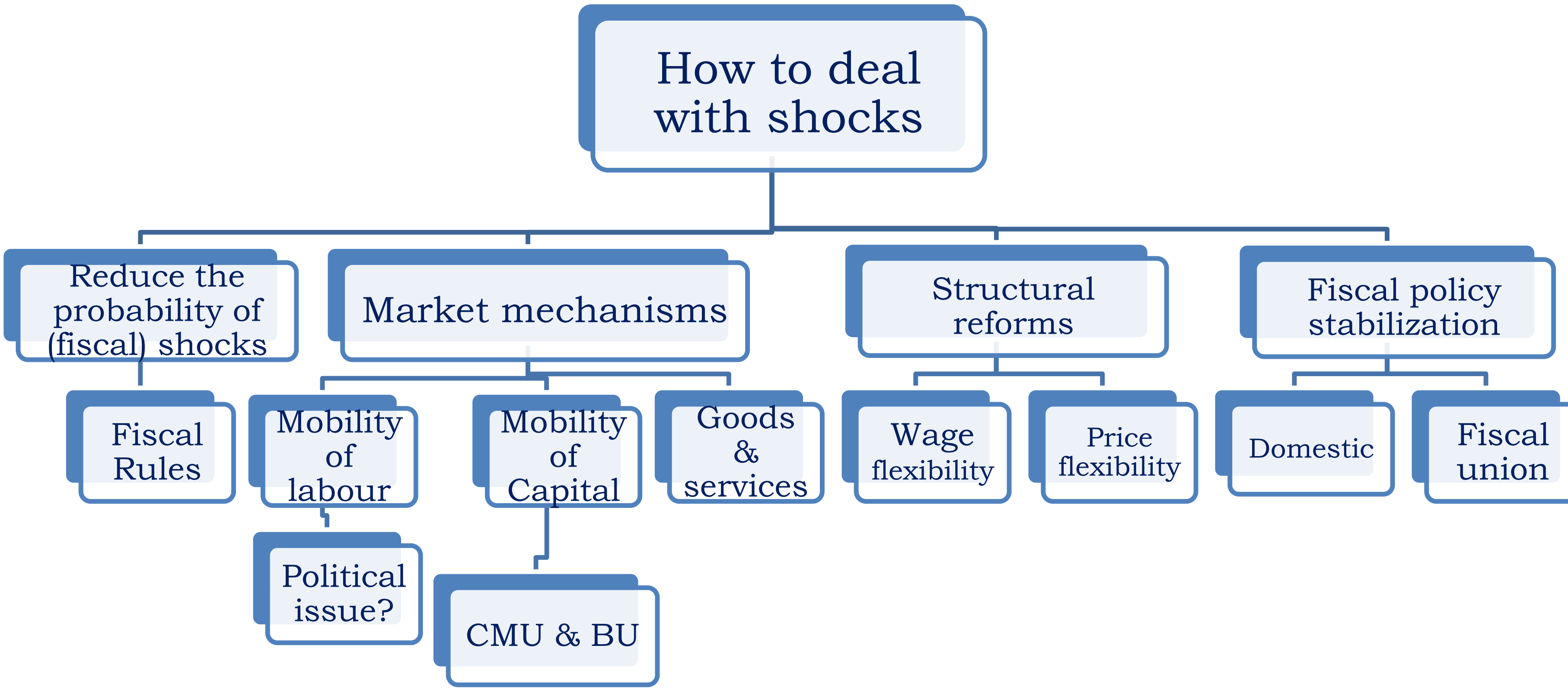
Outline:

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



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:

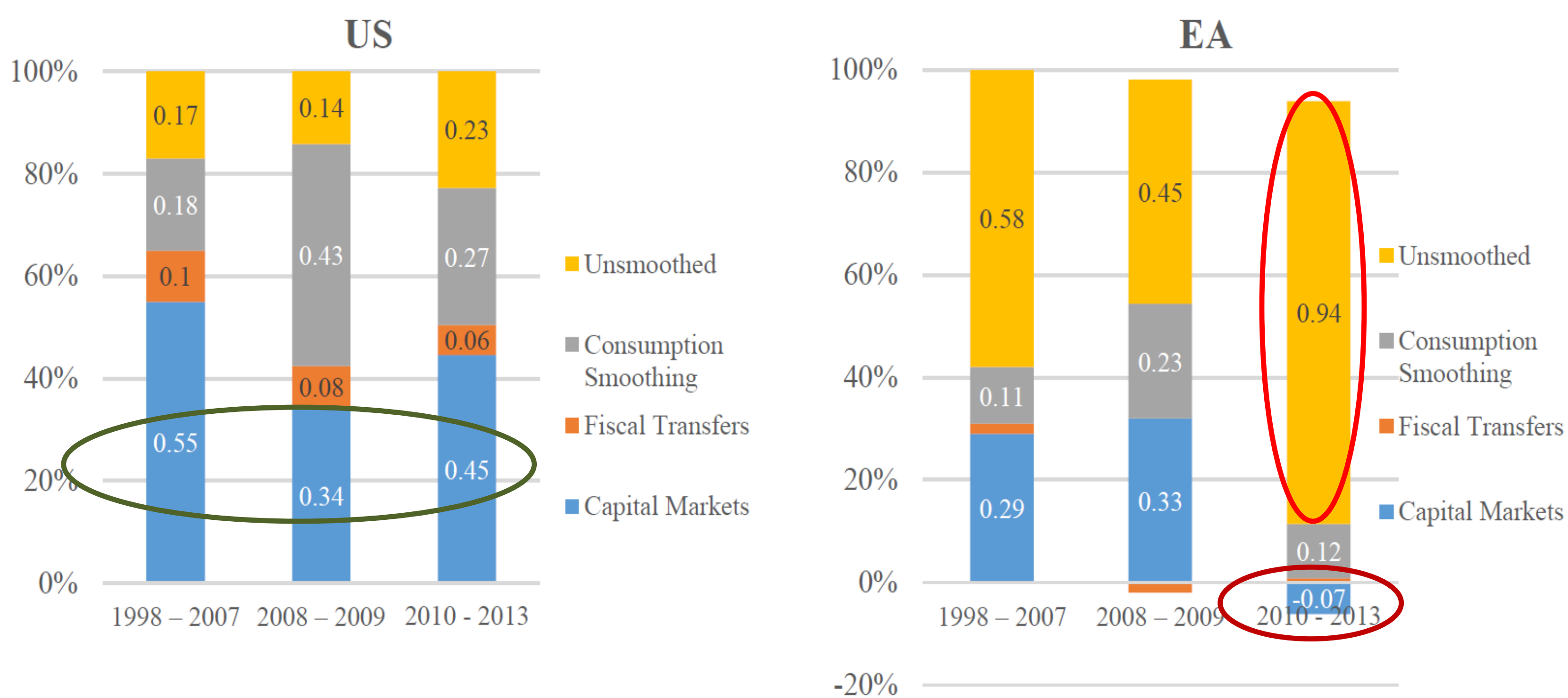
Based on Asdrubali et al. (1996) – GDP variance decomposition - 3 channels for absorbing the impact of a GDP shock before it affects consumption

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

Figure 5. US-EA comparison by sub-periods (comparable data), 1998-2013



Consumption smoothing: <u>HH savings and domestic fiscal policy</u>

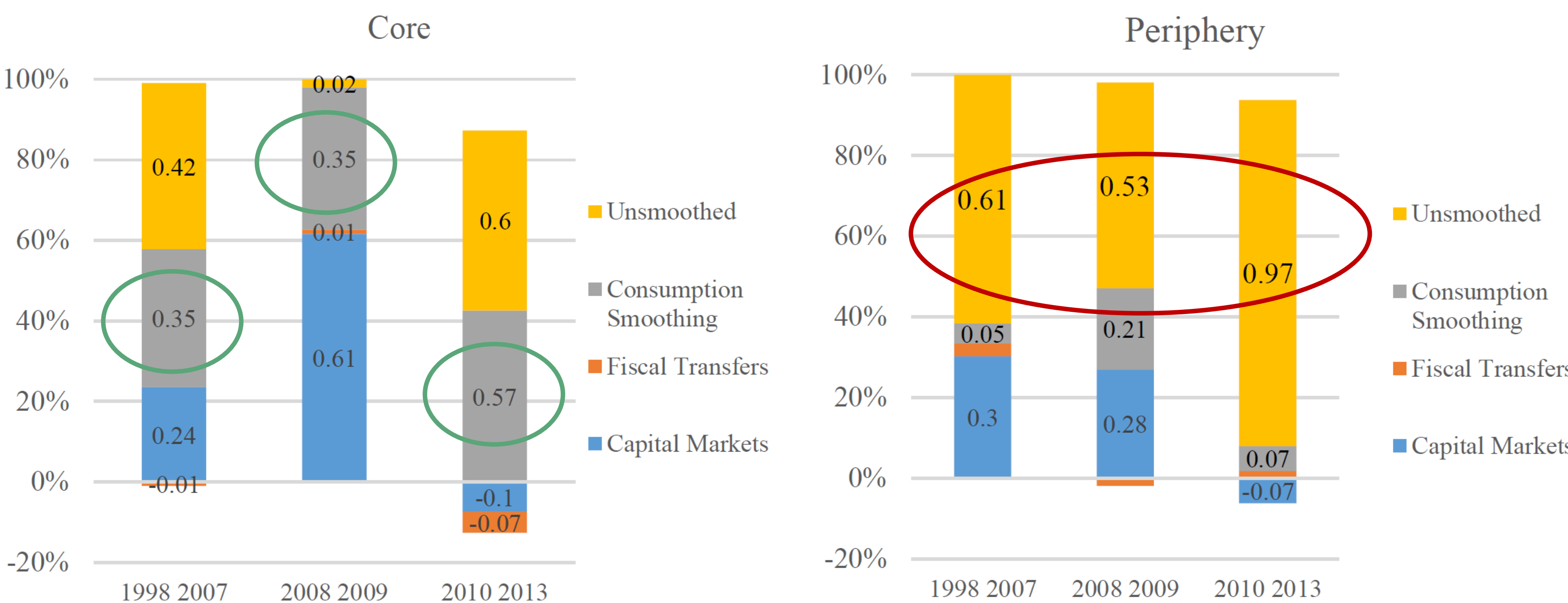
Fiscal transfers means federal/central transfers

Source: Alcidi et al. (2017)

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

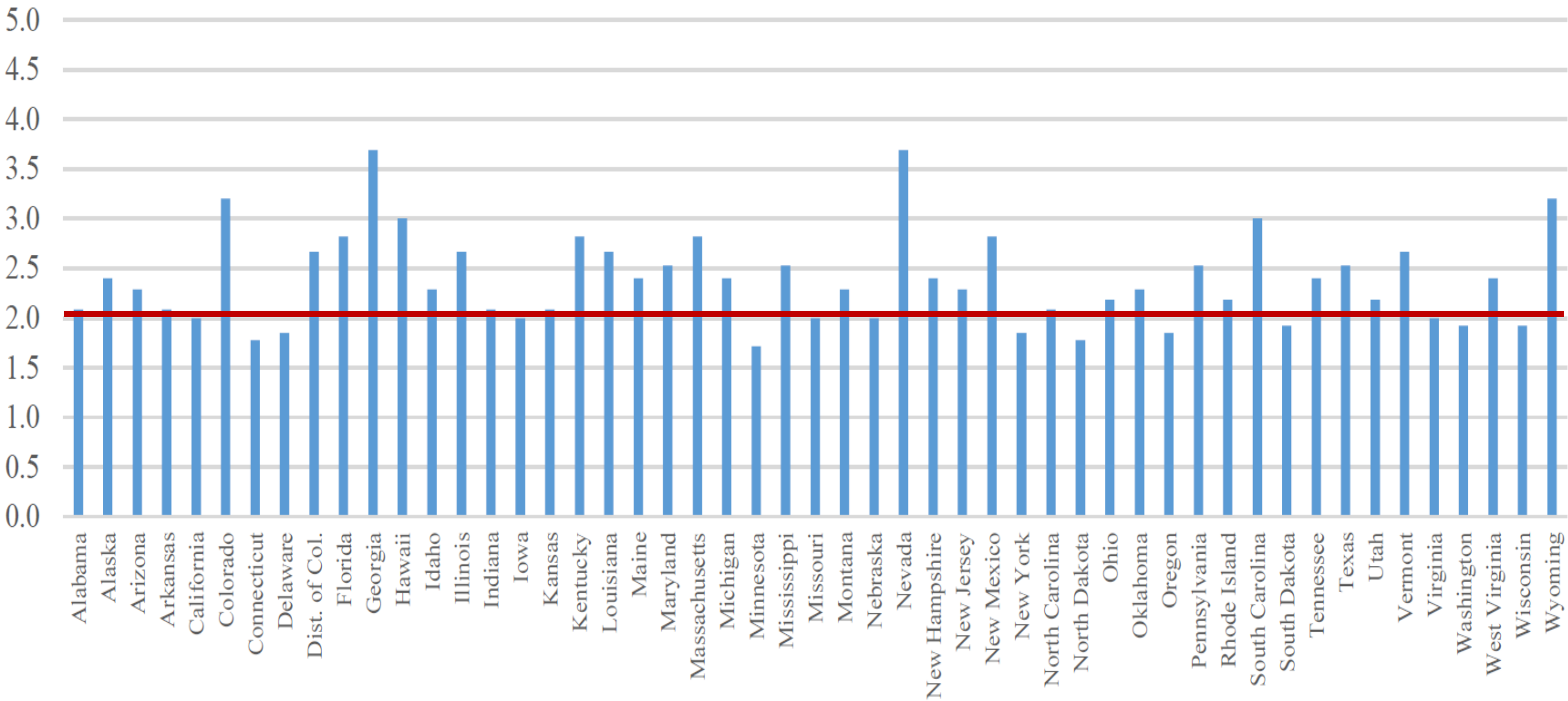
Source: Alcidi et al. (2017)

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

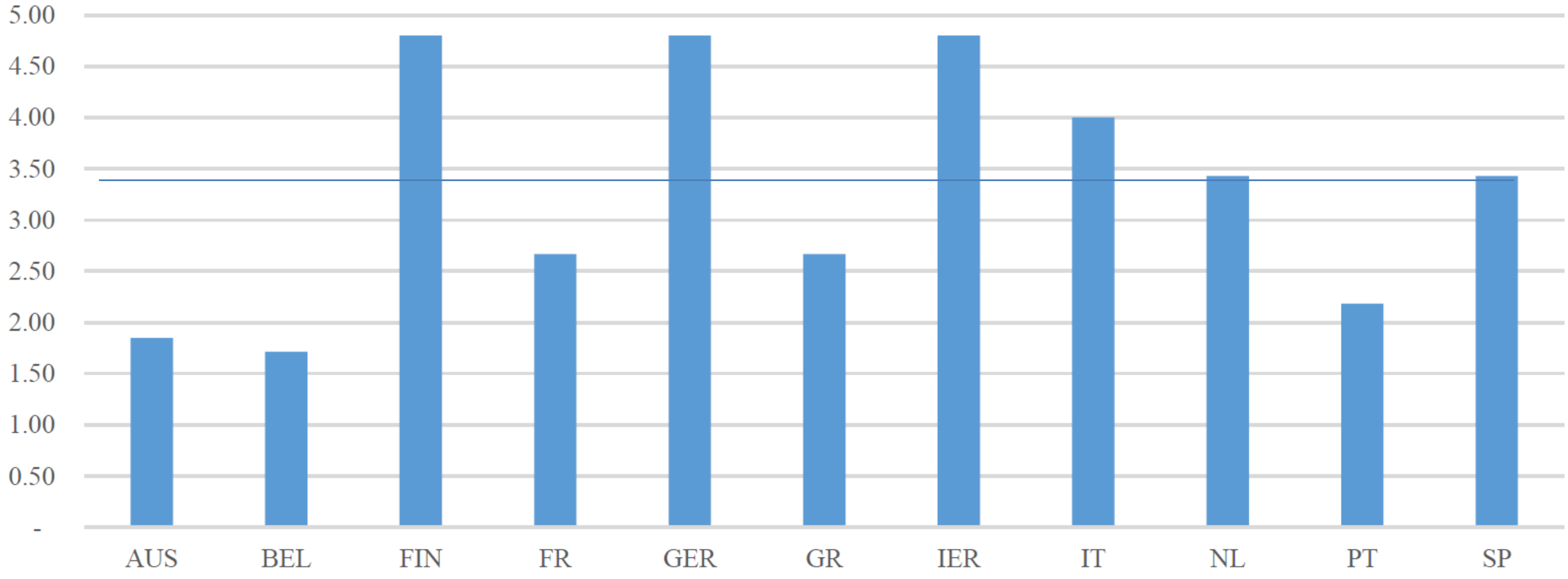
US: average duration of asymmetric shocks by State (1965-2013)



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

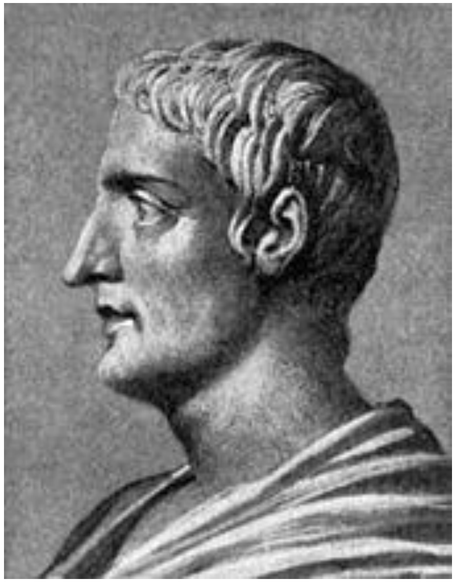
- Literature focussing until 2008 : EA financial integration improved IRS
- During the crisis financial integration showed no risk-sharing properties
- What went wrong?
  1. No capital mkt integration but cross-border debt, i.e. no risk-sharing
  2. Common underlying factor which prevented cross-country 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



"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