Risk-sharing in the euro area

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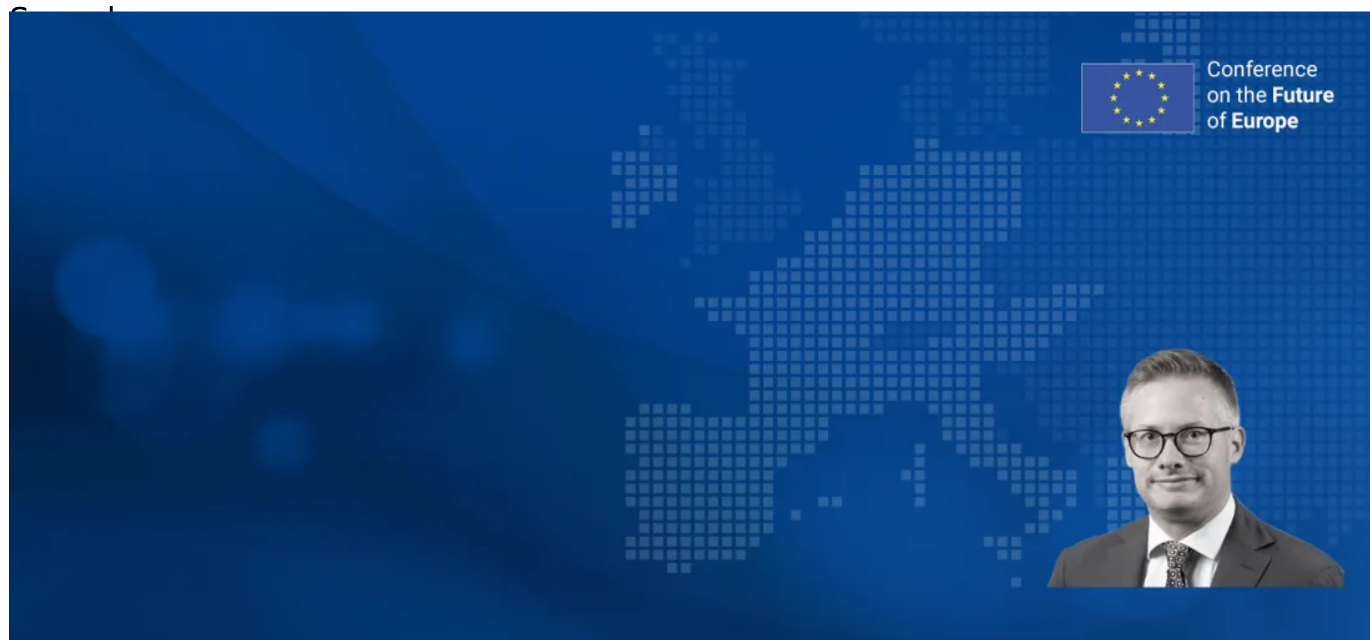

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Risk-sharing in the euro area

Since its establishment, much effort has been put into improving the resilience of the euro area, especially after the sovereign debt crisis a decade ago. We have made great progress in sharing more risks between countries, which are benefiting from this stronger institutional architecture today.

But as we deal with the economic consequences of the pandemic, we are again reminded that more can be done to be better prepared for future crises and to strengthen European sovereignty.

More effective cross-country risk-sharing would go a long way to strengthen euro area resilience. Risk-sharing facilitates income and consumption smoothing and reduces vulnerability to external shocks. Further work is needed to enhance both the private risk sharing channels – for instance, mechanisms to promote capital mobility – and the public risk sharing channels, which include public safety nets.

I will focus on public risk-sharing today. I will argue that a euro area fiscal stabilisation mechanism could be a useful complement to the current economic and monetary union architecture.

It could help cushion shocks by complementing national countercyclical fiscal policies and providing more fiscal space during economic downturns. This is especially the case for large asymmetric shocks where the common monetary policy cannot help and where national fiscal buffers may be insufficient to shoulder the burden alone.

I will argue that now is an appropriate time to consider setting up a fiscal stabilisation mechanism for the euro area. While there have been many proposals on how such a mechanism could work – I will detail them later on - one way to set it up quickly and efficiently would be, for example, to introduce a credit line that would not require additional resources. This facility would not take the form of a common euro area budget but would be a revolving fund which could be drawn upon by euro area countries in economic distress. In principle the ESM would be well placed to provide such a credit line since it is pretty much in line with its mandate and existing financial toolkit.

Current context

The starting point of my argument is that establishing a fiscal stabilisation mechanism now, under the current economic circumstances, it is more important than ever before.

First, public debt levels in some countries remain high and have increased due to the much needed measures to tackle the Covid-19 pandemic. As a result, fiscal space in those member states seems to be more limited than in the past.

Moreover, it will take time rebuild fiscal space given the large spending needs, for instance to support the green and digital transitions.

Second, asymmetric shocks, crises which hit countries differently, could become more severe in the coming years due to climate-related factors. Extreme weather events have started to become more frequent. And, the transition to a greener economy – which is inevitable – can also cause economic distress, large fiscal costs, and threaten the financial stability of the euro area.

Colleagues at the ESM are looking at all these issues and will publish a piece of research soon, which will elaborate the arguments in more detail.

Designing a fiscal stabilisation mechanism

Let me discuss two important features of a fiscal stabilisation mechanism:

First, regarding economic design, most proposals for a fiscal stabilisation mechanism for the euro area include the establishment of funds – insurance funds, rainy day funds and revolving funds. These types of funds differ by the degree of risk-sharing as well as the mix of grants and loans in the event of shocks, although delineation can be somewhat blurry.

For instance, some more recent proposals focus on the idea of establishing an insurance fund that creates some sort of a European unemployment benefit scheme. It would be mainly financed through contributions of the member states and disburse grants. However, these schemes would require a new institutional architecture. It would also take many years until they could become operational because contributions need to be accumulated over time until meaningful disbursements can be made.

Instead, to set up a fiscal stabilisation mechanism as quickly as possible, we could think about a revolving fund that provides loans instead of grants, and does not rely on contributions. It could be operational within months, not years, since it would use existing infrastructure, and funds are already available at the ESM. No additional resources would be necessary. This would also ensure loan conditions that are attractive for many member states, as the ESM can tap the markets at excellent conditions due to its high credit rating.

Second, let's look at the conditions for the activation of the facility. There seems to be a consensus among academics that any fiscal stabilisation mechanism should be triggered in case the unemployment rate exceeds a pre-defined threshold. The rationale is sound – the unemployment rate is available at high frequency and almost in real time and is not subject to large revisions.

However, relying solely on unemployment data to activate a fiscal stabilisation mechanism may not be advisable. In fact, comparing trigger events that relate to the unemployment rate with recessions as defined by Eurostat provides a mixed picture. In half the cases, an unemployment-based trigger would activate the fiscal stabilisation facility outside of recessions and would have missed 60% of the recessions identified by Eurostat in euro area countries over the last 20 years.

Therefore, using unemployment indicators to trigger the activation of the facility should be, at least, complemented by expert judgement or, alternatively, be based on a more sophisticated indicator.

What are the main take-aways?

To conclude, let me summarise the main take-aways of my remarks:

- A fiscal stabilisation mechanism would be an important additional element in the euro area architecture to increase risk-sharing and improve resilience.
- Now it is the right time to set it up considering high debt levels in some member states, low fiscal buffers and the possible adverse impact of climate change on financial stability.
- There are many good proposals for fiscal stabilisation mechanisms which are economically sound.
- From an operational perspective, a fiscal stabilisation facility designed as a revolving fund providing loans may be easier to set up, especially if hosted by the ESM. Besides, such a solution would not require additional resources
- Of course, different proposals are not mutually exclusive, and several proposals could be implemented over time.

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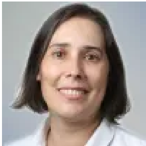

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