A euro area 'rainy-day' fund could support Europe's institutional architecture and resilience

A euro area rainy-day fund to support members in times of crises could further EU reform, enhancing fiscal union and helping lessen the fallout from future economic shocks, in Scope's view. To address risks of moral hazard, a counter-cyclical funding function and strict conditionality would be necessary.

The concept of a 'fiscal capacity' for the euro area has been part of deliberations regarding European Union (EU) reform. Recently, an International Monetary Fund (IMF) staff discussion note emphasised a proposal for EU countries to contribute 0.35% of GDP a year into a collective 'pot'[1]. This could in turn act as a stabilisation mechanism associated with greater risk sharing, and thereby help countries avoid the worst of future economic shocks, facilitate economic recovery, as well as stem the spillover of crises. European Central Bank President Mario Draghi similarly called last week for a 'fiscal instrument' to help member states in crisis.

Scope Ratings analyst Dennis Shen addresses five questions on the ongoing deliberations.

Why does the EU need to develop this fiscal capacity to safeguard monetary union?

Firstly, it's important to recall that the proposal from the IMF for such a rainy-day fund is not new. A compensation tool to support business-cycle adjustment and mitigate the worst regional economic imbalances has been discussed at least since (then EU President) Herman Van Rompuy's roadmap "Towards a Genuine Economic and Monetary Union" was proposed amid the euro crisis in 2012[2]. The concept has been revived in the present debate by calls for greater economic convergence and burden sharing from the IMF, Draghi, and also French President Emmanuel Macron.

The Economic and Monetary Union (EMU) retains economic asymmetries, which cannot be so easily mitigated by monetary policy in a common currency area. These asymmetries were exposed during the global financial crisis and subsequent euro crisis. Even the gradual process of monetary integration can itself cause some of these asymmetries via regional economies of scale[3]. During the euro area crisis, there was a lot of discussion around areas in which the EMU's design still lacks elements consistent with Optimal Currency Area (OCA) theory. However, even if the euro area architecture were to be enhanced significantly in line with OCA precepts, some policy divergence would nonetheless still exist between sovereign nation-states, which have divergent economic and political priorities.

Acknowledging this impossibility of removing all inter-country economic heterogeneity, a theoretical euro area cyclical stabilisation fund or fiscal capacity could help address asymmetric shocks, and maybe ex-ante prevent some of these crises by raising levies to counteract imbalances in times of excess. An automatic financing tool via the fund could support investment in countries suffering an economic down-cycle, when cyclical deterioration in fiscal balances might otherwise restrict fiscal space. This proposal is similar to some other proposals for European automatic stabilisers like calls for an 'unemployment insurance scheme' for the euro area.

[1] IMF. "A central fiscal stabilization capacity for the euro area", IMF staff discussion note, March 2018, SDN/18/03.
[2] Before that, others, notably Enderlein et al. (2012), made similar recommendations.
[3] Krugman, Paul. "Increasing Returns and Economic Geography", Journal of Political Economy, 1991, 99:483-499.

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How would such a rainy-day fund work?

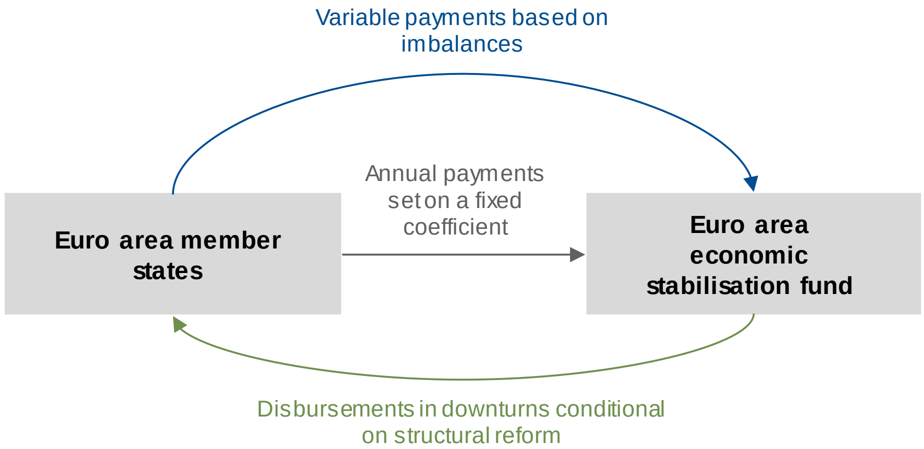
The proposed design from the IMF, Van Rompuy and others involves euro area countries pooling contributions to build fiscal buffers in good times. Countries experiencing a slowdown or recession would then receive transfers from this pool. While the models differ in the degree and automaticity of these transfers, depending on the balance that is struck between risk-sharing and avoiding moral hazard, overall, the idea is akin to a counter-cyclical fiscal insurance mechanism, supporting business cycle stabilisation. This would seek to address the lack of an EMU fiscal capacity and be clearly separate from the multiannual financial framework.

As far as the funding goes, inflows could be based on automatic transfers contingent on a flat coefficient (like 0.35% of GDP a year from each member country, per the IMF’s suggestion), or, in Scope’s view, preferably, be partially variable, levying proportionately greater amounts and ratios from member states that grow above certain trend rates or where increasing macroeconomic imbalances indicate possible bubbles and/or economic mismanagement.

As the main criticism of the rainy-day fund has been and will continue to be that it’s a disguise for what’s really a permanent transfer vehicle, moving monies from economically-viable countries to those that are more crisis-prone, the battle is on doing enough to design a fiscally-neutral set-up to ease such concerns. Transfers from the fund could be conditional, for example, on members implementing a structural reform programme that furthers economic convergence and thus minimises the chances of future asymmetry and relapses, and perhaps be contingent on observance of rigorous EU fiscal rules.

Counter-cyclical contributions ensure to an extent that the more vulnerable countries (with growth above trend or where the EU’s Macroeconomic Imbalance Procedure is flashing danger signs) are also those paying the most into the fund during the boom, and as such, are paying for their own compensatory disbursements once boom turns to bust. A backward-looking function in which countries pay more in the future if they receive funds now (per the IMF’s suggestion) could alternatively be considered, though this changes the nature of the fund from grants to essentially loans – questioning the differentiation then between a rainy-day fund and, for instance, the simultaneously-mooted European Monetary Fund.

Figure 1: Proposed design for a euro area rainy-day fund



Source: Scope Ratings GmbH

Would the proposed fiscal capacity solve the euro area's structural problems?

No. And it's not supposed to.

A solution to economic divergences in the EMU must go well past only counter-cyclical compensation to addressing the root causes of downturns and regional asymmetries. While not all crises can be prevented – speaking to the utility of a rainy-day scheme – significant steps should nonetheless be taken under all circumstances towards reducing economic imbalances and facilitating automatic adjustment regimes, reducing the need then for compensation. For a common monetary policy to be effective, supporting optimal efficiency and maximum employment in the euro area, there needs to be, for instance, adequate convergence in real interest rates and economic cycles. One action here is completion of the single area for labour, goods and services. Next, completion of the banking and capital markets unions, tighter financial and macroeconomic supervision and better coordination in economic policymaking are areas to target. Such convergence mechanisms are complementary and would mutually reinforce the shock-absorption capacity of a rainy-day fund.

The fiscal capacity should also not be confused with discussions about the possible conversion of the European Stability Mechanism (ESM) into a European Monetary Fund. The rainy-day fund could complement the crisis management framework that includes the ESM but would clearly be more intertemporal and a minimum exercise in fiscal solidarity as opposed to a lender-of-last-resort in moments of extreme financial stress and lost market access.

In our opinion, even in what could be called an ideal state in which a stabilisation fund and a lender of last resort were fully institutionalised, such a crisis-management design would, nonetheless, be better at redressing asymmetric shocks in one or a few member(s), than in mitigating periodic global or regional aggregate economic shocks, in which many economies including large member states (like Germany and France) may also simultaneously require recourse to counter-cyclical payments. For these, a more significant commitment to burden-sharing may be needed.

To what extent is there a danger of moral hazard?

The rainy-day fund will continue to be the subject of intense debate, balancing competing objectives of enhancing the EMU's resilience to shocks and avoiding automatic, and permanent, fiscal transfers (and associated moral hazard). This is why a combination of counter-cyclical fund contributions (to penalise countries that live beyond their means), and strict conditionality on disbursements (to facilitate economic reforms so crises don't repeat), are possible key elements in selling the concept.

However, even with such criteria, the European negotiation process will face many complications. In contrast to the progress made on the banking union, or the establishment of a lender-of-last-resort for euro area members, the fact that Van Rompuy's proposal dates to 2012 shows the political reticence in pushing the fund in the context of the European reform agenda. Some of the internal divisions within the new German government and scepticism on wider burden-sharing challenge further progress. Uncertainty surrounding the new government in Italy presents new challenges.

Germany has reservations about increased euro-area fiscal capacity or a large joint budget to boost investment in the bloc if the sole purpose is to support weaker economies in downturns. The European Council summit in June will provide further clarity on Germany's willingness (or not) and ability to spend political capital on these issues. Scope is mindful, however, that other elements of the euro area reform agenda, such as the establishment of a backstop to the Single Resolution Fund, are likely to take precedence to the development of the fiscal capacity.

Here, we note that a fiscal capacity would, however, benefit moreover member states that do not resort to the fund directly for two reasons: first, negative spill-overs (trade flows, financial sector vulnerabilities) would be reduced for neighbouring countries through the stabilisation of euro area peers; second, the introduction of a counter-measure against bubbles is in the interests of capital-exporting member countries.

Are there rating implications from a rainy-day fund?

That's an open-ended question. On the one hand, it's really far too soon to be deliberating what such a fund could mean for euro area sovereign ratings, as its establishment and subsequent mechanics are still open questions. We highlighted in our 2018 Public Finance Outlook that meaningful reforms to Europe's institutional architecture are among the primary routes for potential further rating upside for relevant sovereigns in the region. At the same time, we noted in our recent quarterly update that one of the main risks we see on the horizon is that political constraints and policy complacency might delay meaningful reforms. On this basis, while we would view a credible rainy-day fund as potentially credit positive, in laying out a complementary institutional tool supporting ex-ante crisis prevention and ex-post crisis resolution (improving the resilience of the euro area as a whole and reducing the financial and output costs associated with macroeconomic adjustments), its rating implications are contingent on negotiations regarding, among other key factors, its size, robustness, how long the pre-funding period could be, the structure of funding and disbursement mechanisms, and associated conditionality.

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