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Eurozone: Strengthening resilience

■ Support seems to be growing for the proposal of France and Germany for a eurozone budget ■ This would contribute to a much needed enhancement of economic resilience, that is the ability to cope with shocks ■ Resilience can also be strengthened through private and public risk sharing and policies seeking to boost potential growth ■ Boosting resilience is all the more important considering that risks to global growth seem to be tilted to the downside

Media reported this week that the proposal of France and Germany for a eurozone budget is gaining support from a number of other countries, thereby paving the way for stepping up the efforts in that direction. Although it looks like the journey to come to something significant will be long, the effort needs to be welcomed because, if successful, it would contribute to a much needed enhancement of the resilience of the eurozone economy. According to the OECD, resilience is "*the ability of households, communities and nations to absorb and recover from shocks, whilst positively adapting and transforming their structures and means for living in the face of long-term stresses, change and uncertainty.*" At the current juncture, there are many potential sources of stress: protectionist fears, concern about rising US interest rates, the build-up of leverage in certain domains, (geo)political uncertainty, etc.

Resilience can be enhanced in different ways. One is by taking countercyclical measures, like cutting interest rates when the economy enters into a recession. This means that resilience is proportional to the available policy leeway. However, in many advanced economies, and in the eurozone in particular, room for manoeuvre is limited due to high levels of public sector debt and low central bank rates. In the eurozone the challenge is even bigger due to the absence of a shared fiscal policy and the risk that shocks which hit weaker countries particularly hard would create real and/or financial contagion.

Resilience can also be enhanced through policies which boost potential output: faster growth on a sustained basis reduces the likelihood that a given headwind slows down the economy to its 'stall speed'.

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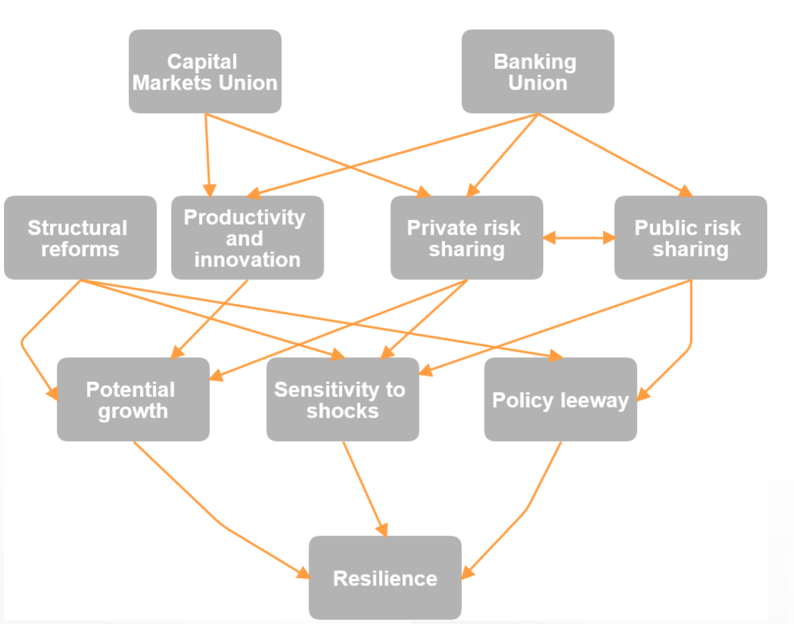
DRIVERS OF ECONOMIC RESILIENCE



Source : BNP Paribas

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The bank for a changing world

This concept refers to a discrete deterioration in economic performance because growth has dropped below some threshold value[1]: confidence declines and triggers a self-reinforcing negative dynamic.

Potential growth very much depends on the capacity of an economy to innovate and to generate faster growth in productivity. In a recent speech[2], Mario Draghi emphasized that "*deep financial markets play a critical role in facilitating diffusion, by providing the risk capital for firms to commercialise new technologies*" adding that "*completing banking union and capital markets union are the critical measures to improve this*."

A third way to enhance resilience is to reduce the sensitivity to shocks. This is reminiscent of the often used metaphor of 'fixing the roof while the sun is shining' by conducting structural reforms. The way activity is financed plays an important role as well. It has been argued many times that establishing a Capital Markets Union will foster risk sharing through more internationally diversified investment portfolios. This implies that the impact of a negative shock in a given country on equity or corporate bond prices will be spread internationally. Along the same lines, completing the Banking Union, by stimulating cross-border banking and hence broader international diversification, will boost private sector based risk sharing. Importantly, Mario Draghi argues that completing the Banking Union and the Capital Markets Union will reduce the need for public risk sharing, which is based on pooling of financial resources. These can be used to create a backstop in the context of bank resolution: "*With common public risk-sharing through a backstop for the resolution fund, the incentives at the national level to limit capital and liquidity flows would disappear. That would in turn lead to greater banking integration and private risk-sharing at the euro area level*." So the implication is that progress in terms of public risk sharing would foster private risk sharing which in turn would reduce the calls on public risk sharing to enhance the resilience of the eurozone. In case of large shocks, public risk sharing would still have an important role to play by financing countercyclical measures whilst being mindful of the necessity to avoid moral hasard. For this reason, the IMF, which has formulated concrete proposals, insists that a central fiscal stabilisation capacity can also be used to improve compliance with fiscal rules in the eurozone: "*our proposed fund seeks to encourage saving by member states with limited fiscal space—to encourage them to build buffers—by requiring regular contributions from all euro area countries while at the same time making transfers conditional on compliance with the fiscal rules*."[3] This is an important point: the promise of financial support in case of economic shocks would be a strong motivation to respect on an ex-ante basis the shared fiscal rules. To look at it from another perspective, it will be all the easier to explain to voters the decision of a government to be compliant with these rules, if in return the country will benefit from support when times are tough. In the IMF proposal, these transfers would be triggered automatically when unemployment would reach certain thresholds.

To conclude, increasing resilience, i.e. the capacity of the eurozone and its members to cope with shocks, may at first glance seem particularly challenging considering the limited policy leeway. Upon closer inspection however, it turns out that a mullti-pronged approach would reduce the need to rely on the traditional instruments of monetary and fiscal policy. Adopting such an approach is clearly ambitious and challenging but, in view of the narrow room for manoeuvre on the traditional countercyclical policy levers, is also necessary, all the more so in an environment where risks to growth seem to be tilted to the downside.

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[1] BIS, *Do economies stall ? The international evidence*, working paper n° 407, 2013

[2] Economic and Monetary Union: past and present, Speech by Mario Draghi at the Europa-Konferenz at Hertie School of Governance organised by the Jacques Delors Institute, Berlin, 19 September 2018

[3] A Financial Union for the Euro Area, Poul M. Thomsen, Director, European Department, International Monetary Fund. Speech delivered at the Conference of the Belgian Financial Forum (BFF) in cooperation with SUERF, Brussels, September 14, 2018