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Abstract

The recent crisis has shed light on the weaknesses and the drawbacks of the European Monetary Union. In particular, many economists and commentators have suggested the need to complement the existing common monetary policy and stability pacts with some kind of *fiscal union*, i.e., enhanced supranational fiscal space and coordination, as a way to limit the impacts of idiosyncratic shocks and provide more risk sharing.

The economic literature has proposed many solutions along this line, such as the institution of a European Minister of Finance, a central fiscal authority, Eurobonds, or a coordinated scheme of unemployment insurance. More specifically, the notion of fiscal union may imply the development of European revenue sources for the EMU budget, the harmonization of taxation within the EMU, a mechanism to increase fiscal discipline at both the union and national levels, building up a union-wide insurance mechanism against financial turbulence, including debt mutualization.

Examples of these proposals are Ubide (2015) and Corsetti et al. (2015) which propose Stability Bonds that would give proceeds to member states and could be used to enact counter-cyclical fiscal policies in the Euro Area. Sapir and Wolff (2015) recommend the creation of a Eurosystem of Fiscal Policy (EFP) with two goals: fiscal debt sustainability and an adequate area-wide fiscal position. Guiso and Morelli (2014) propose the creation of a European Federal Institute to which member states would transfer part of their budget, equal to some agreed-upon share of the value of the EFI's accumulated debt. Further, Clayes et al. (2014) claim that the EMU should adopt a common system of partially centralized unemployment benefits, coming from the need for counter-cyclical horizontal transfers, which should act as mutual insurance. Moreover, the European Commission (2012) advances the idea of building a centralized Eurozone fund which would provide member states with automatic but temporary fiscal transfers in the case of adverse idiosyncratic shocks (repaid in good times). Many of these proposals are on the table with the goal of reinforcing the overall EU governance.

In this work we address two fundamental issues concerning the general Euro Zone architecture and its prospect. One relates to the implementation of a common EMU fiscal policy, its ability to stimulate growth during periods of downturns and to smooth out the effects of adverse shocks, reacting to them at business cycle frequency (aggregate demand management and fiscal multipliers). The other regards shock absorption across state borders

and the strengthening of financial markets' integration (private risk-sharing) and national governments' intervention into credit markets or supranational institutions arrangements (public risk-sharing).

What comes to light is that a unique European fiscal policy may not be as beneficial as it is often claimed, because the fiscal transmission mechanisms are quite different across member states. Indeed, in the first paper of this thesis we show that fiscal multipliers are different across EMU countries (the analysis concerns Belgium, France, Germany, Italy and Spain). The study detects instability in the magnitude of the multipliers and in the slopes of the impulse response functions, both across countries and times, using standard VARs and time varying parameter VARs (TVP-VAR). We claim that the differences are due to transmission mechanisms (in the paper they are captured by the beta coefficients of the TVP-VAR) and driving forces rather than the magnitude and the volatility of national fiscal shocks per se (in the paper they are captured by the standard deviations of the TVP-VAR residuals). We argue that the observed degree of heterogeneity in the fiscal multipliers and in the other response coefficients across EMU countries casts some doubt on the real ability of EMU governments to coordinate their fiscal actions when needed and on the effectiveness of a common EMU fiscal policy in stimulating real economic activity.

In the second paper of this dissertation, instead, we study the mechanisms, extent and characteristics of risk sharing across the EMU. How well do international financial markets allow for consumption smoothing in member countries facing idiosyncratic shocks? How effective are public national and supranational institutions in improving risk sharing? Our analysis extends the work and methodology pioneered by Asdrubali et al (1996) by updating results up to 2014 and by identifying the role of the European institutions (like the European Financial Stability Facility (ESFS) or the European Stabilization Mechanism (ESM)) created right after the great recession with the objective of assisting countries with limited market access. As a matter of fact, we find that the role played by public official transfers from these institutions to more vulnerable countries in order to smooth consumption during the great depression is noteworthy: the ESFS and the ESM have increased the amount of risk sharing within the EMU.

More specifically, we use the method of variance decomposition first implemented by Asdrubali et al (1996) to identify the main channels of risk sharing (net factor income, international transfers and credit markets) and we split the credit market channel into two parts: smoothing achieved through private institutions (markets) and the public sector

(national governments and official European institutions). We find that the European institutions have largely compensated the reduced role of national governments during the recent financial crisis.

Based on these contributions, we derive some fiscal policy suggestions and conclusions. First, we think that there are reasons to be skeptical about the effectiveness and feasibility of a common fiscal policy for the purpose of stabilizing the business cycle. The reasons are that the fiscal transmission mechanisms are different among countries; countries need their own fiscal counter-cyclical measures in order to absorb idiosyncratic shocks, and, last but not least, European countries are not ready and willing to give up their sovereignty. Secondly, we suggest another type of coordination for EMU fiscal governance that is based on sharing resources at central level, through well-functioning and participated European institutions (along the lines of the ESM), that provide transfers to countries in exceptional circumstances and during period of downturns.