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››› Asymmetric shocks within the euro area – absorption mechanism needed

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Similar business cycles in the euro area

The business cycles are largely in sync throughout the different countries of the euro area. This is due to the member countries' economies being closely intertwined for instance via foreign trade and international capital flows. Up until the financial crisis, all the member countries had experienced several years of economic upswing and all of them fell into a deep recession afterwards. However, there were significant differences in terms of their subsequent recovery: Some countries swiftly returned to a stable growth path and their economic output was soon back at the pre-crisis level. Others experienced a renewed economic crisis.

Decoupling during debt crisis

This was due to the asymmetric shock that hit the euro area as from 2010. The debt crisis severely hampered economic growth in some countries while others were affected only indirectly and at most moderately. Cyprus, Greece, Ireland, Portugal and Spain had to ask for financial support. As for Italy, the country at least attracted the attention of investors who doubted Italy's long-term solvency. Italian government bonds therefore suffered from high risk premiums and the country had to cope with considerably higher refinancing costs. This is why Italy is generally considered to belong to the "euro area periphery" (Figure 1).

The other founding states of the euro area are so-called "core countries". Their economic growth was for the most part only affected due to their economic ties to periphery countries. From 2011 to 2013, the core countries' economic output only stagnated, whereas it slumped by almost 6 % in the periphery. The diverging trends in the unemployment rates also show the textbook asymmetric shock in the euro area (Figure 2).

Difficult adjustment for countries affected – support is reasonable

In periods during which asymmetric shocks create fundamentally different economic conditions in the euro area countries, monetary policy is not a very efficient stabiliser. After all, the ECB's monetary policy has to do justice to the needs of all member states simultaneously and may not be geared to the requirements of individual member states only.

Taking major fiscal policy measures in the countries affected was ruled out during the debt crisis. The crisis had after all only arisen because some countries had taken on too much debt and had lost or risked losing access to the capital markets. Against this background, it was not considered appropriate to stabilise the economy with comprehensive economic stimulus packages.

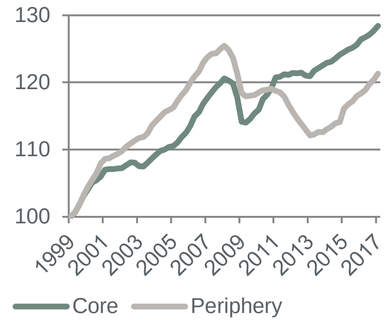
Standard instruments of business cycle management were therefore not an option. This made the adjustment process rather slow and painful for the economies affected. Outside monetary unions the exchange rate mechanism helps with the adjustment and assists in rectifying any undesired developments. Since this tool is not available in the euro area either, alternative instruments are needed.

The euro area members should therefore establish a mechanism that provides financial support to member states affected by an asymmetric shock. This would not only benefit the receiving countries but all members, as such an instrument would help stabilise the euro area economically (and hence also politically). Moreover, such a mechanism would not lead to any permanent and unilateral transfers within the euro area. Provided it is implemented in a meaningful manner, it should be equally possible for all member states to receive financial aid.

A suitable instrument would need to be available almost "automatically" and quickly. Otherwise, if decisions were to be taken on a case-by-case basis, it could take a long time until a political consensus is found. Economic shocks have to be dealt with quickly, however, in order to ensure that spending that is intended to be anti-cyclical will not turn out to have a pro-cyclical effect. ■

Figure 1: Decoupling after financial crisis

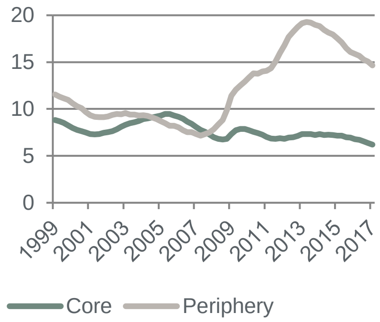
Weighted average real GDP, euro area seasonally adjusted, index Q1/1999=100



Sources: Eurostat, KfW Research

Figure 2: Convergence and divergence

Weighted average unemployment rate, euro area seasonally adjusted, in per cent



Sources: Eurostat, KfW Research