Should the EU budget be used for stabilization?

Session discussion

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Overview

- Current state of play
- Some specific risk sharing schemes
- Risk sharing and reduction should be combined

Current state of play

- Establishment of stabilisation function for euro area has featured prominently in policy debate since outbreak of crisis. Ideas and proposals abound (rainy day funds, unemployment benefit scheme, investment stabilisation fund, etc.)

- May 2018: Commission tables proposal for Multiannual Financial Framework (MFF) 2021 - 2027

  - European Investment Stabilisation Function (EISF) € 30 bn. of loans with interest subsidy

  - Reform Support Programme (RSP)

    Reform Delivery Tool: € 22 bn

    Technical support instrument: € 1 bn

    Convergence facility: € 2 bn

Current state of play

- November 2018: France and Germany propose Eurozone budget with instruments for competitiveness and convergence, part of EU budget but euro area governance
- December 2018: Eurogroup tasked to work on design and timing of a budgetary instrument for convergence and competitiveness for euro area. Instrument to be part of EU budget, consistent with other EU policies, strategic guidance from euro area member states
  - proposal to be ready by June 2019
  - No mention of ESIF any longer in statement of leaders; no consensus in Eurogroup
  - Focus now on how to incorporate convergence and competitiveness instrument for euro area in MFF: amend/adjust Reform Support Programme (RSP)?

Convergence and competitiveness vs stabilisation:

competitors or complements?

Two extreme camps:

– (i) they are competitors. If you converge and remain competitive you will withstand shocks and need less or no stabilisation. (Risk reduction)

– (ii) What matters is size and inertia. Any government spending has stabilising effects as long as it is significant and is not cut during downturns; purpose of spending secondary. In case of large common shocks pooling may not be enough, you need borrowing (Risk sharing).

Both **RSP** and **EISF** are useful in principle, but amounts on the table are far too small to make a difference in both cases. Underlying idea seems to be: first create the instrument, we can make it grow in time.

Some specific risk-sharing schemes

- What triggers transfers?
  - Unemployment: Arnold et al. (IMF, 2018), Pradhan (?)
  - Double condition (Commission / Martinez-Mongay): (1) unemployment higher than average over past 15 years; (2) Unemployment should be increasing fast.
- Earmarking
  - Not necessarily (Pradhan)
  - Investment (Commission / Martinez-Mongay)
- Based on exports on world market (Beetsma, Cima, Cimadomo, 2018)
  - Less prone to moral hazard: based on exogenous shock in world markets and given export weights
  - Based on relative effects of shocks
  - No prescription on how to use transfer, although it could be marked
  - Scheme turns out to be strongly countercyclical

Export-based risk sharing scheme (BCC, 2018): simple example

- There are only two countries (e.g., Germany and Greece), with shares of total EA exports of 90% and 10%

- There is only a shock to one sector (e.g. hotels and restaurants)

- Greece is relatively more specialised in that sector (e.g., w_{ij} = 20%).

- An aggregate negative shock hits the total euro area export for that sector (e.g., $\Delta \mathrm{x}_{jt} = -\$1000$ million)

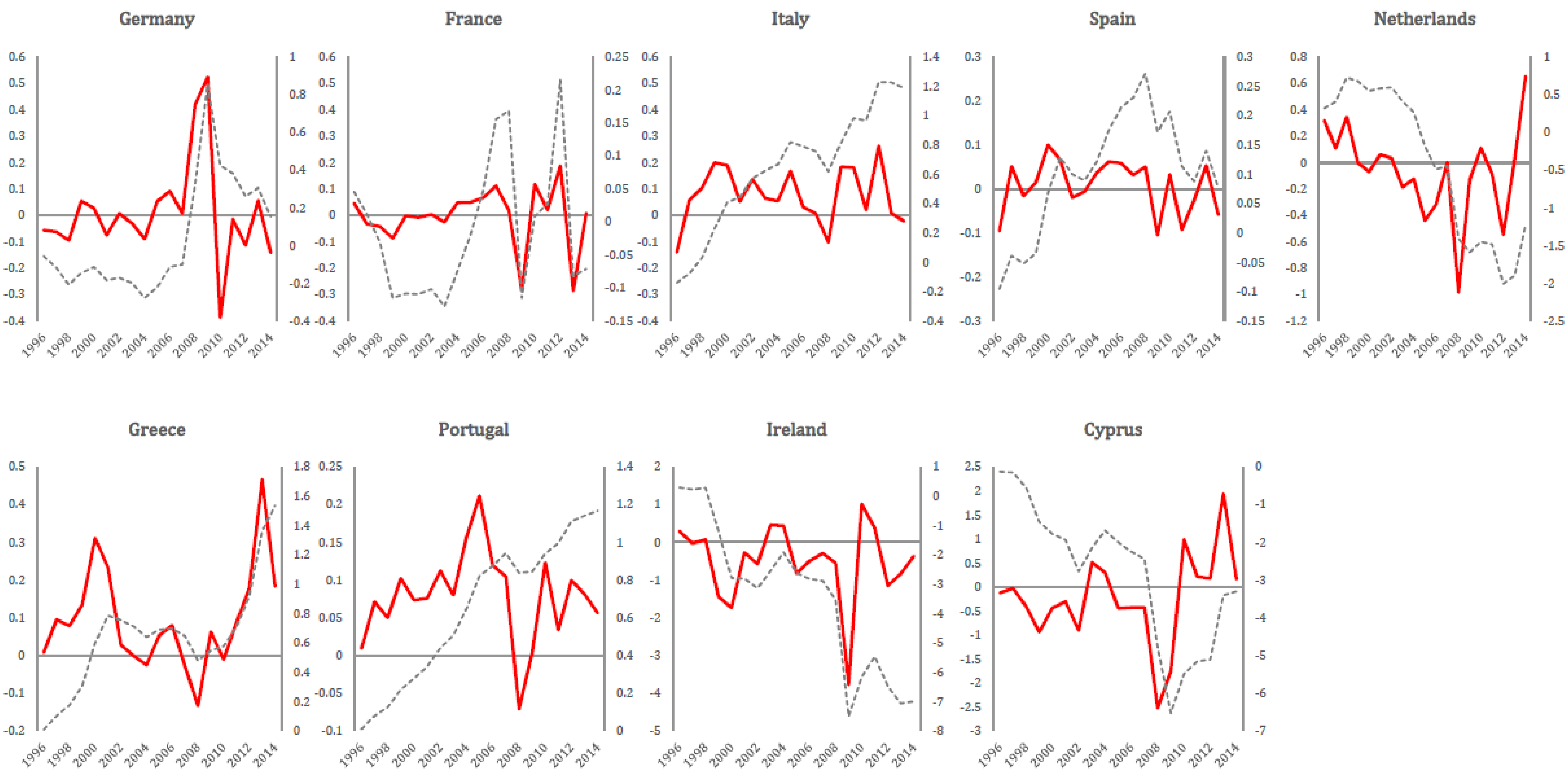
- Using $T_{ijt} = \left[\frac{x_{i,t-1}}{x_{t-1}} - w_{ij,t-1}\right] \Delta x_{jt}$, we have:

$$\mathrm{T}_{GR,j,t} = (0.10 - 0.20)(-1000) = +\$100 \text{ million}$$

In this specific case, the transfer, which compensates Greece for the shock hitting its economy relatively more, would be fully financed by Germany.

Export-based risk sharing scheme (BCC, 2018)

Transfers implied by the baseline scheme, 1996-2014, by country (1)



Annual transfer (lhs)
Cumulated transfers (rhs)

As a percentage of the country's GDP in the year

Export-based risk sharing scheme (BCC, 2018)

Explanatory variable	Output gap	Lag of output gap	Output gap minus weighted average of Eurozone output gap
Baseline: compensation for full income loss			
Estimate	-0.038**	-0.036**	-0.033
p-value	0.011	0.021	0.113
Baseline with cap on transfers			
Estimate	-0.015***	-0.015***	-0.018***
p-value	0.000	0.000	0.000
Compensation for labour income loss			
Estimate	-0.020**	-0.023**	-0.019
p-value	0.049	0.023	0.172
Compensation for labour income loss, with cap			
Estimate	-0.008**	-0.011***	-0.011***
p-value	0.014	0.001	0.008
Compensation based on taxes for full income loss			
Estimate	-0.015**	-0.014**	-0.013
p-value	0.010	0.022	0.108
Compensation based on taxes for full income loss, with cap			
Estimate	-0.008***	-0.007***	-0.009***
p-value	0.001	0.005	0.008
Shock as deviation from 4-year moving-average growth rate			
Estimate	-0.053*	-0.065**	-0.043
p-value	0.056	0.024	0.279
Shock as deviation from 4-year moving-average growth rate, with cap			
Estimate	-0.016***	-0.019***	-0.019***
p-value	0.001	0.000	0.006
Compensation based on stabilisation as a fraction of GDP			
Estimate	-0.076***	-0.043	-0.039
p-value	0.004	0.130	0.300
Compensation based on stabilisation as a fraction of GDP, with cap			
Estimate	-0.008	-0.002	-0.002
p-value	0.138	0.715	0.796

- The ESC would have generally had counter-cyclical effects in the euro area, in all of its versions.
- Introducing a cap reduces the counter-cyclicality of the scheme.

Note: estimates are based on panel regressions including random effects. Dependent variable: annual transfers as a % of GDP

Risk sharing and reduction should be combined (Boone ; BL, 2018)

- Risk sharing and risk reduction should take place simultaneously
- They can also *strengthen* each other – how?
  - Make participation in and disbursement of (ex-post) transfers in a risk sharing scheme conditional on adherence to SGP (Pradhan)
  - Should stimulate discipline-enhancing reform
  - Complication: how to determine that a country adheres to the SGP?
  - Requires reform to simplify SGP (Boone, EFB): debt target – ceiling on spending growth – one escape clause based on assessment and advice of independent body

Conclusion

- Broad agreement among academics that central fiscal capacity is needed to make single currency sustainable in the long run
- Many concrete ideas and proposals on what a central fiscal capacity should look like
- Division among euro area countries about need for stabilisation function persists: concerns of moral hazard will realistically abate only if there are clear signs of risk reduction
- Current political strategy at EU level: let’s create a euro area instrument for convergence and competitiveness; size and purpose can evolve over time

Thank you!