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A budgetary stabilisation function

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A loan-based stabilisation mechanism would add little to a situation where loan facilities are available on the market.

There is no evidence to suggest that the survival of the euro would depend on a budgetary stabilisation mechanism.

Although not vitally important, a budgetary stabilisation mechanism may increase welfare.

CPB Policy Brief
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Summary

There are frequent country-specific shocks in the euro zone, which can have substantial economic impacts. Member States can manage such shocks through fiscal policy, provided they have sufficient financial scope to do so. Another option is that of international risk sharing, via cross-border capital ownership or credit, or budget transfers between Member States. Countries in the euro zone can no longer adjust their exchange rates or use national monetary policy.

In the euro zone, only 25% of country-specific shocks are mitigated among Member States, whereas in the United States, over 60% of state-specific shocks are mitigated in such a way. The most common way of risk-sharing within the euro zone is through the credit channel. Within the United States, shocks are mostly absorbed via cross-state capital ownership, with some additional contributions through (federal) fiscal transfers. In the euro zone, however, international transfers are hardly ever applied to mitigate country-specific shocks among Member States. The debate on the future macroeconomic stabilisation of the euro zone mostly focuses on the implementation of a budgetary stabilisation mechanism. This mechanism concerns a fund from which financial support is provided, either in the form of transfers or loans, for the purpose of stimulating the economy of a Member State that is suffering a country-specific shock.

There is no evidence to suggest that the survival of the euro would depend on a budgetary stabilisation mechanism. There are three options for absorbing shocks within the euro zone. In the first place, the euro zone could increase shock absorption via cross-border capital ownership by completing the banking union and capital market union. Secondly, national fiscal policy could absorb many types of shocks, and, in times of particular need, government authorities could also appeal to the exception clauses in EU budgetary regulations. Thirdly, for Member States losing access to financial markets when their government debt becomes too high, there is the European Stability Mechanism (ESM)—the permanent financial emergency fund that provides loans to EU Member States.

Although not vitally important, a budgetary stabilisation mechanism may increase welfare. A budgetary stabilisation mechanism can be an insurance against large, country-specific shocks. Such an insurance may increase welfare, although its design remains a difficult aspect. The choice for either loans or transfers determines both the level of moral hazard (in terms of structural reform not being implemented) and the added value of a budgetary stabilisation mechanism.

A loan-based stabilisation mechanism would add little to a situation where loan facilities are available on the market. Member States with access to financial markets will not need loans provided by a stabilisation fund. In cases where a Member State is at risk of losing such market access, a loan-based stabilisation mechanism would provide only a limited increase in potential borrowing opportunities. The added value of a budgetary stabilisation mechanism that is based on transfers is of greater added value, but is also politically more sensitive. From an insurance perspective, in rare and extreme cases, having a stabilisation mechanism with larger transfers seems more logical than a fund that provides loans on a regular basis.

1 Introduction

Since the aftermath of the euro crisis, there is policy debate about how to better absorb economic shocks in the euro zone.[1] This debate has been going on for a number of years now and contains both national and international elements. For individual euro zone countries, the debate focuses on how Member States could increase their shock absorption capacity; for example, through structural reforms or by increasing their financial buffers. For the euro zone as a whole, the debate mostly centres on making the monetary union more resilient against economic shocks through international risk-sharing. Late 2018, the Eurogroup (group of euro zone countries) agreed to develop a budgetary instrument for the euro zone budget. At the time, they had not been able to agree on the stabilising impact of this instrument. The Eurogroup will continue negotiations about the technical aspects, in 2019.[2]

This policy brief analyses a budgetary stabilisation mechanism for the euro zone. The countries in the Economic and Monetary Union (EMU) would contribute to such a fund on an annual basis, each in proportion to the level of their gross domestic product. In an economic downturn, for example due to rising unemployment, countries could then receive money from this fund. Transfer or loans provided by the fund would be subject to certain preconditions. For example, a country in need would have to comply with the rules of the Stability and Growth Pact. Such a stabilisation mechanism would operate as an international insurance. The IMF has submitted one of the most elaborate proposals for a budgetary stabilisation mechanism (see text box).[3]

This policy brief also analyses the necessity and efficiency of budgetary stabilisation mechanism. It subsequently discusses practical matters related to design, and what the impact of a stabilisation mechanism would have been in the previous crisis. This led to the conclusion that the need for a budgetary stabilisation mechanism for the euro zone is difficult to substantiate. Although a budgetary stabilisation mechanism of transfers involves risks of moral hazard and legacy issues, certain welfare benefits may be achieved, depending on the system's design. The usefulness of budgetary stabilisation that is based on loans rather than transfers is negligible. A mechanism of larger transfers in rare situations seems more logical, from a insurance perspective.

2 Shocks within the euro zone

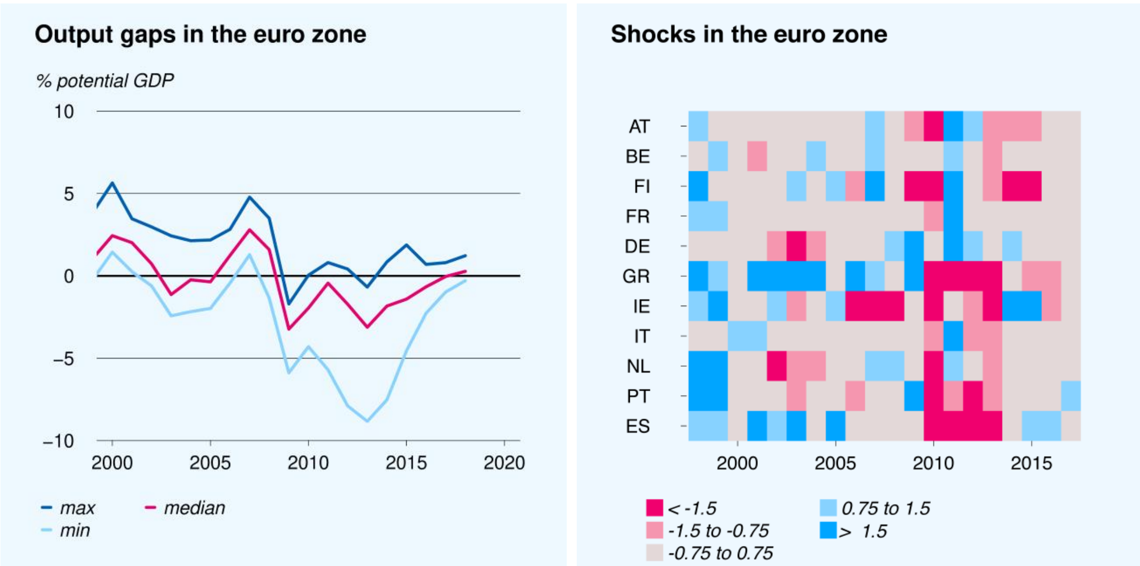
In the euro zone, large country-specific shocks will continue to occur. The internal market and the monetary union are leading to increased financial and economic interwovenness between EU Member States. Such economic and financial integration is subjecting the Member States to collective shocks. Such shocks, also known as symmetric shocks, can be mitigated by monetary policy. The European Central Bank (ECB) is trying to do so, in the euro zone. At the same time, country-specific—or asymmetric—shocks can also occur. These country-specific shocks appear to occur rather frequently and vary substantially in size, particularly in times of crisis (Figure 2.1). Such shocks are often related to certain economic imbalances and policy choices,

[1] See Juncker, J.C., D. Tusk, J. Dijsselbloem, M. Draghi and M. Schultz, 2015, The five Presidents' report: Completing Europe's economic and monetary union (link), and Arnold, N., B. Barkbu, E. Ture, H. Wang and J. Yao, A central fiscal stabilization capacity for the euro area, IMF staff discussion note, SDN/18/03 (link).
[2] See Centeno, M., 2019, Remarks following the Eurogroup meeting of 11 March 2019 (link).
[3] Sometimes in the debate, this also refers to an unemployment insurance between Member States. The Policy Brief focuses on the IMF proposal, see the text box and Arnold, N., B. Barkbu, E. Ture, H. Wang and J. Yao, A central fiscal stabilization capacity for the euro area, IMF staff discussion note, SDN/18/03 (link).

on a national level. Since the introduction of the euro, euro zone countries are no longer able to absorb a country-specific shock by using the exchange rate instrument, nor can they apply country-specific monetary policy. However, although the exchange rate instrument has disappeared, countries are still able to mitigate country-specific shocks through fiscal policy, provided they have sufficient financial scope.

International risk sharing may mitigate the impact of country-specific shocks. There are four ways of doing so. Cross-border capital ownership provides revenues that do not correlate with fluctuations within the national economy (as long as the own economy and the economy in which the investment has been made are not too strongly interconnected). Labour mobility between euro zone countries, due to temporary or permanent migration of workers from countries with high unemployment to those where unemployment levels are low, may also help to absorb the consequences of country-specific shocks. The third possibility is that of cross-border credit provision; when international banks are operating within a national economy, the supply of credit is less affected by country-specific shocks. The final risk-sharing option is that of budget transfers between Member States. In a similar way, in the United States, such transfers by the Federal Government help to reduce the impact of shocks on state or regional levels.

Figure 2.1 Country-specific shocks within the euro zone are substantial and occur frequently (a, b)



(a) The dispersion in the output gap shows the differences between the cyclical positions of the euro zone countries. Following the introduction of the euro in 1999, these differences became smaller. In the lead up to the financial crisis, however, differences in cyclical positions increased, which implies the euro zone is increasingly exposed to country-specific shocks. The figure is based on the first 11 countries to adopt the euro as their joint currency (excluding Greece).
(b) The country-specific shocks were determined as part of a Member State's growth shock that cannot be explained by a growth shock in the euro zone. Growth shocks—for both individual Member States and the euro zone as a whole—were calculated as the residual of a regression of economic growth (in individual Member States and the euro zone) on historical economic growth in the two preceding years.
Source: AMECO; CPB.

IMF proposal for a budgetary stabilisation mechanism

This text box describes the IMF proposal for a central fiscal capacity[a], a budgetary stabilisation mechanism. It is the IMF's attempt at developing a fund that will keep the risk of moral hazard to a minimum, counters long-term transfers, and functions as automatically as possible.

This central fiscal capacity consists of a macroeconomic stabilisation fund for the EMU, which facilitates fiscal transfers in unfavourable economic times. This fund would be financed through annual contributions from all participating countries. These annual contributions form a buffer against times of economic downturn.

The central fiscal capacity would need to include a borrowing option, as it is not unimaginable that the fund's means become depleted. This could happen, for example, in case of an exceptionally large shock requiring money transfers that are so large as to deplete the fund. Such a situation would require the fund itself to borrow money in order to maintain its stabilising function. In practice, this would mean that the borrowing option becomes activated when the fund's reserves fall below a certain threshold.

Transfers to countries would be triggered on the basis of a cyclical indicator and be proportional to the cyclical fluctuations around this indicator. The IMF argues that the deviation of unemployment from its multiannual moving average would be a suitable indicator, which means that the transfers would be in proportion to deviations from multiannual average of unemployment.

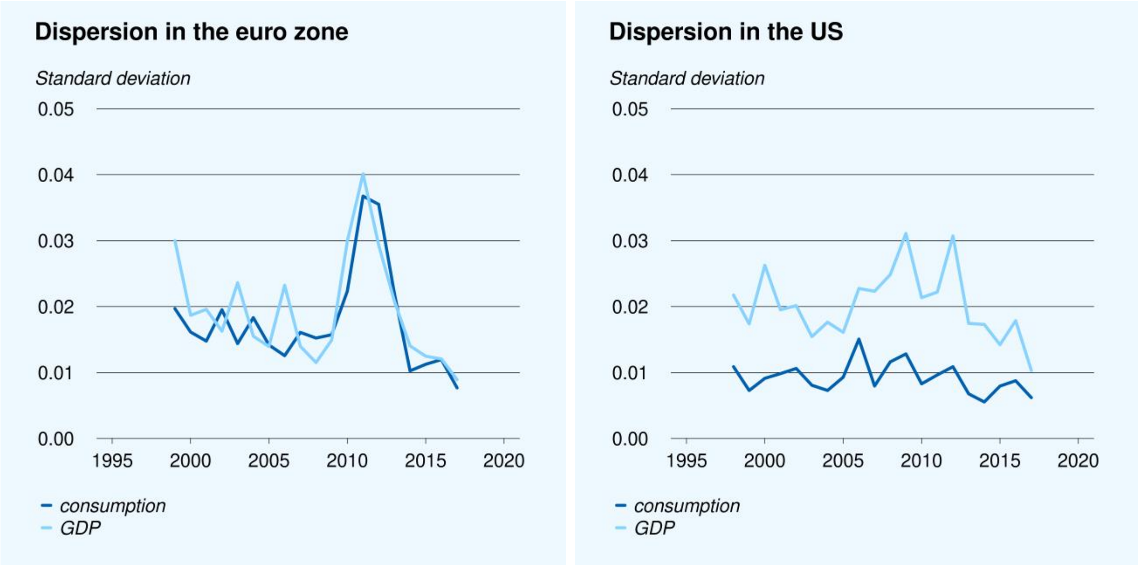
In addition, the central fiscal capacity would provide measures to counter moral hazard and long-term transfers. The risk of moral hazard could be reduced by the precondition of Member States only being eligible for transfers if they meet the European budgetary regulations or—in case a Member State violates the SGP rules—by requiring them to abide by the rules of the Excessive Deficit Procedure (EDP). The IMF describes a number of options for countering long-term transfers; for example, setting an upper limit for fund contributions and/or withdrawals.

[a] Arnold, N., B. Barkbu, E. Ture, H. Wang and J. Yao, A central fiscal stabilization capacity for the euro area, IMF staff discussion note. SDN/18/03 (link).

Cross-border mitigation of country-specific shocks occurs to a lesser degree in the euro zone than in the United States. In situations of perfect risk sharing between euro zone countries, country-specific shocks in GDP hardly affect consumption. Figure 2.2 shows that the distribution of production and consumption growth is very similar between euro zone countries, whereas, in the United States, the distribution of production growth between states was substantially larger than that of consumption growth. This seems to imply that the United States has adjustment mechanisms that mitigate state-specific shocks along credit and capital channels or federal transfers. Another way of illustrating the same point is that of estimating the degree of mitigation of country- or state-specific shocks via the credit and capital channels and federal or government transfers. Figure 2.3 shows the size of these channels for the euro zone and the United States. In the euro zone, on average, only 25% of country-specific shocks are mitigated, although this percentage has been slightly higher in recent years.

The United States, however, mitigates over 60% of state-specific shocks. There, most absorption occurs via cross-border capital ownership and employment, rather than via fiscal policy. In the euro zone, risks are mainly mitigated via the credit channel.[4] Risks are shared to a larger degree in the United States than in the euro zone.

Figure 2.2 GDP and consumption distribution in the euro zone (left) and the United States (right)

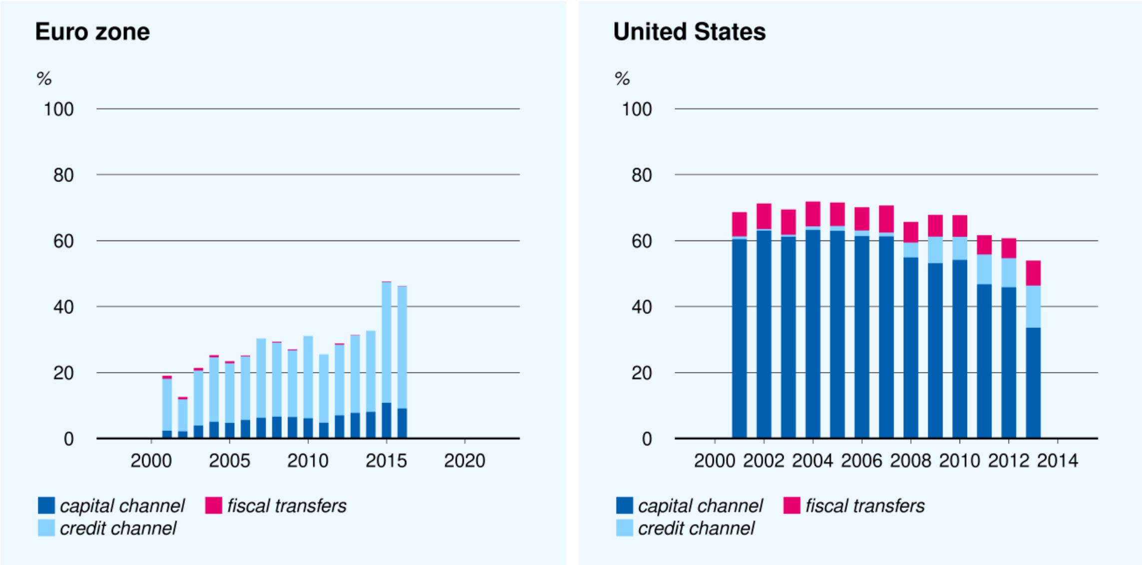


Source: AMECO; CPB.

A budgetary stabilisation mechanism may also include risk sharing to prevent country-specific shocks from turning into a financial crisis. Interstate fiscal transfers in the United States absorb around one tenth of state-specific shocks, see Figure 2.3. In the euro zone, fiscal transfers between Member States hardly contribute to the mitigation of country-specific shocks. The difference in cross-border shock absorption between the euro zone and the United States, however, is mostly related to the degree of risk sharing via capital and credit markets. Proponents of a budgetary stabilisation mechanism argue that more risk sharing is required in the euro zone, in order to compensate for the inadequate functioning of the other means of mitigation. In the euro zone, this concerns the poorly functioning cross-border credit channel and the limited impact of the automatic stabilisers in certain Member States, caused by high levels of government debt.[5] To prevent large, country-specific shocks from turning into a financial crisis, certain studies contend that additional risk sharing via a budgetary stabilisation mechanism is required.[6]

[4] Incidentally, the credit channel has not had much of an mitigating impact during the financial-economic crisis. During the euro crisis, the credit channel was stabilised by the euro zone's borrowing facilities (i.e. EFSF, EFSM and ESM). See Furceri, D and A. Zdzienicka, The euro area crisis: Need for a supranational fiscal risk sharing mechanism?, IMF working paper WP/13/198 (link).
[5] See Furceri, D and A. Zdzienicka, 2013, The euro area crisis: Need for a supranational fiscal risk sharing mechanism?, IMF working paper WP/13/198 (link).
[6] See Allard, C., P.K. Brooks, J.C. Bluedorn, F. Bornhorst, K. Christopherson, F. Ohnsorge, T. Poghosyan and IMF staff team, 2013, Towards a fiscal union for the euro area, IMF staff discussion note SDN/13/09 (link).

Figure 2.3 Part of the shocks that is absorbed via cross-border risk-sharing, in the euro zone, 2001–2016 (left), and in the United States, 2001–2013 (right)



Source: AMECO; CPB calculations based on Asdrubali, P., B. Sorensen and O. Yosha, 1996, Channels of interstate risk sharing: United States 1963–1990, *Quarterly Journal of Economics*, 111(4): 1081–1110 and Beers, N. van, M. Bijlsma and G. Zwart, 2014, Cross-country insurance mechanisms in currency unions, Bruegel Working Paper 2014/04 (link).

3 No need for a budgetary stabilisation mechanism

There is no evidence to suggest that the survival of the euro would depend on a budgetary stabilisation mechanism. In order to stimulate shock absorption via cross-border capital ownership, it is important that the euro zone completes its banking union and capital market union. Many shocks can be additionally absorbed through national fiscal policy, and governments may call on the exception clauses of the European budgetary regulations, in times of particular need. And, lastly, Member States that have too much government debt and have lost access to financial markets are able to turn to the European Stability Mechanism (ESM).

Within the current framework, average sized shocks are absorbed via the national budget and extreme shocks via European institutions. As long as the Member States in the euro zone are in a solid budgetary position, they will be able to absorb average sized, country-specific shocks. This would however require having a certain buffer. There are a number of European institutions for larger and extreme country-specific shocks that cannot be absorbed via national fiscal policy. The Stability and Growth Pact (SGP), for example, contains certain stipulations, such as the 'exceptional circumstances stipulation' and the 'investment clause', which may offer certain flexibility to Member States in exceptional economic difficulties in complying with the debt and deficit rules of the SGP.[7]

The ESM was established during the euro crisis. The European Stability Mechanism (ESM) is a permanent emergency fund from which loans can be granted to EU Member States with financial difficulties. The objective is to safeguard economic and financial stability. Thus, the ESM is in fact a European instrument to

[7] See European Commission, 2019, Vade Mecum on the stability and growth pact, 2019 edition, Institutional Paper 101 (link).

alleviate the pressure of the financial markets on Member States in financial trouble. ESM support is provided on the precondition that the country in question is willing to participate in a reform programme. This is meant to ensure that, for those countries, government debt becomes manageable again, market access is restored, economic and financial imbalances are reduced, and growth potential is enhanced. The underlying principle is for the ESM to support confidence levels in the market and to guarantee that reform programmes will enhance market access, which in turn ultimately reduces the actual use of the ESM.

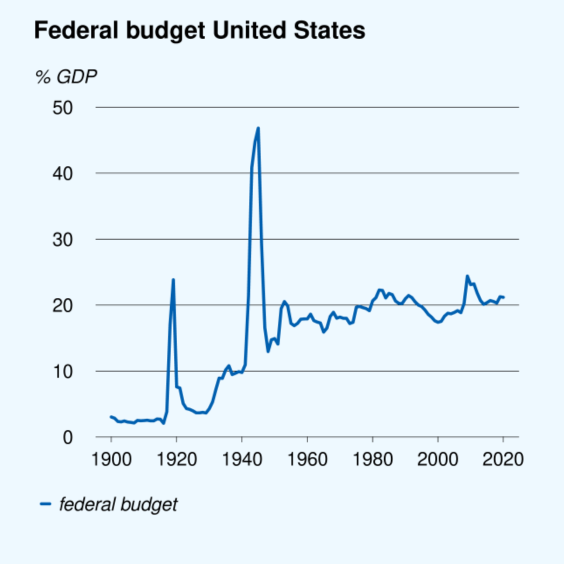
Certain other monetary unions and federal states are indeed stabilised via net fiscal transfers, but this does not prove their absolute necessity. In the United States, individual states are primarily responsible for unemployment insurance. At the same time, states are also contributing to a federal fund, to which they can apply for help, to mitigate the impact of large state-specific shocks, under certain conditions. In this way, around one tenth of all state-specific shocks are mitigated (see Figure 2.3). Although the United States currently has a large federal budget, this was not always the case. Before the First World War, the federal budget was between 2% and 3% of GDP (Figure 3.1). In Germany, before the unification, around 91% of federal-state-specific shocks were mitigated, 54% of which through federal transfers. After the reunification, this decreased to 10%.[8]

In the past, monetary unions have been known to fail without a budgetary stabilisation mechanism, but not in all cases. For example, up to the First World War, the United States hardly had any budget on a federal level. Moreover, in Europe, there have been various monetary unions, in the past. Examples are the Latin Monetary Union (LMU), initiated in 1865 by Belgium, France, Switzerland and Italy. Inspired by the LMU, Sweden and Denmark established the Scandinavian Monetary Union (SMU) in 1873, to which later also Norway acceded. The Austro-Hungarian Monetary Union (AHMU) was established in 1867. In the end, all three monetary unions were dissolved, after the First World War.[9] Although the LMU, SMU and AHMU shared the characteristic of not having a federal budget, this does not prove the need for one. A group of eight African countries (i.e. the West African Economic and Monetary Union — also known as UEMOA from its name in French) has been sharing one currency since 1945 (i.e. the CFA franc; these days coupled to the euro). And there is also the Economic and Monetary Community of Central Africa (or CEMAC from its name in French), the currency of which is coupled to the West African CFA franc on the basis of parity. Within these monetary unions, there is no significant degree of international risk sharing.[10]

Completion of the banking union and more private risk sharing will provide credibility for the no-bailout clause. The no-bailout clause states that euro zone countries are not to provide help by financing the government debt of another Member State in financial trouble. The preventative objective of this clause, however, proved to be insufficiently effective in the euro crisis. The underlying causes were the interwovenness between banks and governments, and the ambiguous procedures for dealing with Member States that were facing solvency problems. This meant that the impact of one euro zone country going bankrupt on the other euro zone countries could not be predicted. Completion of the banking union and a greater degree of risk sharing via a capital market union will reduce the risk of losses for other governments, thus also making it more credible that other euro zone countries will not be tempted to co-finance a country with untenable government debt. However, further progress can still be made, with respect to the banking union (e.g. a joint deposit insurance system). It is also still unclear what a completed capital market union would look like.[11]

[8] See Hepp, R. and J. von Hagen, 2013, Interstate risk sharing in Germany: 1970–2006, Oxford Economic Papers, 65(1): 1–24 (link).
[9] See Ryan, J. and J. Loughlin, 2018, Lessons from historical monetary unions – is the European monetary union making the same mistakes?, *International Economics and Economic Policy*, 15(4): 709–725 (link).
[10] See O. Basdevant et al., 2015, Strengthening the West African Economic and Monetary Union: The Role of Fiscal and Market Institutions in Economic Stabilization, IMF African departmental paper (link).
[11] See Wiel, K. van der, B. Smid, A. Dubovik, K. Ji, B. Soederhuizen, R. Teulings, B. Vogt and L. Zhang, 2018, Risicorapportage financiële markten [CPB Financial Stability Report (in Dutch)], CPB Communication, 29 May 2018 (link).

Figure 3.1 The US federal budget was not always as large



Source: The White House; CPB.

Other recent studies conclude that the added value of a strong banking union is far greater than that of a budgetary stabilisation mechanism. Major country-specific shocks particularly consist of national *boom–bust* cycles, followed by a financial crisis. The question is, therefore, what type of mechanism would be most suitable to mitigate such shocks. Here, the example of the United States is illustrative, once again. The shock absorbing capacity of explicit federal transfers is small, but, in contrast, that of those by the US banking union is large.[12] The shock absorbing capacity of the euro zone institutions can be enhanced by a strong banking union.[13] This does however require a credible safety net for the Single Resolution Fund (SRF)[14] and a European Deposit Insurance Scheme (EDIS). A strong banking union would not only ensure that countries do not bring each other down, in cases of instability of banks, but also sees to it that countries share the impact of shocks, via banks.

[12] See Gros, D. and A. Belke, 2014, Banking Union as a shock absorber – Lessons for the Eurozone from the US, Centre for European Policy Studies (link).
[13] See Jones, E., 2016, Financial markets matter more than fiscal institutions for the success of the Euro, The International Spectator, 51(4): 29–39.
[14] See Wiel, K. van der, B. Smid, A. Dubovik, K. Ji, B. Soederhuizen, R. Teulings, B. Vogt and L. Zhang, 2018, [CPB Financial Stability Report (in Dutch)], CPB Communication, 29 May 2018 (link). A proposal has recently been prepared for the European Stability Mechanism (ESM) to be given the role of safety net for the Single Resolution Fund (SRF).

4 Would a budgetary stabilisation mechanism increase welfare?

A budgetary stabilisation mechanism could increase welfare. A budgetary stabilisation mechanism could serve as an insurance against large, country-specific shocks. An insurance mechanism, thus, could prevent harmful divergence between Member States, provided it is set up in a way that would minimise the risk of moral hazard.[15] An insurance against large unforeseen shocks could increase welfare.

Recent model analyses show that a budgetary stabilisation mechanism has certain, limited efficiency benefits. Farhi and Werning (2017) analyse which part of the decrease in welfare due to a shock to one of the members of the monetary union would be absorbed, under various policies.[16] In most cases, an international budgetary stabilisation mechanism would achieve a lower reduction in welfare than would the optimal national fiscal policy. The advantages depend on the openness of the economy in question, as well as on the persistence of the shocks. The more open the economy, the smaller the welfare gains from a budgetary stabilisation mechanism. This is due to the fact that, in an open economy, a larger share would spill over to other countries. Under more persistent shocks, the efficiency benefits are greater, because, in such situations, households tend to adjust their consumption behaviour to a greater degree. Additional government spending, in that case, will be less effective, because this would also require tax increases for a longer period of time, which in turn decreases consumption.

Countries in a monetary union partly take the effects into account of their fiscal policy on other member of the monetary union. Furthermore, market parties will purchase too few private, cross-border insurances, because they will not internalise the positive externalities of the macroeconomic stabilisation that emanates from their portfolio choices. This type of market failure can be addressed via a so-called safe asset or via a budgetary stabilisation mechanism.[17]

A budgetary stabilisation mechanism involves moral hazard, as do most insurances. Establishing an insurance against country-specific shocks carries the risk of Member States not implementing unpopular or politically sensitive structural reform measures. There is the simultaneous risk of national governments incurring more debt, following a country-specific shock.[18] In order to prevent such a situation, a budgetary stabilisation mechanism should provide incentives for them to maintain budgetary discipline. This could involve a type of policy excess or co-financing, or certain preconditions to the participation in a budgetary stabilisation mechanism that must be met in order to be eligible for a transfer. The IMF proposes that transfer should only be granted when (i) European budgetary regulations are complied with, or (ii) the agreement in the corrective arm is followed in case a Member State does not comply with European budgetary regulations.[19] These preconditions, incidentally, cannot prevent political pressure resulting in transfers nevertheless being granted in cases of non-compliance.

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[15] See Enderlein, H., L. Guttenberg and J. Spiess, 2013, Making one size fit all. Designing a cyclical adjustment insurance fund for the eurozone, Jacques Delors Institute Policy Paper 61 (link).

[16] See Fahri, E. and I. Wening, 2017, Fiscal Unions, *American Economic Review*, vol 107(12): 3788–3834 (link).

[17] See Arnold, N., B. Barkbu, E. Ture, H. Wang and J. Yao, A central fiscal stabilization capacity for the euro area, IMF staff discussion note, SDN/18/03 (link).

[18] The analysis by Farhi and Werning does not include the consequences of moral hazard.

[19] See footnote 17.

The type of design determines both the degree of moral hazard and the added value of a budgetary stabilisation mechanism. Moral hazard may be limited by requiring Member States to repay any payouts they received via the budgetary stabilisation mechanism. However, in cases of access to financial markets, the added value of a stabilisation mechanism that is based on loans is not very great compared to the borrowing options on the market. Whenever such a Member State faces the risk of losing market access, a loan-based stabilisation mechanism will extend market access only to a limited degree. Moreover, the situations in which only a period of a few months of additional market access would prevent a European financial crisis are few and far between. The ESM emergency fund is available for countries with problems related to market access.

A budgetary stabilisation mechanism with transfers is politically sensitive. After all, the euro zone is not a political union. The size of the total transfers can be restricted, though, by setting limits to net transfers and/or contributions.[20] Such an upper limit, however, does not guarantee that higher transfers cannot take place under a certain amount of political pressure.

5 Design and practical matters

A budgetary stabilisation mechanism should provide transfers to Member States as automatically as possible, on the basis of a core parameter. This, to prevent disagreement about the granting of individual transfers. Such a core parameter should be unambiguously measurable, be able to be understood by all, and be automatically activated. The output gap would be the most suitable parameter, in theory, but experience with the European budgetary regulations have shown that the output gap is difficult to measure, in practice.[21] In addition, output-gap revisions often lead to major adjustments, by up to 1.5% of GDP for EMU Member States.[22] The core parameter in the IMF proposal is that of unemployment development, set against the seven-year moving average (see text box).

The insurance aspects need to be taken into account when designing a budgetary stabilisation mechanism. An insurance is an efficient instrument for large, unforeseen and uncorrelated shocks. When designing a budgetary stabilisation mechanism, it is therefore important that transfers are made only in cases of large and unforeseen shocks. This means that it would be efficient to limit the frequency of transfers to large country-specific shocks. A known problem with insurance is that of moral hazard. In this context, there would be the risk of governments changing their behaviour (e.g. put off reforms, or creating insufficient budgetary buffers) when they know that, in cases of problems, there would be transfers through the stabilisation mechanism.

Fully eliminating the risk of moral hazard would result in a budgetary stabilisation mechanism that never pays out. The IMF argues that the risk of moral hazard could be reduced by making the transfers conditional on compliance with SGP rules (in the corrective arm).[23] In cases of substantial crisis, in many Member States the budget balance will move earlier than unemployment, which would represent a higher chance of them entering the Excessive Deficit Procedure (EDP) than of meeting the criteria required for transfer from the stabilisation fund. A strict interpretation of compliance with SGP rules, in that case, implies no moral hazard but also no transfer. However, there is also another way to look at this issue, namely that a

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[20] See footnote 17.
[21] See Hers. J. and W. Suyker, 2014, Structural budget balance: a love at first sight turned sour, CPB Policy Brief 2014/07 (link).
[22] See Tereanu, E., A. Tuladhar and A. Simone, 2014. Structural Balance Targeting and Output Gap Uncertainty, IMF Working Paper 14/107 (link).
[23] See Arnold, N., B. Barkbu, E. Ture, H. Wang and J. Yao, 2018, A central fiscal stabilization capacity for the euro area, IMF staff discussion note, SDN/18/03 (link).

Member State in such a situation, in fact, needs a transfer from the stabilisation fund. This then does imply a case of moral hazard, to which governments could adjust their behaviour. Thus, there is either no moral hazard, combined with no transfers in times of need, or transfers when needed, in combination with a certain risk of moral hazard.

The relationship between a transfer through the budgetary stabilisation mechanism and the SGP rules is not self-evident. For example, the transfer rule in the preventative section of the SGP stipulates that government spending levels cannot increase more rapidly than potential economic growth, also taking into account the distance to the medium-term objective (MTO). Question is whether spending that is financed from means acquired through the budgetary stabilisation mechanism would also fall under this spending rule. It seems logical that it would not. After all, interest expense, economy-related unemployment expenditure, and revenues from natural gas sales are also excluded from the expenditure rule, so as to provide scope for automatic stabilisation. In economically difficult times, therefore, there is no need for governments to reduce their additional unemployment expenditures—which, in turn, also avoids inducing an even greater economic downturn.

There are various proposals for a budgetary stabilisation mechanism for the euro zone. The European Commission (EC) and the IMF, for example, have presented proposals for a euro zone fund that would provide transfers or loans. Together with the proposals for the new multiannual financial framework, the EC launched the European Investment Stabilisation Function (EISF). This is a fund that is to help mitigate country-specific shocks that often have a negative impact on investments. The EISF may provide an insurance for national growth potential, but because of the long lead time of investment projects it is doubtful whether the fund will effectively contribute to economic stability.[24] The IMF proposes the establishment of a budgetary stabilisation mechanism (see text box). Furthermore, there are ideas about an insurance or re-insurance system for unemployment on the euro zone level. Under this system, countries that face a serious recession, high unemployment and pressure on social services will be able to borrow from this fund to deal with those problems. Another often-named option is that of a euro zone budget.[25] Although this option has not been fully elaborated, this budget could be used to strengthen the economies of the euro zone countries and, thus, help mitigate shocks.

The IMF proposal comes the closest to meeting these criteria. The IMF proposal uses unemployment (in deviation from its long-term average) as the core variable. Unemployment is easy to measure and the outcome does not need revision. It is however true that reform measures that lower unemployment would decrease the chances of a transfer being granted, in the first few years. Transfers from the fund would depend on countries having complied with budgetary regulations in an earlier phase. This may reduce the risk of moral hazard, but does not fully exclude it (see Chapter 4). At the same time, the chances of transfers being conducted under great political pressure, even when such compliance is lacking, remains. The fund would grant transfers more regularly, not only in cases of large shocks. Under this mechanism, the Netherlands would also have received a transfer, in 2004 and 2005 (see Figure 6.1).

[24] See Riel, B. van and M. Bos, 2018, Het financieel instrumentarium van een begrotingsunie in wording [the financial instruments of a budgetary union in the making (in Dutch)], *ESB*, vol 103(4764): 356–358 (link).
[25] See footnote 24.

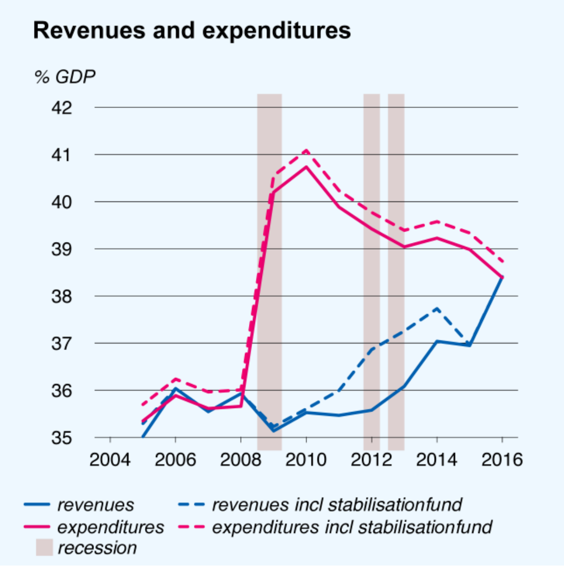
6 How effective would a stabilisation mechanism have been during the last crisis?

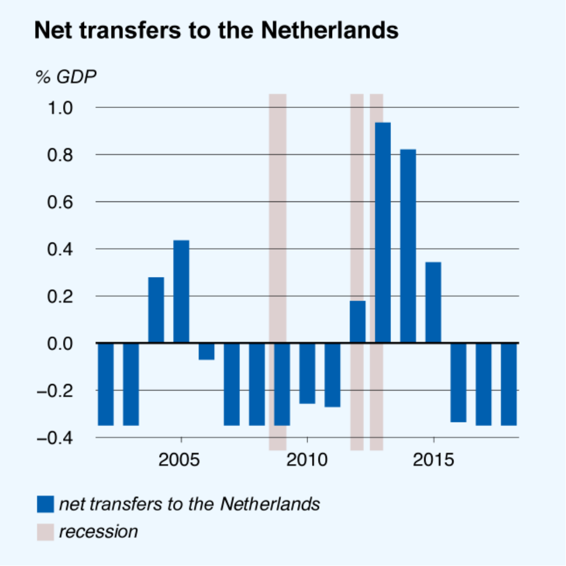
We constructed a simple approach to transfers from a budgetary stabilisation mechanism, following the IMF proposal (see text box), where countries that experience a 1 percentage point higher unemployment than the seven-year average would receive a transfer of 0.5% of GDP. In 2010, unemployment in Spain was 20%, while the average over the seven previous years had been 11%. Spain, under this mechanism, would have been entitled to receive a transfer of 0.5% of GDP times this difference (i.e. 4.5%). We did not look at whether all countries would have been in compliance with the SGP requirements. In addition, increased government spending would also have caused a smaller increase in unemployment during the crisis. This would have had an impact on transfers from the stabilisation fund, as those would be dependent on the level of unemployment. Taking also these second-order effects into account would require a complete macroeconomic calculation, and an analysis of the impact on consumption, production and unemployment would also require elaborate model calculations—which were outside the scope of this Policy Brief.

Transfers from the budgetary stabilisation mechanism as proposed by the IMF would have had only a limited impact during the credit crisis in the Netherlands. The crisis has caused a permanent loss in GDP, which led to an increase in the expenditure share. Once the credit crisis started, the Netherlands proceeded to implement austerity and reform measures in order to reduce the budget deficit. Transfers from the budgetary stabilisation mechanism would hardly have changed this policy (Figure 6.1, on the left). It took some time before unemployment started to increase in the Netherlands, which is why a first net transfer from the fund would not have occurred until in 2012 (Figure 6.1, on the right).

For the euro zone, transfers from the budgetary stabilisation fund, generally, would have been made shortly after the onset of the financial crisis. The first net transfers would have occurred in 2009 and continued to 2014. This shows that withdrawals from the fund would have continued up to the lowest point of the euro crisis, which seems to imply that a budgetary stabilisation mechanism for the euro zone would have an anti-cyclical character. However, the European financial crisis began over the course of 2008, while net transfers did not start until in 2009 (Figure 6.2, on the left). Therefore, we cannot rule out that, under this mechanism, net transfers would start too late for the euro zone to mitigate the shock of a crisis. Moreover, the volume of the transfers would have been so large that the fund's capital would have been negative after 2012 (Figure 6.2, on the right). The fund, thus, would have needed to borrow money itself, for instance on financial markets. Therefore, this shows that Member States would be required to guarantee those loans and would need to step in when the fund would be unable to service its loans.

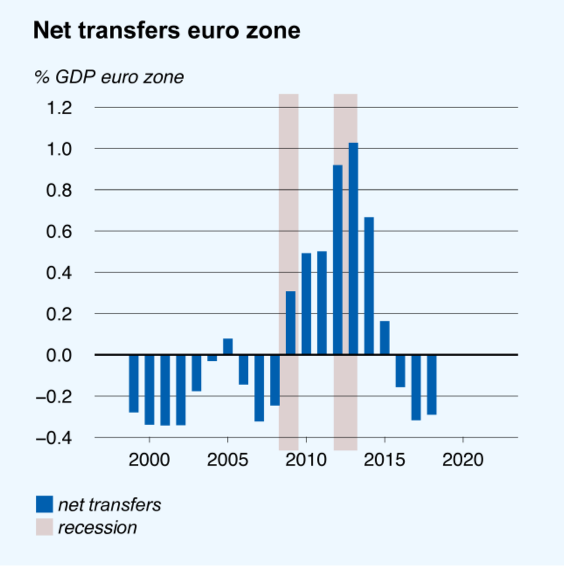
Figure 6.1 Consequences of a budgetary stabilisation mechanism for Dutch public finances

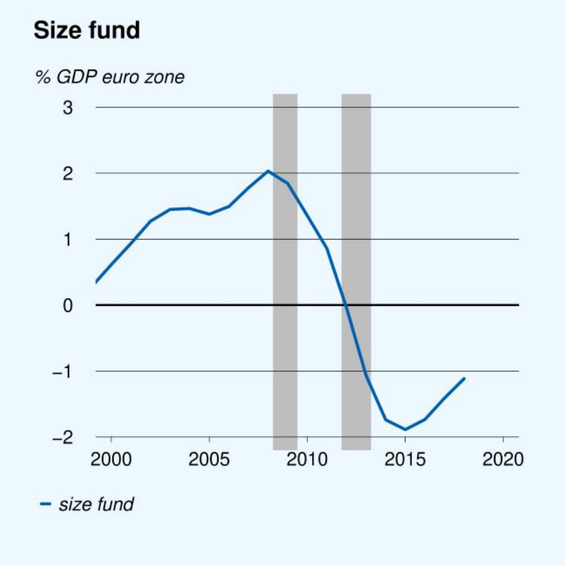




Source: CPB. Recessions are indicated in grey.

Figure 6.2 Net transfers from stability fund for the euro zone (left), capital of the fund would become negative (right)

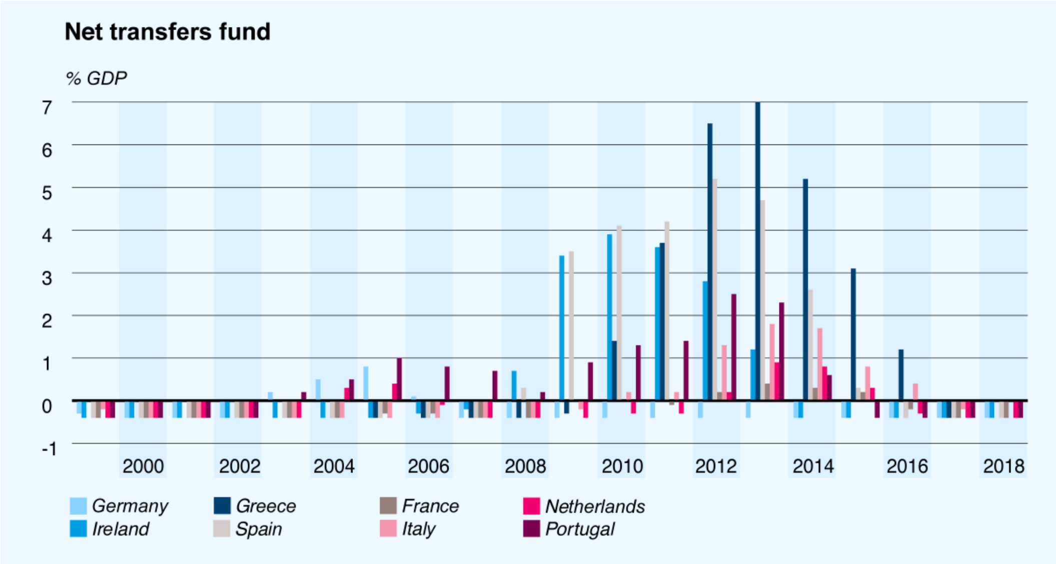




Source: Ameco; CPB. Recessions are indicated in grey. The fund is assumed to achieve a nominal return of 3%.

The budgetary stabilisation mechanism would work well for certain Member States, while for others, transfers would come far too late. During the financial crisis, Spain and Ireland would have been net recipients. For other countries, such as Germany and the Netherlands, transfers would have come either too late or not at all. Although, following the onset of the financial crisis, both countries showed a substantial downturn and deterioration of the balance, this did not translate into a strong increase in unemployment. The Netherlands would not have received the first net transfer until in 2012, and Germany would have received nothing (Figure 6.3). This could be considered a design failure, as there would be no support for countries that, in times of large shocks, implement national policy to prevent immediate increases in unemployment. The scheme would also punish those that are more flexible in the intensive margin than in the extensive margin. After all, in those countries, adjustments more often are made within companies rather than by allowing unemployment levels to increase.

Figure 6.3 Net transfers from the budgetary stabilisation fund



Source: Ameco; CPB.