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Ten lessons from a decade of debating EUBS

Robust findings, popular myths and remaining dilemmas

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Ten lessons from the EUBS debate

Robust Results

Insurance through markets in the euro-area did not work well

Fiscal rules were not sufficient to prevent pro-cyclical fiscal policies

Shocks can be so large that self-insurance might not be sufficient

Transfer systems based on output gap estimates are questionable

„Equivalent“ systems are easier to implement

Popular Myths

In federal systems, fiscal stabilization is small

If we had more cross-border migration, we would not need a transfer system

Stabilization through EUBS is negligible

Remaining Dilemmas

Equivalent system might not stabilize as hoped

Compromise solutions might limit benefits of EUBS

Insurance through markets in the euro-area did not work well

- Basic idea: Risk sharing through markets
 - Households' portfolios are diversified
 - Agents borrow internationally in the wake of asymmetric shocks
- Reality during the crisis of 2008/9 and the euro crisis
 - Households' portfolios were not diversified
 - Private sector had borrowed pro-cyclically before the shock and had to reduce borrowing when crisis hit
 - Banks actually cut back cross-border exposure during crisis

Fiscal rules were not sufficient to prevent pro-cyclical fiscal policies

- Basic idea: Fiscal rules would make sure that countries have enough room for manoeuvre if a crisis hits
 - Stability and Growth Pact prior to crisis: Medium-term objective of balanced budget + 3-percent-rule
- Reality: Countries ran pro-cyclical expansionary fiscal policies and could not strongly react after euro crisis hit
 - Partly because of SGP had been ignored
 - Partly because SGP was asymmetric
 - Partly because output gap measures misestimated cycle

Shocks can be so large that self-insurance might not be sufficient

- Original hope: In a deep crisis, governments can borrow in international financial markets what they need to counter shocks
- Reality: Shocks in some cases proved too large and investors got scared
 - Ireland and Spain
 - Budget surpluses and low debt-to-GDP ratios prior to the crisis
 - Banking crises pushed debt levels and deficits up
 - Investors feared default and demanded higher risk premia

Transfer systems based on output gap estimates are questionable

- Some proposals for transfer mechanisms were based on output gaps (e.g. CSI by Enderlein et al. 2012)
- Lessons learned:
 - Output gap estimates are inherently unreliable
 - Transfer payments based on output gaps would lack political legitimacy
 - Transfer payments based on output gaps might actually *destabilize* economic cycles

„Equivalent“ systems are easier to implement

- Original proposals on EUBS were for a „genuine“ system (with individual insurance claims)
- Lessons learnt:
 - Legally and technically, these genuine systems are very difficult to implement
 - As a consequence, „equivalent“ systems might also be politically more realistic

QUESTIONABLE: In other federal systems, fiscal stabilization is small (I)

- Core reference: Asdrubali et al. (1996) claim: In the U.S., federal government only stabilizes minor part of asymmetric shocks:
 - Government 13 percent
 - Credit markets 23 percent
 - Capital markets 39 percent
 - Unsmoothed 25 percent

QUESTIONABLE: In other federal systems, fiscal stabilization is small (II)

- Problem I: Methodology systematically understates role of the government (Dullien 2016)
 - Effects of direct federal spending is ignored
 - Discretionary (and semi-automatic) measures are effectively taken out (by time dummies)
- Problem II: Methodology systematically overstates role of markets (Dullien 2016)
 - Smoothing of dividend flows is counted as „cross-border risk-sharing by capital markets“, even if no cross-border transaction is involved
 - If households adjust their consumption by less than the fall in income, this is called „cross-border risk-sharing by credit markets“ even though this could happen in a closed economy likewise

QUESTIONABLE: In other federal systems, fiscal stabilization is small (III)

- Hence: Asdrubali et al. (1996) probably strongly underestimates the role of U.S. federal government in shock absorption!
 - EUBS potentially much more important
 - Hopes for significant stabilization by capital markets union probably overdone

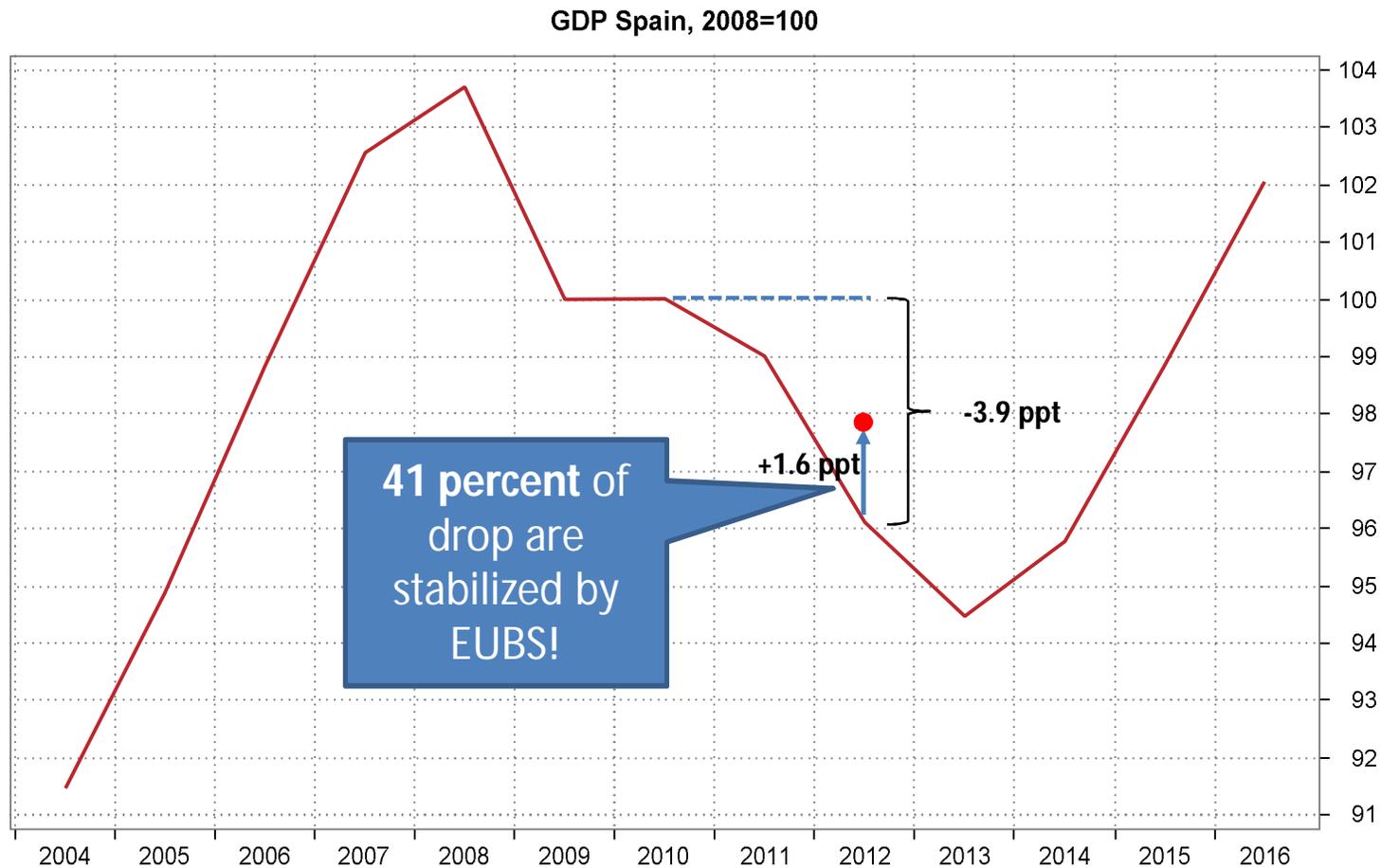
QUESTIONABLE: With more cross-border migration, transfer system would not be needed

- Claim: If Europeans migrated more between countries, transfer system would not be needed
- Problem: There can be excessive migration
 - With different languages and different cultural norms, human capital can be destroyed by migration
 - Does a former Spanish bank teller find a good job in Germany?
 - Migration should only be a reaction to *permanent* shocks
 - Huge waves of migration might cause political backlashes

QUESTIONABLE: Stabilization through EUBS is negligible

- Often, potential EUBS benefits are reported as change in GDP relative to baseline, sometimes even over the cycle
- Yet, what is most relevant is **marginal stabilization in a deep recession**
 - Impact here can be sizable
 - Example: CEPS EUBS study, Spain in 2012
- Plus: Simple measures neglect non-linearities
 - Investor confidence
 - Political dynamics (populists!)

QUESTIONABLE: Stabilization through EUBS is negligible



Source: **Macrobond**

Equivalent system might not stabilize as hoped

- For equivalent systems, it is still questionable if they stabilize as hoped
- Interaction with European semester is difficult
 - Budgets are usually prepared in September
 - With a certain forecast for the unemployed
 - Funds will be disbursed only with a delay
 - Trigger mechanism makes it difficult to predict pay-outs
 - Chances are that national governments do not spend funds
- Despite all other problems, problem does not exist in genuine systems

Compromise solutions might limit benefits of EUBS

- Some proposals try hard to defuse Northern European (German) fears
 - Limits for payouts, both time-wise and volume-wise
 - National compartments
- These features seriously limit stabilization impact of scheme

Conclusions

- Overall, one can be amazed how much progress the idea of an EUBS has made
- Interestingly, there even seems to be some political movement
- However, one needs to hope that political compromise does not reduce the idea to ineffectiveness