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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

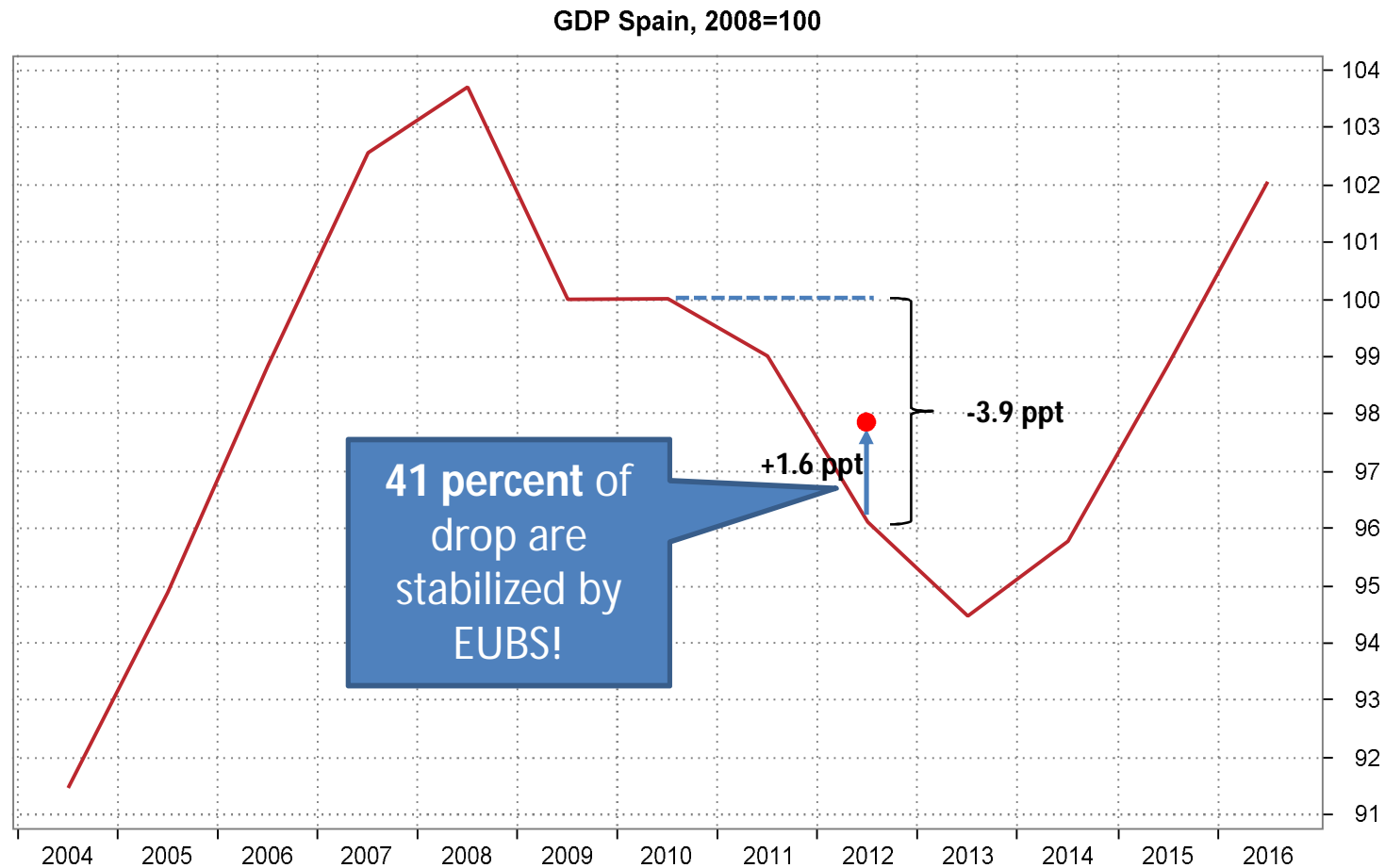
# QUESTIONABLE: With more cross-border migration, transfer system would not be needed

- 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