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A Cyclical Transfer Mechanism as a Stabilization Tool in the EMU

Kerstin Bernoth and Philipp Engler

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1 Motivation

- The European Monetary Union (EMU) is a unique currency area:
  - EMU member states have committed to a common monetary policy.
  - Fiscal policy remains in the responsibility of the individual governments.
- To date, no other group of countries has attempted to reach such high levels of monetary integration without fiscal and/or political centralization.
- A monetary union certainly has benefits, however, it also comes at some not negligible costs:

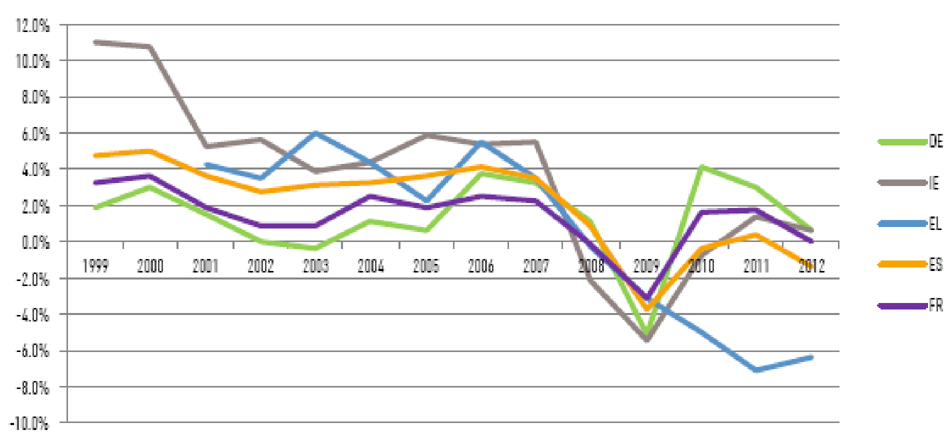
  ⇒Monetary and exchange rate policy cannot be used as a stabilizing tool in the event of asymmetric shocks in the individual member states.

1 Motivation

- Another consequence of the common currency: Business cycle divergence among EMU countries even get exacerbated in the presence of a-symmetric shocks:
  - Single monetary policy is oriented to average inflation and economic development in the currency area.
  - As a consequence, monetary policy is too restrictive for a country in economic downturns, but too expansive for countries in a more favorable economic situation.

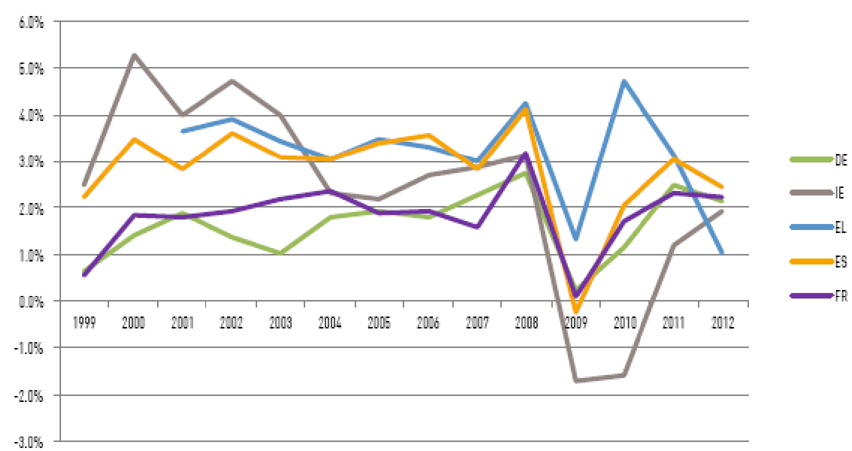
- And indeed, EMU countries certainly faced a-symmetric shocks in the past and business cycles and inflation developments are quite heterogenous:

FIGURE 1B ► Real GDP growth in selected Eurozone countries, 1999-2012



Source: AMECO February 2013

FIGURE 2b ► Inflation (HICP) in selected Eurozone countries, 1999-2012



Source: AMECO February 2013

2 Alternative Stabilization Tool in a Monetary Union

- Factor mobility (capital, labour, goods) alone is unlikely to achieve the desirable levels of cyclical stabilization.
- Thus, as already suggested in the literature on the `Optimal Currency Area' (Mundell (1961), McKinnon (1963), Kenen (1969)):

  ⇒ As long as European markets are not fully integrated, EMU needs alternative shock-absorbing instruments that dampens the effect of asymmetric business cycle shocks on an individual country level.

2 Alternative Stabilization Tool in a Monetary Union

Obvious candidate: National Fiscal policy.

- Idea: Governments should follows a counter-cyclical fiscal policy to stabilize economic fluctuations of a country: Accrue surpluses in booms, and borrow in downturns.
- However, experience of recent years shows that national fiscal policy does not fulfill this function sufficiently:
  - Due to lack of fiscal discipline and/or as a result of the financial crisis, governments debt has piled up and countries have no room for (fiscal) maneuver.

  $\Longrightarrow$ Most countries have to pursue pro-cyclical fiscal policies that amplify rather than dampen business cycles.

3 A Cyclical Transfer Mechanism as Stabilization Tool

Additional stabilization instrument within a monetary union possible:

- Introduction of a international insurance system against asymmetric cyclical income fluctuations.
- Basic idea:
    - If a country is in a favorable <u>cyclical</u> economic situation compared to the average of the euro area, it receives net payments from a compensations scheme.
    - If a country has an unfavorable <u>cyclical</u> climate compared to other member states, it is a net recipient: it receives more transfer payments than it pays into the system.

3 A Cyclical Transfer Mechanism as Stabilization Tool

- Goal of such compensation payments is to balance out business cycles.
- The goal is **not** to achieve a balance of income and general living standards among EMU member states.
- In a purely cyclical transfer mechanism:

  → Each country would be both recipient and donor over the entire business cycle; no permanent transfers in one direction.

- Engler and Voigts (2013) show that the introduction of a simple transfer mechanism can be as effective as if the countries were pursuing a national monetary policy.
- Enderlein et al. (2013) find that the average deviation from the euro area business cycle would have decreased by around 15-40% for the period 1999-2014.

3 A Cyclical Transfer Mechanism as Stabilization Tool

- In most monetary unions embedded into a federal state, i.e. the USA or Germany, cross-country insurance scheme exists.
- In the USA, any shortfall of income in a state is compensated by transfers that amount to between 10 and 40 per cent of the loss: insurance against asymmetric shocks.
- In EMU there is no such system.
- The EU budget is small, just 1% of GDP, which is spend on: Commission's operating expenses, Common Agricultural Policy and the Structural Fund's that supports the poorer regions.

4 Implementation of a compensatory payment mechanism

- To be effective and also implementable, the cyclical insurance scheme should fulfill the following characteristics:
  - Payments should be transferred quickly and on time to serve their stabilizing and synchronizing purposes.
  - The payment mechanism should be governed by rules to prevent arbitrary political decisions and to increase transparency.
  - The compensatory mechanism should be oriented to cyclical fluctuations.
  - The transfer mechanism should be accompanied by strong fiscal rules: such a system should not replace a sound economic and budgetary policy.
  - Participation in a compensation system should be subject to conditions such as structural reforms.

4 Implementation of a compensatory payment mechanism

- Such a system could be implemented in different ways (von Hagen and Wyplosz (2007) for details):

  a) A direct fiscal transfer payment:

  - Countries would pay a small fraction of their tax revenues, which is closely linked to the business cycle (i.e. VAT) into a joint European fund.
  - These payments would be redistributed to the individual member states in relation to per-capita potential growth.

  ⇒ Counter-cyclical fiscal policy without burdening national budgets.

  ⇒ The more synchronous the economic cycles of the member states, the fewer payments are made.

4 Implementation of a compensatory payment mechanism

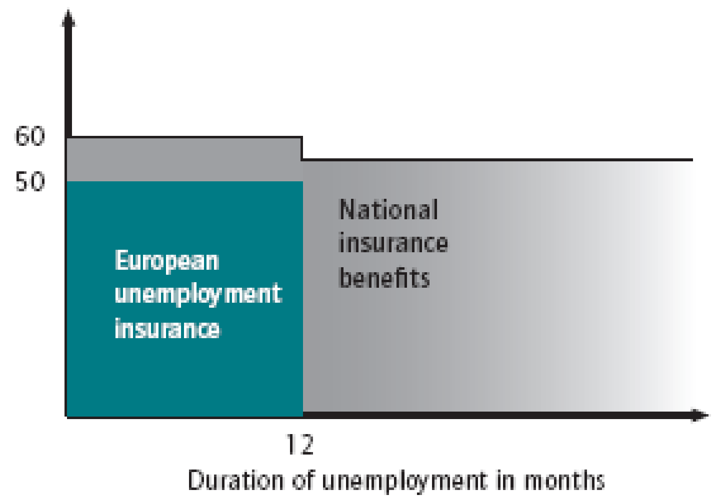
b) A indirect transfer mechanism: Introduction of a European unemployment insurance scheme parallel to the national insurance system:

- Employees pay a part of their wages into a European Unemployment insurance.
- In the event of unemployment, their receive compensation payments from the fund (plus national payments)
- Only short-term unemployment will be covered by limiting the duration of payments to address cyclical element of unemployment.

Implementation of a compensatory payment mechanism

- Example in case of fifty-percent wage compensation over a period of one year:

Diagram of a European Unemployment Insurance System
As a percentage of previous income



Source: the authors.

4 Structure of a compensatory payment mechanism

Advantage of an European unemployment insurance compared to the direct transfer mechanism:

- Factors determining the transfers are set quickly and automatically.
- Less scope for arbitrary political decisions.
- Aggregated demand is affected quickly, since not governments receive transfers, but private households.
- Such a system could be introduced without imposing additional burden on labour market costs, since new insurance would partly replace existing national system.
- Bureaucratic burden could be kept to a minimum by processing the European unemployment insurance via existing national security institutions.

4 Structure of a compensatory payment mechanism

- Compensatory payment mechanism cannot replace sound economic and budgetary policy, since they should be complementary to national counter-cyclical fiscal policy.

- To minimize risks that a cyclical compensatory scheme changes incentives for regional governments to protect their citizens against income fluctuation

  ⟹ Participation in the Cyclical Transfer Mechanism should be made conditional on e.g. labor market reforms or compliance with fiscal policy rules.

5 Conclusions

- The introduction of a European Cyclical Transfer Mechanism could be an important instrument to facilitate the single monetary policy of the ECB.
- Cyclical Transfer system is not intended to redistribute tax revenues or debt burden across countries.

  ⇒ Fiscal discipline and sufficient level of competitiveness still of importance for stability of the euro area.
- This mechanism is not an instrument to solve to current crisis in the euro area, but it could provide more stability to EMU in the medium and long run.