EUROZONE: A FISCAL BUFFER THAT EVEN GERMANY MIGHT ACCEPT?

Berenberg Macro Flash

In theory, the Eurozone could benefit from fiscal buffers to soften blows to the region as a whole and to cushion asymmetric shocks that hit individual member countries hard. In practice, proposals for such buffers have come almost to naught for two major reasons. First, they might have automatically and permanently transferred money from stronger to weaker member countries through the back door. This has turned out to be politically unacceptable. Second, such buffers could have rewarded weaker member countries for pursuing bad policies. That would have been counterproductive.

In her speech to the European Parliament, Ursula von der Leyen yesterday argued for a European Unemployment Benefit Reinsurance Scheme. If designed well, such a scheme could become a fiscal buffer that works without permanent transfers and without setting the wrong incentives (no “moral hazard”). In recent years, proposals for such a scheme have been discussed even within Germany’s centre-right CDU. Because of objections from the conservative wing, the idea did not get very far within the CDU. Von der Leyen hails from the CDU. Her very prominent support for such a scheme now creates an opportunity to discuss its merits within the CDU/CSU again. As the German centre-left (SPD and Greens) is in favour anyway, it is at least conceivable that Berlin may finally endorse such a proposal for a significant Eurozone reform. At the margin, it could even reduce slightly the risk that the badly battered SPD walks out of the German government and brings down Chancellor Angela Merkel in the process.

ELEMENTS OF A COMMON UNEMPLOYMENT REINSURANCE

How could a well-designed Eurozone unemployment reinsurance scheme work?

- In normal times, each country pays an amount of, say, 0.2% of its GDP into a common fund every year until its cumulative contribution has reached a limit of, say, 2% of its GDP.
- In bad times, that is when the European Commission projects a rise in the country’s unemployment rate by, say, 0.5 percentage point or more beyond the average of the last three years, the country can draw on its contribution to the scheme.
- If a country has exhausted its own contribution, it can receive a credit from the fund with an interest rate slightly above the 5-year funding costs of the European Stability Mechanism (or of the scheme’s own funding costs if the fund is itself borrowing on the market). The maximum credit would be capped at, say, 3% of a country’s GDP.
- One year after the rise in the unemployment rate has stopped, the country no longer receives funds.
- Two years after the rise in the unemployment rate has stopped, the country starts to pay in again into the scheme until it has repaid any credit it may have received and replenished its cumulative contribution.
- Contributions to the scheme count as normal government expenditure under Maastricht rules, receipts from the scheme count as normal government income under these rules.
- Payouts from the scheme to the budget of an eligible country are calculated according to a common rule such as the rise in the number of unemployed times 0.3 the country’s average
wage per employee, potentially rising to a factor of 0.5 in case of extreme surges in unemploy-ment.
• Tighter payout-rules would apply for a phase-in period unless a country has made a signifi-
cant one-off upfront contribution beyond its standard annual contribution beforehand.

The fund would work as a fiscal buffer. In normal or good times, countries would have to run a
slightly tighter fiscal policy to meet the Maastricht rules until their cumulative contribution to the
scheme has reached the agreed ceiling. In bad times, countries could pursue a looser fiscal policy
than otherwise as they could draw on the unemployment reinsurance scheme to partly cover the
cost of rising unemployment.

The scheme would not reward bad policies in any significant way. Misguided labour market poli-
cies show up in a higher average rate of unemployment. However, the fund only steps in to cush-
ion abrupt rises in unemployment which are typically caused by a sudden drop in demand rather
than by bad labour market policies. The scheme would also not be an instrument for significant
permanent transfers from, say, Germany or the Netherlands, to countries on the periphery. Ger-
many and the Netherlands would have been among the recipients of funds in previous reces-
sions. Also, all receipts from the scheme have to be paid back on a fixed scale through a country’s
annual contributions to the fund in normal times.

Only a tiny element could potentially be deemed a “transfer” from stronger to weaker Eurozone
members: countries that receive a credit from the scheme would do so at an interest rate that may
be below their own funding costs. However, the “transfer” element in this is marginal. In many
cases, the fund itself would not even have to borrow as it can use the sum of all paid-in contribu-
tions to extend credit to some members hit by an asymmetric shock. And if the scheme has to
borrow, the extra issuance of bonds by a joint institution would probably drive up the funding
costs of those countries who are not receiving payouts from the scheme only very marginally.

IS IT REALISTIC? IT WILL BE AN UPHILL STRUGGLE
Whether or not Germany will agree to a Eurozone unemployment reinsurance scheme is a very
open question. In a knee-jerk reaction, many German conservatives are inclined to reject any
scheme that seems to “mutualise” the cost of unemployment before even looking at the merits of
the proposal. The discussion often fails to distinguish between a much more problematic com-
mon unemployment insurance and re-insurance schemes such as the one presented above. Von
der Leyen’s influence within the CDU/CSU is also quite limited. Still, that she has put the proposal
forward as part of her high-profile agenda for the European Union can encourage other CDU
members to restart a discussion that will be more difficult to brush off than before. While we
would not bet too much on it, we do see at least a chance that Germany could come round to the
idea. German support for a well-designed scheme could also have a fringe benefit for Merkel. Her
coalition partner, the SPD, is in favour. Finance Minister Olaf Scholz and his chief economist
Jakob von Weizsäcker are authors of a variant of such a proposal, drawing on the work of German
academic Sebastian Dullien. Relative to other concessions which Merkel may have to make in or-
der to keep the SPD on board, this should be an easy one. And unlike some other SPD policy ideas, such a scheme would make sense instead of costing money or creating economic distortions.