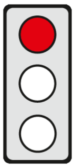
STABILISATION FUNCTION

cep**PolicyBrief** No. 2018-04

KEY ISSUES

Objective of the Communication: A European "stabilisation function" - consisting of ESM loans, loans from the EU budget, grant support and an "insurance mechanism" - will protect Member States, and particularly eurozone countries, from the consequences of an economic shock.

Affected parties: All citizens and politicians.



Pro: The stabilisation function may reduce the risk of a Member State having to apply for an ESM loan.

Contra: (1) The stabilisation function weakens the only effective incentive for a sound fiscal policy - the fear of a reform programme linked to ESM loans.

(2) Payments from the stabilisation function may delay necessary structural reforms. Not permitting such payments to be linked to a reform programme, is therefore entirely ill-conceived.

(3) The explicit ban on linking payments from the stabilisation function – such as ESM loans – to reform conditions, undermines the basic principle of the ESM that ESM loans are only issued under strict conditions: No state will subject itself to an ESM reform programme if it can obtain enough money without making reform commitments.

The most important passages in the text are indicated by a line in the margin

CONTENT

Title

Communication COM(2017) 822 of 6 December 2017: **New budgetary instruments** for a stable euro area within the Union framework; **stabilisation function**

Brief Summary

► **Context and objectives**
- The general rule is:
  - When a state is affected by an economic shock - such as the bursting of a property bubble - the national central bank may rely on monetary-policy instruments - such as interest rate reduction or currency devaluation - in order to stabilise macroeconomic demand.
  - In addition, in order to stabilise demand, the government should keep public expenditure at a constant level. This generally results in a significant rise in the public deficit because, as a result of the shock, tax income falls (p. 4).
- However, in the particular case of the eurozone, the rule is:
  - When an individual eurozone country is affected by a shock, its central bank cannot take counter measures to stabilise demand based on monetary policy (p. 4) because that is the responsibility of the European Central Bank (ECB). The ECB bases its monetary policy on developments in the whole eurozone. Overcoming shocks therefore takes longer than in countries with their own currency. This means:
    - A eurozone country that is affected by a shock and whose government keeps public expenditure constant, has to finance its expenditure by way of loans for a much longer period than a country with its own currency.
- In some eurozone countries affected by a shock, public deficits rose sharply. This led to doubts about their solvency (p. 4) and they had to apply for financial assistance.
- A "stabilisation function" aims to prevent this in the future.
  - It was first proposed in the Five Presidents Report of June 2015 (see cep**PolicyBrief** 2015-22) and in the reflection paper on the deepening of the economic and monetary union of May 2017 (see cep**Input** 2017-06).
  - This Communication consolidates the proposal. The Commission wants to submit a detailed proposal in May 2018 within the framework of the EU Multiannual Financial Framework post 2020, which is to be newly agreed. The stabilisation function will be established as from 2021.
- In the Communication, in addition to setting up a stabilisation function, the Commission suggests:
  - financial [COM(2017) 826; cep**PolicyBrief** to follow] as well as "greater technical" [COM(2017) 825] support for eurozone and non-eurozone countries in the implementation of structural reforms,
  - a "convergence facility" to support non-eurozone countries with introducing the euro [COM(2017) 822] and
  - a backstop for the European Bank Resolution Fund [COM(2017) 827; cep**PolicyBrief** to follow].

Authors: Dr. Matthias Kullas and Till Brombach | kullas@cep.eu
cep | Kaiser-Joseph-Strasse 266 | 79098 Freiburg | Telephone +49 (0)761 38693-107 | www.cep.eu

- **Basic principles of the stabilisation function**
  - "Participants" in the stabilisation function are all eurozone countries and – voluntarily – other Member States.
  - The stabilisation function aims to reduce the risk of a Member State having to apply for loans from the European Stability Mechanism (ESM) or the European Monetary Fund (EMF) – which the ESM is to be converted into until the stabilisation function has been established [COM(2017) 827] (p. 14).
  - In this regard, the stabilisation function will
    - provide an incentive for a sound fiscal policy in the participating states and
    - support states affected by a shock, with financing public investment projects which are "already planned", so as to maintain the investment level.
  - The stabilisation function will be able to make net payments of 1% of the GDP of the eurozone countries in order to enable effective support at all times (p. 14).
  - The stabilisation function will not result in permanent transfers between Member States (p. 14). It is to be designed in such a way that all Member States have the same chance of benefiting from the function (p. 14).
  - It will be administered by the Commission.

- **Requirements for benefiting from the support provided by the function**
  - A Member State can receive support from the stabilisation function if
    - national stabilisation measures - such as constant public expenditure - are insufficient to overcome the shock (p. 13),
    - previously defined thresholds – such as the fall in "investment" or rise in unemployment – are exceeded (p. 14) and
    - the Member State complied with EU fiscal and economic requirements prior to the shock (p. 14).
  - Further conditions – such as the agreement of a reform program – are not allowed to be attached to access to the stabilisation function.

- **Three instruments of the stabilisation function**
  - The stabilisation function will consist of three instruments which can be enlisted by a Member State that is affected by a shock.
  - **Instrument 1: Loans**
    - The Member State affected by a shock receives loans from the EU and/or the EMF.
      - Loans from the EU will be counter-financed by the EU itself, which will take out loans that are guaranteed by the EU budget.
      - The Multiannual Financial Framework post 2020 will allow for limited borrowing by the EU which, depending on the extent, would require an increase in the ceiling on own resources – the maximum amount that EU revenue can reach.
      - Loans from the EMF may take the form of ordinary loans or precautionary credit lines.
    - Member States must repay loans received.
  - **Instrument 2: Non-repayable grant support from the Structural and Investment Fund**
    - The Member State affected by a shock receives grant support from the European Structural and Investment Fund (ESI Fund). This fund provides resources to strengthen economic, social and territorial cohesion in the EU.
    - Budgetary lines will be set up for this in the ESI fund. The relevant resources will feed every year into the stabilisation function in order to build up its capital.
    - Setting up the budgetary line will not result in a reduction of the resources currently contained in the ESI and intended for other purposes.
  - **Instrument 3: "Insurance mechanism"**
    - An "insurance mechanism" outside the EU budget "complements" the grant support "over time".
    - The participating Member States voluntarily pay an annual contribution to the insurance mechanism or agree on another method of financing.

- **Additional stabilisation measures**
  - In addition to establishing the stabilisation function, the Commission is considering further measures, in particular the deployment of EU funds. These include
    - a temporary increase in the EU co-financing rate for project support by the ESI fund,
    - advancing payments from EU funds - such as from the ESI fund -,
    - the enhancement of existing instruments under the EU budget with a stabilisation effect.

Policy Context

The Communication serves to implement the Roadmap for deepening economic and monetary union of 6 December 2017 [COM(2017) 821]. The Roadmap provides for completion of the economic and monetary union by 2025 and, for this purpose, also contains the establishment of a European monetary fund [COM(2017) 827; cep**PolicyBrief** to follow], the transposition of the European Fiscal Compact into EU law [COM(2017) 824] and the creation of an EU Finance Minister [COM(2017) 823; cep**PolicyBrief** to follow].

Options for Influencing the Political Process

Directorates General:	General Secretariat
Committees of the European Parliament:	Economy & Currency (leading) Rapporteur: TBA
Federal Ministries:	Finance (leading)
Committees of the German Bundestag:	TBA

ASSESSMENT

Economic Impact Assessment

The Commission's grounds for the introduction of a **stabilisation function are unconvincing.** Although eurozone countries do in fact take longer to overcome a shock than countries with their own currency, which results in greater pressure on the budgets of eurozone countries, that is no justification for the introduction of a stabilisation function. Instead, **eurozone countries should have such low levels of public debt and deficits** prior to the occurrence of a shock **that, in the event of a shock, they can assume high deficits** over a long period of time **without capital market players having doubts about their solvency.** In addition, eurozone countries in particular should have flexible labour markets because a high level of employee mobility as well as flexible wages and working hours substantially facilitate the ability to overcome shocks in a monetary union. The stabilisation function, however, weakens the incentive of Member States to create these conditions for overcoming economic shocks.

Although the stabilisation function reduces the risk of a state having to apply for an ESM loan, because in the event of a shock it will receive, financial support, **at the same time, it weakens the only effective incentive** so far found **for a sound fiscal policy – the fear of an adjustment programme linked to ESM loans.** The Commission's attempt to counteract this reduced incentive, by only allowing Member States access to the stabilisation function where they have previously complied with EU fiscal and economic requirements, is implausible because experience with the Stability and Growth Pact has shown a failure to apply such conditions due to political considerations. It is more likely that the already high level of pressure from some Member States, to relax the Stability and Growth Pact by way of the stabilisation function, will increase.

The fact that the stabilisation function can be claimed when certain thresholds are exceeded - the Commission names a drop in investments or a rise in unemployment - does, on one hand, allow Member States affected by a shock to benefit promptly from payments. On the other hand, however, this automatism means that Member States will also - automatically - receive financial support where the shock is caused by the Member State itself. Thus investment may fall where the country downgrades conditions for foreign investment or saves on public investment. A rise in unemployment is of limited use as an indicator because the unemployment rate is a lagging economic indicator. Due to employment protection regulations, its increase lags significantly behind the shock. In addition, it falls well after a shock has been overcome. Payments from the stabilisation function would therefore be made too late and for too long.

With these indicators, there is also the risk that payments from the stabilisation function will be made not only in the case of a shock but also because of structural distortions because structural distortions can also result in a drop in investment or a rise in unemployment thereby triggering payments from the stabilisation function. The stabilisation function is only appropriate - if at all - in the case of shocks. Structural distortions, on the other hand, can only be overcome by way of structural reforms. In this case, **payments from the stabilisation function can** even **delay necessary structural reforms. The fact that they are not permitted to be linked to a reform programme, is therefore entirely ill-conceived.** Such a programme should be obligatory at least in the case of structural distortions. Ensuring that necessary reforms are not left undone as a result of financial aid is precisely what the bail-out ban aims to do. If payments from the stabilisation function are also paid in the case of structural distortions, the bail-out ban will also be weakened.

The explicit ban on linking payments from the stabilisation function to reform conditions, undermines the basic principle of the ESM that ESM loans can only be issued under strict conditions. **No country will subject itself to an ESM reform programme** in order to obtain credit **if it can receive enough money without committing to reforms** by claiming that there has been a shock. Instead of creating a stabilisation function, the Commission should expand the existing possibilities for stabilising investment. Thus, especially for promoting investment, there is the European Investment Bank and the Fund for Strategic Investments, whose lending is being extended anyway.

Although the EU currently already has a very limited right to borrow, the plan to expand this to include economic policy measures enters a whole new dimension.

The proposal to increase the EU co-financing rate or prioritise EU funds where a Member State is affected by a shock, is appropriate.

Legal Assessment

Legislative Competency

The EU's competence to set up a stabilisation function arises solely from the flexibility clause, which requires the unanimity of the Member States (Art. 352 TFEU). The relevant requirements are fulfilled:
Firstly, the stabilisation function serves to stabilise the budgets and financial stability of Member States and thereby to achieve the objectives of the EU treaties, namely price stability and balanced economic growth (Art. 3 (3) TEU).
Secondly, it is also necessary for this - in the legal sense - because the existing coordination and supervision of economic and fiscal policy has not achieved this aim.
Thirdly, the stabilisation function has no "constitutional dimension" (CJEU, Opinion 2/94, para. 33 - 35), and thus does not require a treaty amendment (Art. 48 TFEU). Although the stabilisation function breaches the principle that general economic policy falls within the area of responsibility of the Member States, it does not limit the sovereignty of the Member States in the area of economic policy.
Fourthly, the stabilisation function cannot be based on another competence because it cannot be established as a new investment fund, under Art. 175 (3) TFEU, in the context of structural policy. This competence only permits the EU to take measures to strengthen EU economic, social and territorial cohesion (Art. 174 TFEU). Although attenuating the consequences of a macroeconomic shock may, under some circumstances, counteract future economic disparities between the Member States, reducing the existing divergence between the structurally weak regions and economically strong ones, is not one of the objectives of the stabilisation function specified by the Commission. The stabilisation function does indirectly promote balanced economic growth, but it does so in all Member States rather than targeted at the structurally weak regions. Although public investment in those regions may promote cohesion in the EU, it would only be as a side effect. Compliance with the Stability and Growth Pact as a requirement for access to the stabilisation function may also contradict the objectives of structural policy because, although effective incentives for a sound fiscal policy do promote economic growth in all Member States, the main aim of structural policy is to provide targeted support for structurally weak regions that generally have little influence on collective fiscal policy, rather than to provide collective financial stability. Making the latter a requirement for investment may, however, prevent the former.

Subsidiarity

Unproblematic.

Proportionality with respect to Member States

Unproblematic.

Compatibility with EU Law in other respects

The stabilisation function is not in breach of the "bailout ban", under which the EU cannot be liable for the liabilities of Member States (Art. 125 (1), sentence 1 TFEU) because, firstly, the stabilisation function only supports the implementation of public investments and not the settlement of the liabilities of Member States. Secondly, it applies where the economic situation in the Member States is starting to deteriorate and thus before the insolvency of a Member State becomes imminent. Thirdly, payments from the stabilisation function are to be linked to previous compliance with EU fiscal and economic policy rules.

Conclusion

The Commission's grounds for the introduction of a stabilisation function are unconvincing: Eurozone countries should have such low levels of public debt that, in the event of a shock, they can assume high deficits without capital market players having doubts about their solvency. Although the stabilisation function reduces the risk of a state having to apply for an ESM loan, at the same time, it weakens the only effective incentive for a sound fiscal policy – the fear of an adjustment programme linked to ESM loans. Payments from the stabilisation function may delay necessary structural reforms. The fact that they cannot be linked to a reform programme, is therefore entirely ill-conceived. The explicit ban on linking ESM loans to reform conditions, undermines the basic principle of the ESM: No state will subject itself to an ESM reform programme if it can obtain enough money without making reform commitments.

Authors: Dr. Matthias Kullas and Till Brombach | Telephone +49 (0)761 38693-107 | kullas@cep.eu