EMU ARCHITECTURE AND THE FUTURE OF RISK SHARING IN EUROPE

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OUTLINE

- [Main item] Future of risk-sharing in EMU
- Banking in EMU

Presentation based on chapter 10 of

I. MAASTRICHT APPROACH

A political project

1. Limited mobility of
   - labor
   - and (since the economic crisis) savings
2. Lack of a shared European budget and European debt

Bailouts are driven by

- *Economic externalities*: reduced trade, subsidiaries' and banks' exposures, run on other countries
- *Non-economic concerns*: empathy, jeopardy of European construction, distressed country's geo-political nuisance power

Implications

- Collateral damages of a country's default are de facto collateral for the country, which allows it to borrow more
- Very limited insurance pool

FOUR INSTITUTIONAL LIMITS

1. **Uniformity.** No magic number
   - fiscal capacity, which itself hinges on
     - the country's fiscal infrastructure
     - dominant political constituencies
   - rate of growth
   - debt maturity, legal jurisdiction, currency
   - feasible sanctions against defaulting countries
   - home bias

2. **Measurement issues** (despite recent reforms)
   - Guarantees given to social security system and public enterprises, unfunded pensions…
   - ECB guarantees, European Stability Mechanism

3. Implementability

- Pivotality
- Political agendas
- Expectation of quid pro quo

Necessary conditions

- Measurement: budget council should be European, independent and professional
- Capable of imposing prompt and corrective action

Financial sanctions not efficient $\Rightarrow$ other measures $\Rightarrow$ sovereignty issue.

4. The limits of solidarity

Distinguish between:

- Ex-post solidarity (bailouts)
- Ex-ante commitments to go beyond ex-post solidarity: automatic transfers, joint-and-several liability

Form of insurance

- Insurance agreements usually reached behind the veil of ignorance. Healthy countries have no incentive to go beyond ex-post solidarity (gains from insurance, but distressed countries have no means to compensate healthy ones for insurance)
- If more symmetric risks, joint liability may be optimal provided that country shocks are sufficiently independent. Hazard: domino effects (reduce borrowing relative to its maximal level under no joint liability)

II. FEDERALIST APPROACH

More risk-sharing

a) Eurobonds (or their variants, European safe assets)

b) Common budget, deposit insurance and unemployment insurance: automatic stabilizers.

TWO PREREQUISITES

1) *Transfer acceptability*

- Either systematic transfers must be fully assumed
- Or the insurance contract must be drawn behind the veil of ignorance

2) *Limited moral hazard*

Contrast

- Unemployment insurance
- Banking Union

BANKING

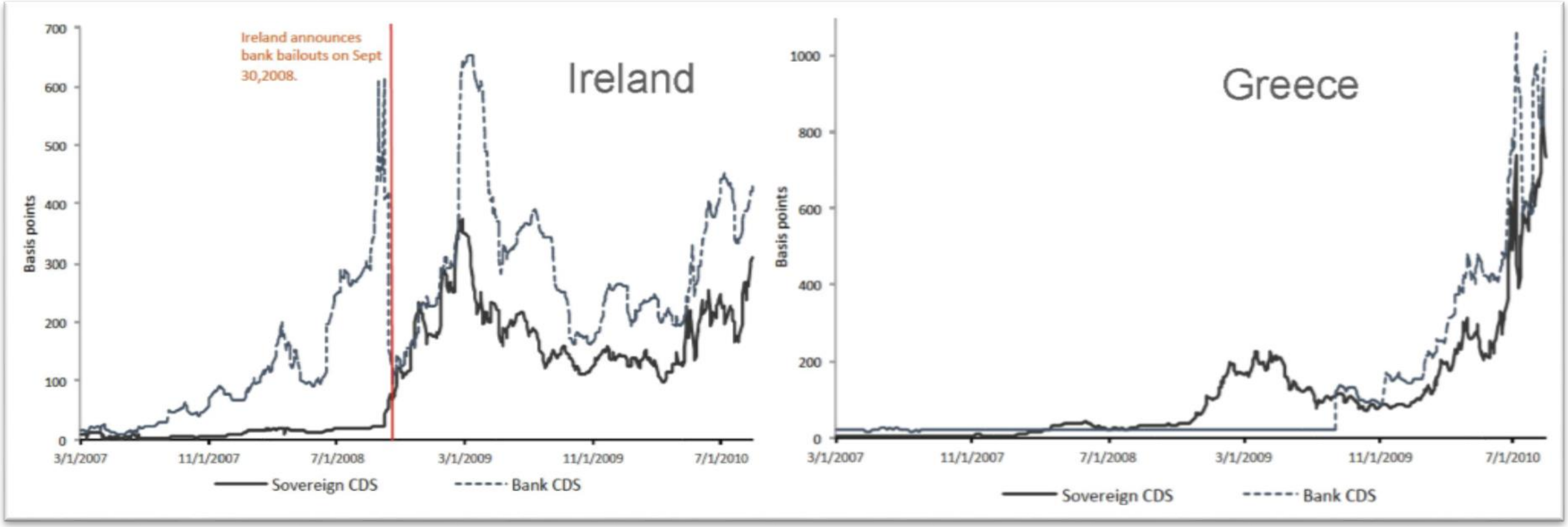
1) Progress
2) Shadow banking
3) Europe: doom loops
4) Financing a sustainable economy

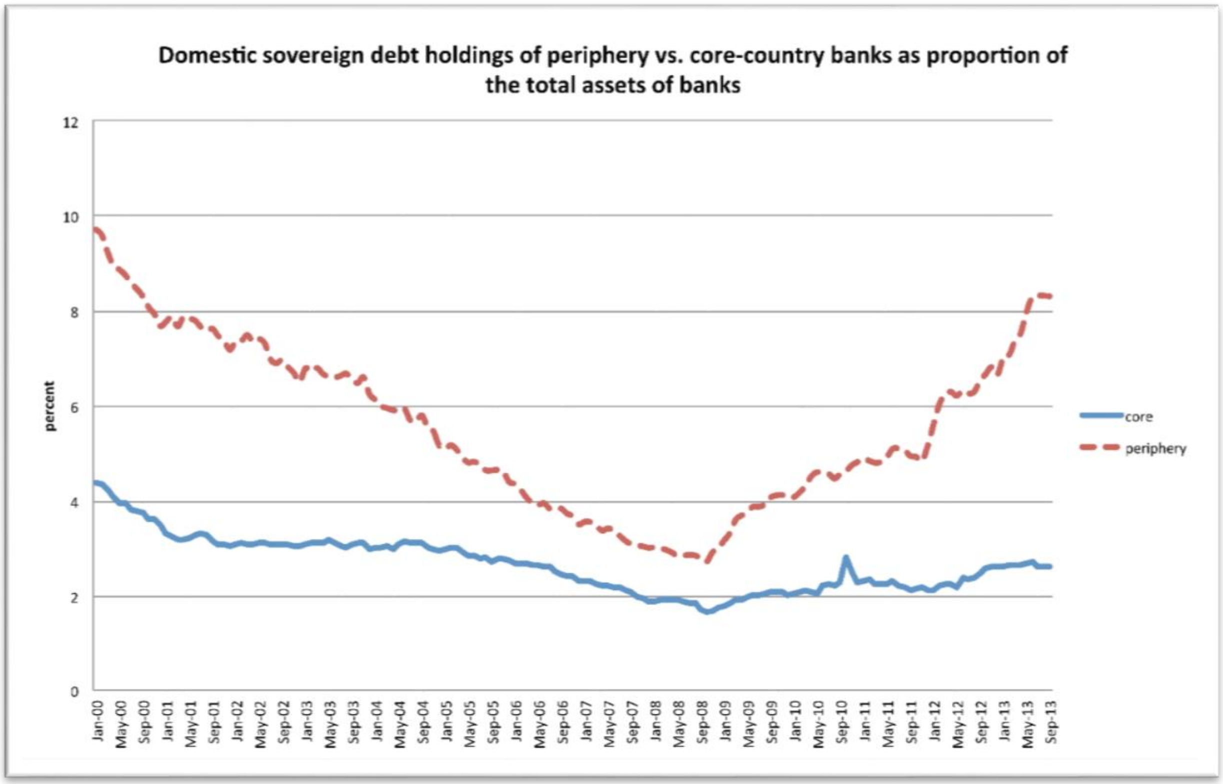
Doom loops

CONCLUDING REMARKS

- Rise of populism
- Sequencing of political and economic union
- We Europeans need to accept the loss of sovereignty that goes together with living under the same roof

THANK YOU FOR YOUR ATTENTION!





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