

# **Managing Financial Crisis: Where do we stand on Risk Sharing in the Euro Area?**

**Beatrice Weder di Mauro**

CEPR and INSEAD

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## Overview

What needs solving?

How to fix it ? (7+7) and the debate

Why is it so hard to agree?

## What to fix

1. Underdeveloped private and public risk-sharing (for a currency union)
  - Limited financial integration, lack of fiscal stabilization tools,
2. Amplification during crisis
  - Doom loop, runs for safe havens, procyclical fiscal
3. (An inefficient and politically divisive approach to maintaining fiscal discipline)
  - Based on fiscal rules that are error-prone, require micromanagement from Brussels, and are hard to enforce.

7+7 = ...



## Reconciling risk sharing with market discipline: A constructive approach to euro area reform

**Agnès Bénassy-Quéré**, Paris School of Economics and University of Paris I; **Markus Brunnermeier**, Princeton University; **Henrik Enderlein**, Hertie School of Governance and Jacques Delors Institute Berlin; **Emmanuel Farhi**, Harvard University; **Marcel Fratzscher**, DIW and Humboldt University Berlin; **Clemens Fuest**, Ifo Institute and University of Munich; **Pierre-Olivier Gourinchas**, University of California at Berkeley; **Philippe Martin**, Sciences Po, Paris and Conseil d'Analyse Économique; **Jean Pisani-Ferry**, Bruegel, EUI, Hertie School of Governance and Sciences Po; **Hélène Rey**, London Business School; **Isabel Schnabel**, University of Bonn and German Council of Economic Experts; **Nicolas Véron**, Bruegel and Peterson Institute for International Economics; **Beatrice Weder di Mauro**, INSEAD and University of Mainz; and **Jeromin Zettelmeyer**, Peterson Institute for International Economics<sup>1</sup>

## How to fix it - Core message: Need both

1. More and better risk sharing:
  - Uniform deposit insurance (EDIS)
  - Liquidity line at ESM for pre-qualified countries
  - “Safe asset” based on diversified sovereign debt portfolio
2. Greater role for market discipline
  - More credible no-bail-out rule
  - Breaking doom loop – disincentives for home bias
  - Incentives for fiscal discipline

## **More Insurance and Discipline are Complements: Reducing the Probability of Crisis**

Better pricing of sovereign risk

- + More stabilization against shocks


- + Larger liquidity buffers (for protection of innocent bystanders and prevention of runs)

Disincentives for concentration of sovereign risk in banks

- + Uniform deposit insurance (EDIS)

- + “Safe asset” based on diversified sovereign debt portfolio

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## Euro Area Reform

**Debate Moderator(s):** Jean Pisani-Ferry, Jeromin Zettelmeyer

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- **Vox Column:** [Panic-driven austerity in the Eurozone and its implications](#)

Some reactions to the report, and independent contributions that have already been published by leading economists:


[A Franco-German consensus on the euro?](#)  
By Martin Sandbu, 17 January 2018 in the Financial Times  
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## The Debate: Agree with Variations

Broad agreement

- need to reconcile risk sharing with market discipline

Some argue for wider focus

- need for European public goods,
- incentivize structural reforms

Disagreements on specific proposals

- ESBies versus other safe assets,



## **Disagree Type A: Need (much more) risk sharing**

On fiscal stabilization

- Need a capacity to borrow
- More stabilization tools

On redenomination risk and safe assets

- OMT
- Eurobonds

## **Disagree Type C: Don't like market discipline**

### On debt restructuring

- Principled opposition against debt restructuring
- Debt restructuring is seen as dangerous – Always
- Markets are mispricing – almost always

### On banking

- Need for banks as safety valves

## **Disagree Type B: Market discipline is conditionally counterproductive**

### Debt restructuring

- is destabilizing in high-debt countries

### On banking

- Need for banks as safety valves (given the limitations of
- Doubts about concentration charges

*Crozza : "A un passo dal burrone e fate i 'coglionas avec le scarpon'"*

Take legacy debt seriously



# Euro area reform: An anatomy of the debate

**Jean Pisani-Ferry**

**Mercator Senior Fellow, Bruegel; Tommaso Padoa-Schioppa chair, EUI;  
Professor of Economics, Hertie School and Sciences Po<sup>1</sup>**

The euro is nearly 20 years old – ten quiet years followed by ten tumultuous ones. The end of the first decade was marked by glowing, oddly uncritical reviews.<sup>2</sup> Ten years later, however, complacency has largely vanished from assessments of the state of the euro area and disagreements over its future remain unsolved. Already six years ago, the heads of the European institutions issued a blueprint for the future, the *Four Presidents' Report* of June 2012 (Van Rompuy *et al.*, 2012), and in a statement on 29 June 2012 the euro area heads of state agreed on “breaking the vicious circle between banks and sovereigns” by establishing a banking union.<sup>3</sup> Much has been done for sure, but the agenda endorsed

the launch of the European currency would mark the start of a journey and that further decisions on economic integration, financial policy, the creation of a fiscal capacity and the coordination of national policies would be needed down the road. But they assumed that participation in the euro would create momentum and help to tackle future issues. It is therefore striking that discussions have proved so difficult and that since the crisis erupted in 2010, so many decisions were only taken on the edge of the precipice.<sup>5</sup>

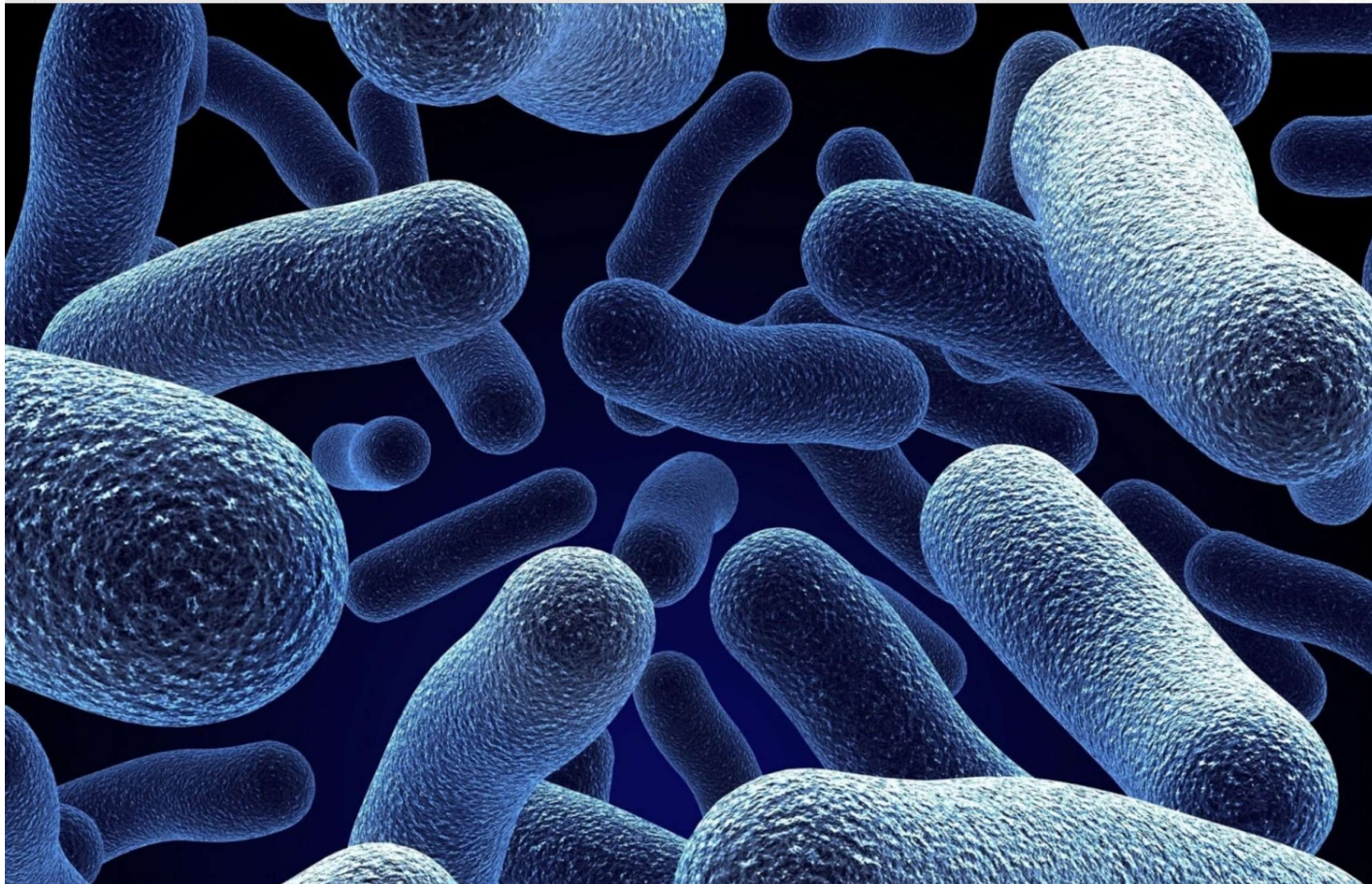
There are essentially two possible theories for this enduring state of controversy: the ‘battle of interests’ and the ‘battle of ideas’. The first posits

## Why is it so difficult to agree? The battle of interests vs. ideas

- Interest Theory: problems are distributional
  - creditors against debtors, high-debt against low- debt states, stable against crisis-prone countries, or global banks against local banks.
  - Zero sum game, easy to understand analytically
- Ideas Theory : problems are cognitive
  - disagreements because actors do not share the same representation of reality, but rather work with different implicit or explicit models of it
  - Reasoning with different models is harder to “solve”



## **The battle of ideas Contagionist vs Miasmatic**



**Vibrio Cholerae**

**Thank you**