The Risk-Sharing Fallacy

By Jürgen Stark

A better approach is risk reduction.

Since 2010, many measures have been adopted to "crisis-proof" the eurozone. In addition to tighter budgetary rules and the start of a banking union, new efforts are underway to strengthen the European Stability Mechanism, which is now meant to serve as a backstop for the Single Resolution Fund. At a recent Eurogroup meeting, eurozone finance ministers agreed on reforms to allow fundamentally "sound" member states to access "contingent" ESM credit lines if they meet certain conditions, and for all sovereign bond contracts to include collective action clauses by 2022.

With policymakers still debating whether to create a eurozone budget and deposit guarantee scheme, we should consider what the reforms introduced so far might mean for the future. At issue is whether we want a monetary union in which member states are individually responsible for their policies, or one based on solidarity, complete with risk sharing and financial transfers.

In accordance with the European Union's solidarity principle, the reform has focused on introducing more safety nets and backstops, with a shared budget, joint unemployment and deposit insurance, and so forth. The assumption is that the more risks are shared, the more stable the eurozone will be. But this is a fallacy. In practice, the proliferation of new safeguards has introduced a high degree of moral hazard and created perverse incentives for governments and market participants alike.

Under the latest eurozone reforms, the principle that those who assume a risk should be liable for it has been replaced by a principle of joint liability, implying financial transfers on an unprecedented scale in the event of a crisis. The current situation in Italy should serve as a warning to all those advocating

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risk sharing. Making matters worse, the sole focus on solidarity means that the eurozone's real problems have gone unaddressed. These include high levels of public and private debt, weak institutions, overregulated markets, and still-incomplete balance sheet corrections on the part of corporations and banks.

The arguments in favor of expanded solidarity measures are unconvincing. Either risk-sharing instruments are unnecessary, or they can be deployed only under conditions in which they would undermine eurozone stability. Why, for example, should a "sound" eurozone member state need to obtain a "contingent credit line" unless it is harboring hidden weaknesses?

Equally dubious are the justifications given for a shared eurozone budget. Is the purpose to stabilize the bloc in the event of shocks? Is it to make investments? Or is it to create financial incentives for domestic economic reforms?

As to the first question, during its twenty-year history, most of the eurozone's shocks have been asymmetrical, centering on member states that pursued irresponsible policies. With the exception of the 2008 crisis, then, eurozone shocks have generally been small and self-inflicted, suggesting that the appropriate response take the form of domestic policies to build more robust budgetary buffers.

If the purpose is to provide investment funds, the EU budget, the "Juncker Plan," and the European Investment Bank already perform this role. Europe's problem is not a lack of financial resources, but rather a lack of suitable projects and limited capacity within member states.

Finally, the argument for a joint budget to reward domestic economic reforms assumes that such reforms create large-scale financial burdens in the short term. But the empirical evidence for this is inconclusive. In any case, the costs of not carrying out necessary reforms would have to be offset against the costs of doing so, if only to make clear that structural reforms are in individual countries' own interest.

A eurozone deposit-insurance scheme is similarly ill-advised at this time, given the scale of non-performing loans in many member states. The immediate need is for a drastic reduction of existing balance-sheet risks. As for future risks, the preferential regulatory treatment afforded to government bonds must end. Sovereign debt should come with equity backing, and emissions of government securities should be capped.

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Rather than install ever more safeguards, it is time to address the eurozone's real weaknesses. The sovereign debt crisis started with weak fiscal positions and doubts about the sustainability of public debts, combined with structural deficits that led to a loss in competitiveness. Economic reforms therefore remain essential. Unless the risks emanating from high public debt are systematically reduced, eurozone countries will be heavily exposed when the next crisis strikes.

Moreover, budget rules should be made more transparent, credible, and enforceable through automatic sanctions against conduct displaying a lack of solidarity. The focus on "structural deficits" should be replaced by a simpler spending rule that is less dependent on the economic cycle. And an independent and credible European fiscal agency should be entrusted with budget monitoring and the implementation and enforcement of the rules. The highly politicized European Commission does not meet these requirements.

The eurozone also needs an insolvency code, which would restore credibility to the Lisbon Treaty's no-bailout clause. And, of course, the nexus between governments and banks should be broken without further delay.

In view of this agenda, the latest reform efforts are a step in the wrong direction. Joint liability in the name of solidarity will quickly become a one-way street for governments that pursue imprudent economic policies to escape accountability. And, given the eurozone's high level of public debt, joint liability entails enormous financial risks.

The limits of the eurozone's solidarity policies are now being tested. The proliferation of backstops not only prevents risk mitigation, but actually invites even more risk. In the event of a crisis, governments' incapacity to assume this collective burden will be laid bare, with far-reaching implications for the sustainability of public finances and the financial and monetary stability of the eurozone.

Needless to say, the entire point of reform is to prevent such a scenario. For Europe's Economic and Monetary Union to be secure, risk sharing must give way to risk reduction. ◆