CHAPTER 21

When all else fails: European re-insurance of member states[1]

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1. Introduction

By 2023, the EU has gone through 15 years of almost uninterrupted crises. It started with the North Atlantic financial crisis in 2008, which morphed into its sovereign debt phase with the Euro Area (EA) crisis in 2010. This reached its turning point in 2012 but lingered on until mid-2015 with a renewed escalation related to Greece's third bailout programme. In that same summer, a refugee crisis erupted, partly due to a large number of Syrians who fled the war that President Assad waged against his own people, partly due to EU-internal disagreement over how to address this recurrent hard policy problem. This unedifying image has almost certainly tipped the Brexit referendum in favour of the Leave vote in June 2016; the much anticipated membership crisis of the EU did not materialise, however. The slow recovery was then rudely interrupted by the Covid-19 pandemic that the EU

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for once shared with the rest of the world. The Russian invasion of Ukraine has led to another surge of refugees but this is less salient than the cost-of-living crisis, fuelled by pent-up demand and supply chain interruptions from the pandemic as well as the bounty of liquidity with which central banks tried to tide economies over wave after wave of severe disruptions since 2008.

So far, so familiar. The EU responded with a whole battery of reforms and new institutions. It is arguably underappreciated what an achievement it is to pull this off in terms of overcoming collective action problems (Rhodes, 2021; Schelkle, 2017). But do these new institutions add up to anything or is it just muddling through, preparing the ground for another crisis (Jones, Kelemen and Meunier, 2016)? This chapter argues that a system of re-insurance has emerged, i.e., insurance that covers the excess loss of severe member state crises, which could sink these primary insurers, here: national welfare states. The system emerged not because it was designed that way but because it is what governments with very different views of inter-state solidarity can agree on. This is not institution building of the second-best, lowest-common denominator variety. It is potentially a genuine functional and political alternative to a fiscal federation, not its weak imitation.

2. Why re-insurance?

In economics, re-insurance is a risk exchange between insurers. Re-insurance is different from co-insurance in that only the excess loss or tail risk is covered, not a share of any (normal) risk that materialises (James, 2013: 9-11). Primary insurers, such as those who sell home content and life insurance, want to cede the risk of excess loss, e.g. in the case of a major earthquake in a region where their business is concentrated. The excess loss occurs under the exceptional circumstance of highly correlated risks where all their clients are affected at the same time, their homes heavily damaged and lives lost. From the primary insurers' point of view, it is often insurance against becoming insolvent when such a disaster strikes.

The national (welfare) state is a primary insurer of resident individuals. And just like a private insurer in an earthquake, the nation state can get overwhelmed when catastrophic risks materialise, such as a systemic financial crisis or a pandemic. Membership in the International Monetary Fund (IMF) is a form of taking out re-insurance, which materialises in the form of adjustment programmes that also protects other members against negative collateral damage. But, until recently, the IMF could only come in when a shock had led to capital flight in a balance of payments crisis. The IMF's resources are also too small when relatively wealthy countries, like those in the EU, are affected. Equally, a fiscal federation can act as re-insurer, for instance provide federal disaster relief when a hurricane hits a member state. This is different from co-insurance, such as a federal top-up of the state unemployment insurance scheme paid in normal times.

For a union of nation-based welfare democracies like the EU, re-insurance has at least three advantages that go beyond economics.

1. It requires much less institutional convergence of welfare state schemes than federal co-insurance. The assessment of excess loss, triggering a payment for instance if unemployment rises over 20 per cent of the workforce, does not require to harmonise the coverage of previous earnings or the eligibility criteria. It is therefore much less intrusive and disruptive than constructing a federal fiscal system out of 27 different fiscal systems and welfare states.

2. Relatedly, moral hazard should be much less of a concern. Risk-taking in the knowledge that downside risks can be socialised is contained by the very fact that the losses up to the excess have to be borne by the primary insurer. So, if a country wants to be generous to its unemployed, it has to find its own fiscal means for 19.9 per cent of unemployed residents.

3. Re-insurance can take many forms, it does not have to be fiscal. Given the limited fiscal capacities of the EU level, it is quite important. Lending-of-last-resort by central banks can provide re-insurance to financial markets and thus reduce the amount fiscal authorities have to spend on recapitalising banks and compensating losers of bank failure. Micro-prudential regulation can allocate the losses from failure of foreign bank subsidiaries in a member state such that the member state where the banks have their headquarters share in the (excess) loss.

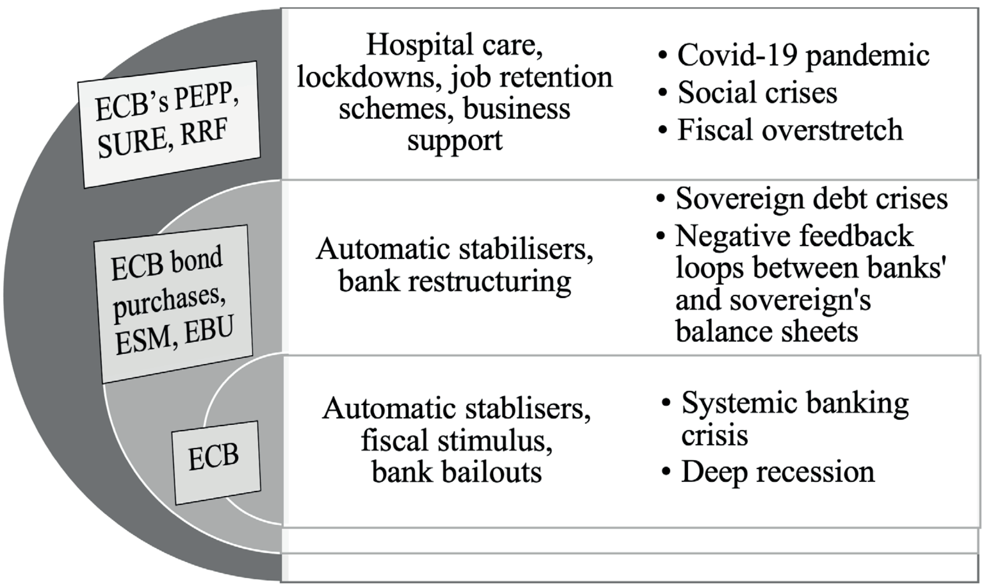
Risk pooling through re-insurance can thus be an alternative to co-insurance on which fiscal federations are based and is arguably more in line with the state of political integration in the EU.

3. How does the system work?

This section illustrates how the emergent system of re-insurance works. It started with a systemic financial crisis, which was cumulative and self-reinforcing. This can bring down entire economies if not stopped, the biggest and wealthiest included. Lending of last resort by central banks was deployed on an unimaginable scale that included a whole swap arrangement between central banks. Too much reliance on monetary re-insurance became untenable with the Euro Area crisis, because the cumulative effect spilled over from banks **to** sovereigns (so-called doom loop). The European Central Bank (ECB) then insisted that some fiscal capacity be created, the European Stability Mechanism (ESM) for bailing out sovereigns as well as for restructuring national banking systems. Elements of the later European Banking Union (EBU) can also be interpreted as re-insurance, and again, it was the ECB that requested it. During the pandemic, the re-insurance character of EU support became quite explicit with a back-up scheme for national job retention schemes, the temporary Support for mitigating Unemployment Risks in an Emergency (SURE). SURE and the Recovery and Resilience Facility (RRF) soon afterwards stretch the notion of re-insurance since they are pre-emptive, paid out before disaster strikes. But in contrast to economics, political economy can also highlight the differences between re-insurance as a public good and as a private service, which does allow to extend the notion to the pre-emptive use of re-insurance.

The following figure gives a stylized image of the EU's, not only the Euro Area's, system of re-insurance.

Figure 1 – System of re-insurance, primary insurance and major crisis concerns



Reading Figure 1 from right to left, the long stretch of crises in the EU started in 2007-8 with a bank run, more precisely: a run on banks from banks in wholesale markets. The fire sales drove down asset prices, drawing more and more banks into the maelstrom. While governments supported the automatic stabilisers of the budget[2] with additional fiscal stimulus and bailed out failing national banks, only central banks with their deep pockets and instruments that can be mobilised quickly can come to the rescue of a systemic financial crises. Their re-insurance to financial markets was crucial to keep payment flows and thus national and international trade going even as banks did not want to hold claims on each other. Financial markets completely failed to act as primary insurers of household wealth, from the portfolios of the rich to the savings of the less well-off.

The financial crisis prepared the ground for negative feedback loops in a sovereign debt phase, which was specific to the Euro Area crisis (De Grauwe, 2023, this volume). By fighting the financial crisis and the ensuing recession, governments had weakened their balance sheets; in turn, banks had weak balance sheets but also held a lot of government bonds and even more from their own government than before the crisis (so-called home bias). The doom loop of weak(ening) bank and government balance sheets could start either way. In the case of Greece, the sell-off and, ultimately, default of government bonds weakened the Greek banks that required them to be rescued with credit from the ESM; in Ireland, it was the weak banks that sank the government soon afterwards. In the Euro Area, the prohibition of buying bonds directly from the issuing government meant that the doom loop could not be stopped straight away. Bonds had to be sold to banks first and held there for a time before the ECB could buy them. Foreign banks were not willing to buy bonds of certain countries, so governments leaned on domestic banks to buy their bond issues, making the home bias ever worse. Again, only central banks with their deep pockets could intervene quickly and provide re-insurance of financial markets and governments. The latter, extending re-insurance to governments through their asset purchases, was a breakthrough, even if provided at the beginning only in pre-committed amounts which did not reassure investors.

As five countries got trapped in a doom loop (Schelkle, 2017: 193-196), governments became ever more reluctant to clean up their banking systems, for fear that more public debt, contingent liabilities and bad bank assets could raise alarm

2 Automatic stabilisers are items on the revenue side, such as the income tax, and on the spending side, notably unemployment insurance, that are responsive to the business cycle and make the budget balance move counter-cyclically.

in their bond market. This made the ECB a lone firefighter, in danger of providing extraordinary amounts of liquidity indiscriminately because it could not force governments to recapitalise and restructure national banks more resolutely (Mabbett and Schelkle, 2019). It argued hard for a bailout fund in 2010 and got eventually the ESM. This bailout fund, with a lending capacity that is three times larger than the maximum that the IMF ever lent to sovereigns at a particular point in time, came with hard conditions for sequential disbursements. Again, it did not consistently reassure bond investors that the fiscal re-insurance for the European monetary union and its members was reliable. It is against this background that Draghi's famous 'Whatever it takes' speech was so powerful.

The ECB also lobbied hard for the EBU with Euro Area-wide supervision and resolution capacity that started in 2014. It was particularly interested in a resolution capacity for insolvent banks. Like a European Deposit Insurance Scheme, it is, in principle, a useful element of the system. Both are conceived as re-insurance for member states when their national schemes are overstretched. However, Germany was singularly opposed to the EBU and obstructed the usefulness of the Single Resolution Mechanism and reneged on an agreement to introduce the deposit scheme. This is rather puzzling because both schemes would make the banking industry share in the cost of producing this public good.

The refugee crisis and Brexit were political, not financial-fiscal crises. But financial markets became nervous each time and forced the ECB to continue extraordinary monetary measures that kept real interest rates negative. The Covid-19 pandemic, however, threatened livelihoods quite directly, through loss of life and severe illness, damage to business, employment and education. Governments had to increase hospital capacities and buy medical equipment but also provide income and credit support to businesses and households during lockdowns. The ECB announced immediately a Pandemic Emergency Purchase Programme (PEPP) that kept interest rates of government borrowing low and took out all restrictions as regards buying the most distressed bonds. SURE provided re-insurance for national unemployment insurance but with a twist: its cheap loans incentivised member states to use their funding for job retention schemes during lockdown. For the EU, this had the advantage of being self-terminating when lockdowns ended.

But it was also clear that ever more credit support for the primary insurers would not be of much help in the case of governments whose creditworthiness had greatly suffered from a long crisis decade. Moreover, Troika programmes had made the ESM toxic. Its contingent credit line for pandemic-related expenditures was rejected explicitly by Italian and Spanish governments as stigmatising even though no conditionality was attached (Schelkle, 2021). Hence the need for an alternative.

The RRF broke truly new ground. It provided grants to the tune of more than 3 per cent of EU GDP on average, and a slightly higher amount of loans (which most countries did not take until the Ukraine war). It targets countries that were poorer to begin with and/or particularly hard hit by the pandemic. At least for those who suffered a deeper recession than others, the re-insurance element is clear: while forward-looking to recovery, it is assessed on the basis of damage suffered. As usual, re-insurance here wants to allow an economy to return to its growth trajectory, if possible even on a higher one – hence, governments had to submit detailed reform and investment plans. The political intervention here is clear: the stipulation tries to placate the opposition to such largesse and presumably ensure that next time the main beneficiaries will be in a better position to help themselves (Rutte, in Valentino 2020). The second R, for Resilience, stands for this transformative re-insurance that was given in anticipation of a predictably difficult recovery; above all, it signals a political compromise.

4. A better alternative?

Risk pooling through re-insurance can be an alternative to co-insurance on which fiscal federations are based. It is less demanding in terms of institutional adaptation required, which is crucial in a union of diverse welfare states. It is also politically more acceptable for members that resist creating a budgetary union but acknowledge that integrated markets can be a source of systemic risks and interdependence through spillovers, for which some safety nets of last resort are required. And it can use the whole arsenal of instruments at the EU's disposal, which is much better developed in the regulatory and monetary than the fiscal domain. These three reasons can explain why governments with very different views on the future of the EU can agree on some form of re-insurance scheme.

I have argued that it works now increasingly as a system. Monetary policy can act swiftly and provide relief to governments' public debt management as well as to banks playing their role for payments and credit in the Euro Area. Swap arrangements can extend this to non-Euro members. But on its own, easy money maintains too many unviable banks and incentivises speculative investments. Fiscal authorities need to be given room for manoeuvre for more targeted action but not all may have the capacity. Re-insurance can protect them against bond market panic but also enable them to rebuild their economies and perform primary insurance roles.

One may still argue that re-insurance is a politically weak substitute for a fiscal federation: it comes in only after all else failed. Institutionalised co-insurance in fiscal federations, by contrast, creates strong bonds between different levels of government and harmonised entitlements project community and identity. Possibly. But there is also evidence that co-insurance creates rivalry between the state and federal level, e.g. for credit claiming when a crisis is solved. States' free riding on federal capacity is another notorious problem in some fiscal federations, blaming the centre for accumulating so much debt while relying on and simultaneously obstructing its stabilisation efforts.[3] These political incentives make the functional imperative of fiscal federalism much less compelling. Moreover, established federations like the United States do not break apart because of these rivalries. But this would be a real threat in the EU, which has not (yet) reached the same status of being taken for granted. Political developments that are conducive to permanent co-insurance take time and trying to force them with functional imperatives may even backfire.

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3 Inspired by the work of Jonathan Rodden (2005), Alexander-Shaw, Ganderson and Schelkle (2023) provide evidence for these federal-fiscal rivalries in the U.S. during the Covid-19 pandemic, in contrast to the EU with its weak centre.

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