

To the editors of Le Monde and Frankfurter Allgemeine Zeitung**Dear Sirs,**

A group of influential French and German economists just published in your newspapers a call for a joint initiative by their respective governments to reform the Euro area. The endeavor to publicly discuss how to improve European economic integration must be praised and encouraged. In their document, the Franco-German economists try to find a balance between risk reduction and risk sharing in the Euro area, although with the first prevailing on the second. Among several other constructive ideas, the document's two key proposals claim that discipline and convergence would be fostered by a new mechanism for sovereign debt restructuring, and by the application of risk weights on sovereign bonds held by European banks for the calculation of their prudential capital ratio. While we strongly support the idea that the Euro area needs further reforms to prevent it from falling prey again to financial shocks, we also believe that these specific proposals may bring about the opposite result, making the monetary union more fragile.

As for the debt restructuring mechanism, one cannot be oblivious to the effects of the agreement on Greek (privately held) debt restructuring reached by France and Germany in Deauville in October 2010. That deal triggered contagion, spreading financial market turmoil from Greece to other countries, including Spain and Italy. It brought the monetary union on the verge of collapse and generated a deep recession in most of the Euro area. In order to stop this turmoil, it took the ECB announcement in July 2012 that it was ready to do "whatever it takes" to break speculation, leading to the OMT market intervention programme and the implementation of Quantitative Easing that effectively stopped the crisis and brought the area back onto a path of self-sustained recovery.

In our view, what the French and German economists fail to see is that by raising fears that sovereign debts might not be honored, the introduction of ex-ante automatic mechanisms for sovereign debt restructuring would make it more difficult for markets to distinguish liquidity from insolvency risk. Rather than improving market discipline, such mechanisms would again open the door to the possibility of an investor run, leading to a self-fulfilling financial crisis. As the Latins used to say, "errare humanum est, perseverare diabolicum".

The second proposal - to introduce positive risk weights on sovereign bonds issued by Euro-area members in the calculation of banks' capital requirements - seems equally counterproductive, and, indeed, has already been rejected by all countries outside the Euro area within the Financial Stability Board. Rather than making banks safer and preventing contagion, this proposal may, in fact, exacerbate financial fragmentation. The reason is that in the absence of an ultimate Euro-area fiscal backstop against massive liquidity runs and of a safe asset of common reference for the management of banks' liquidity, banks' borrowing costs will inevitably be linked to those of their sovereign. A risk weight on national sovereigns held by the banks may aggravate fragmentation by reinforcing the perverse link between government debt and banks' balance sheets, depriving banks of the instrument needed to manage their liquidity.

In sum, the proposals contained in the document by the French and German economists do not offer a workable solution for the completion of the monetary and banking union, and could very well increase the risk of idiosyncratic shocks that endanger its survival. Such measures run counter to the massive empirical evidence gathered by the profession on the causes of the financial crisis in 2011-12, showing how in a world with multiple equilibria, misguided policies can push the economy into a 'bad equilibrium', destabilize financial markets and perhaps again push the Euro area to the brink.

A reflection by economists on the future of the Euro area is welcome and overdue, and we are more than willing to contribute to this endeavor. However, any workable solution presupposes the identification of some appropriate combination of risk reduction and risk sharing measures apt to reassure investors in financial markets against the reemergence of asymmetric shocks hitting more fragile countries and by doing so endangering the integrity of the monetary union. The establishment of cross-border deposit insurance and adequate fiscal back-stops for both the on-going Resolution Fund and the future Deposit Insurance Fund – possibly enabling the ESM to issue its own liabilities to that end – must go in parallel with appropriate and non-destabilizing policies in order to bring down both the debt-to-GDP ratios and sovereign exposure of banks in the most fragile countries.

We would be delighted if you could publish our dissenting views on the French and German economists proposals.

With best regards,

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