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Messori and Micossi's reading of the Franco-German 7+7 paper is a misrepresentation

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Rejecting the critique by Messrs Messori and Micossi of their earlier paper as "fundamentally inaccurate and misleading", Jean Pisani-Ferry and Jeromin Zettelmeyer offer a succinct rebuttal in this new contribution.

Together with 12 other French and German economists of various affiliations and viewpoints, we recently published a report that proposes a comprehensive reform of the euro area.[1] Our aim was to trigger a debate on the fundamental reforms that are needed to ensure the resilience of the euro area and turn it into an engine for collective prosperity. As we very deliberately crossed the usual national red lines – because we thought that the acceptance of the corresponding constraints was bound to result in an insufficiently ambitious, and possibly empty compromise – we did not expect our proposals to be consensual. We were especially conscious that some of them would elicit opposition among colleagues who are especially sensitive to the risk of financial instability. Because of Italy's high debt and its recent banking problems, many Italian economists rightly have such concerns. Several of our recommendations were in fact designed in light of the Italian situation and the imperative to reconcile the need for bold reforms with the necessity to avoid triggering turmoil.

We therefore welcome the contribution by Marcello Messori and Stefano Micossi (M&M), with whom we had the opportunity to discuss our ideas before the report was published.[2] There are many things on which we agree, as they note in passing in their paper. But we were shocked by the way in which their piece misrepresents our analysis and our proposals. Having read it

[1] A. Bénassy-Quéré, M. Brunnermeier, H. Enderlein, E. Farhi, M. Fratzscher, C. Fuest, P.O. Gourinchas, P. Martin, J. Pisani-Ferry, H. Rey, I. Schnabel, N. Véron, B. Weder di Mauro and J. Zettelmeyer, "Reconciling risk sharing with market discipline: A constructive approach to euro area reform", CEPR Policy Insight No. 91, Centre for Economic Policy Research, London, January 2018.

[2] M. Messori and S. Micossi, "Counterproductive Proposals on Euro Area Reform by French and German Economists", CEPS Policy Insight No. 2018/04, CEPS, Brussels, February 2018.

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carefully, we cannot escape the impression that they have built a strawman characterised as largely aligned with the propositions put forward in a non-paper circulated by former German Finance Minister Wolfgang Schäuble. This is most visible in the table in which they provide what they regard as evidence of such an alignment. But their reading is a fundamentally inaccurate and misleading presentation of our ideas.

This is unfortunate. At the present juncture, the euro area needs genuine, honest debate, not the cultivation of cultural and national prejudices. To play down points of agreements systematically while emphasising points of contention ends up creating the false impression that our perspectives are fundamentally different. It is factually wrong and politically toxic to pretend that our proposals "do not differ in substance from Schäuble's on the critical issues of financial stability in the euro area and the balance between risk reduction and risk sharing, and in some respects are even more rigid". To follow this route promises the surest way to prevent the type of debate Europe urgently needs and instead to fuel unhelpful acrimony.

We respect our critics' right to disagree with our views, and we are keen to engage with them. But we would like to be criticised on the basis of what we actually say.

1. Banking union

- M&M's main claim is that we are calling for the removal of the financial stability exception to bail-in rules. The basis for this claim seems to be point (4) in the first paragraph of p. 7 and footnote 4 on the same page. However, the footnote says that exemption "should not be generally presumed, but assessed on a case-by-case basis". M&M suggest that this would prohibit having recourse to the exception in case of systemic crisis, which is plainly wrong. In fact, we do not suggest any redrafting of either the systemic exemptions in the bank recovery and resolution Directive (BRRD) or the treaty basis for systemic-risk exemptions under state aid control, but only a revision of the Banking Communication (BC) of 2013 on the application of State aid rules to support measures in favour of banks in the context of the financial crisis, which was explicitly linked to a context of systemic banking crisis. Unless one assumes that the EU banking sector should be presumed to be in a permanent state of systemic fragility forever, this is a common-sense proposal.
- M&M says we propose that "concentration charges should become a tool to 'structurally' prevent banks to use their sovereigns as collateral to obtain access to their ECB (emergency) credit facilities in conditions of special distress". The basis for this claim appears to be the following sentence on p. 8 (first para): "The diversification of banks' sovereign exposures is not merely a matter of handling the crisis legacy, or a risk reduction from its current level associated with high sovereign debt ratios. It should rather be viewed as a structural change, in which the loss of the specific role of national banking sectors as default absorbers of domestic sovereign debt is more than offset by the resilience gains from a well-designed EDIS and the corresponding sharp reduction of redenomination risk." This sentence says nothing about preventing the use of

sovereign debt as collateral. In fact, our proposal would not reduce banks' ability to do so, since it is not intended to reduce their aggregate sovereign debt holdings – only concentrated exposures to individual sovereigns.

- With regard to European Deposit Insurance, M&M claim that we advocate to "continue imputing banking losses to national compartments even in the final stage". In fact, what we propose is simply a waterfall structure, in which national compartments would absorb the 'first loss' caused by deposit insurance claims in that country, while the mutual compartment would absorb any further losses, regardless of the origin of the shock. Any country would benefit from the mutual compartment after its national compartment is depleted. Our proposal in fact entails more risk-sharing and less danger of financial fragmentation than the one made by Stefano Micossi in a paper published a few months ago.[3]

2. ESM Tasks

- M&M say that "PI 91 makes the ESM a direct instrument of creditor countries" because we write that programmes must be approved by member states. But this is the case already. Furthermore, we advocate greater operational independence of the ESM from its political masters: "the ESM should be governed by a sufficiently compact Board of Directors, appointed or elected by the members via an IMF-like constituency system. To increase the operational independence of the ESM, directors should operate at arm's length from the governments that appoint them." (p.20).
- M&M criticise us for proposing that "ESM lending would be normally subject to some prior debt restructuring". Indeed, we are clear that the maturity of junior bonds that we propose should be issued as an alternative to sanctions in the case of a violation of the fiscal rules must automatically be extended if a country enters an ESM programme. But we are equally clear that there should be no automaticity whatsoever for standard bonds. Instead, we propose that the ESM should develop a lending policy that would lead to a debt restructuring only if this is the only way of restoring solvency to a crisis-struck country (p. 14). And we go out of our way to refer to debt restructuring as "a last resort" when debts are unsustainable (p. 5, p. 9). "Last resort" means that debt restructuring would *not* be used unless it is unavoidable to restore the sustainability of sovereign debt. This is very different from making the "ESM normally subject to some prior debt restructuring".

[3] S. Micossi, "A Blueprint for Completing the Banking Union", CEPS Policy Insight No. 2017/42, CEPS, Brussels, 27 November 2017.

3. Sovereign debts

- M&M say that we are seeking a quasi-automatic trigger of restructuring based on quantitative indicators. What we actually say, however, is that the ESM should "develop its own criteria for deciding when there is a significant risk that an assistance programme might not restore solvency to a crisis-struck country" and that "when this is the case, it should insist on a private debt restructuring" (p. 14). We add that "when introducing such a policy, it is essential to ensure that it does not give rise to the expectation that some of the present debts of high-debt countries will inevitably be restructured, triggering financial instability in debt markets" (also p. 14). And we use the IMF's new exceptional access policy as a leading example for how such a policy might look. This is notable for the fact that it does *not* involve any hard thresholds or rules that would mechanically require countries to restructure as a condition for ESM support. We reject the notion that the no-bail-out rule can be made credible by introducing ever-harder commitment devices. Instead, we want to make the rule credible by lowering the economic and financial disruptions associated with debt restructuring, if required as a last-resort solution.

4. Fiscal discipline

- M&M pretend that "[our] transparent objective is not only to exclude the Commission from any role in negotiating policy goals with member states within the European Semester procedures, but also to wrest control of the process from the hands of national parliaments". This is not correct. What we are saying (p.19) is that "while we do not oppose the assignment of the chair of the council of ministers to a Commissioner – a model that is already used in the case of the High Representative of the Union for Foreign Affairs and Security – we are opposed to merging the roles of prosecutor and judge". This leads us to envisage two models, both of which would actually lead to the transfer of the chair of the Eurogroup from the Council to the Commission. In one of these models, Commissioners would be responsible for both the economic and fiscal monitoring and the forging of political compromises. As far as national parliaments are concerned, it is hard to see why they would be deprived of any of their prerogatives: they currently do not play any role in fiscal surveillance.