François Villeroy de Galhau: The challenge of an efficient European economic governance as a contribution to a prosperous global community

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Emerging Markets Forum, Paris, 11 April 2016.

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Dear friends and distinguished guests,

Let us take the long view. This forum, thanks to Michel Camdessus and Harinder Kohli, is a rare opportunity to discuss what the global economy and its governance might look like two generations from now. In a moment, we will argue about global megatrends and alternative scenarios. With so many distinguished participants from emerging market economies and specialists of the international monetary system in the room, I would like to speak today as a European. As I see it, the European perspective is relevant in this Forum for at least three main reasons:

- ***Regional integration may be one of the megatrends***: how it will affect the delicate balance between sovereignty and international cooperation is a question that the EU has been mulling over since its inception.
- ***Many of the global and coordination challenges we are facing*** have been confronted over the course of European integration, and are still at the core of the debate: economic spillovers and externalities, monetary stability, and effective governance.
- ***A strong Europe is all the more necessary in a multipolar world, as a "balancing power."*** By 2050, the divide will no longer be between emerging and advanced economies, but rather between who was prepared and who wasn't.

Ideas to enhance European economic governance are not new. Mobilization and implementation have proved tricky however: this is what I would like to focus my remarks on speaking of the motivations (I) and then of the concrete tasks of a Euro area Finance Minister (II).

I. Why we need a "full coordination" institution in the Euro area

We know there is deep political resistance to sharing fiscal resources and sovereignty, as well as Euroscepticism. The sad example of the refugee crisis illustrates how European countries so far have displayed little solidarity to find a common solution. ***This is why we need to make the economic case*** for a stronger governance of the euro area: it is not a theological issue and not solely a political one either. This discussion is not about "more Brussels", it is very concretely about more growth and jobs in Europe. Clearly***, monetary policy cannot be a substitute for economic policy coordination or the lack of reforms***. For that reason alone central bankers need to take part in this debate, while taking action will obviously be a decision for political leaders. This is also why our focus should be on the Eurozone economic governance. We should not fear different speeds in Europe. I am strongly in favor of the UK remaining within the EU; yet, irrespective of the outcome of the British referendum, the Eurozone can and should pursue further integration.

The euro crisis has revealed how unprepared we were. The expected dynamics between peer pressure and market discipline did not work, as markets did not believe in the no-bail-out principle, and as national authorities did not really accept peer pressure, nor the implementation of the rules.

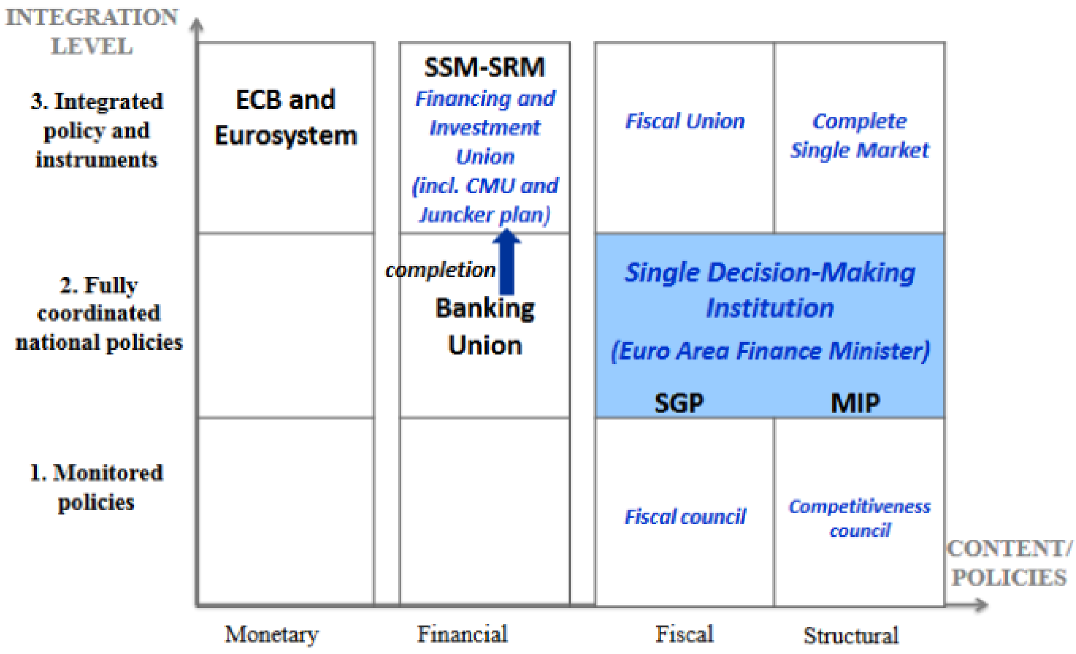
The absence of coordination has a genuine economic cost. It includes the cost of crises and assistance programmes, as well as the impact on growth due to uneven compliance with budgetary rules before the crisis and rigidity of the rules during the crisis. Several studies point to a significant cost of non-coordination, in the order of 2 to 5 % of ***GDP*** since the crisis.

To take the debate forward, three principled choices have to be made: First: making parallel progress on both domestic reforms ***and*** European coordination. This is the cornerstone of any French-German agreement: to be fair, the French call for Germany to support coordination, and the German doubt about French reforms, have been and are still well-founded. This requires overcoming distrust between countries and putting both aspects under the same umbrella, namely a common institution.

Second, we must recognize that ***institutions with a mandate are superior to rules without institutions***. To bolster policy consistency and coordination, we admittedly need simpler rules. But they should be supported by strong institutions with discretionary powers. Mario Draghi pointed out[1] the fundamental difference between a monetary policy institution and fiscal rules, which are exemplified by the track records of the ECB and SGP respectively.

Third, there is room for an intermediate level of integration, as shown in a simple but illustrative matrix.

European Economic Governance Matrix



Legend – SSM: Single Supervisory Mechanism; SRM: Single Resolution Mechanism; CMU: Capital Markets Union; SGP: Stability and Growth Pact; MIP: Macroeconomic Imbalances Procedure.

I would call it "***full coordination of national policies***", a presently missing link between integration, as we have for monetary policy decision-making, and rule-based surveillance, such as is currently the case for national fiscal policies in Europe and which is clearly lacking teeth.

[1] Speech by Mario Draghi, President of the ECB, at SZ Finance day 2015, Frankfurt am Main, 16 March 2015.

To be sure, the highest level of policy integration would logically involve building a genuine fiscal union, as well as completing the Single Market; but that would surely require more ex ante convergence and resolution of legacies from the past. My view is that we should leave the door open to further integration for countries that are willing and ready to consider it. Yet the most urgently needed part of EMU reform, is ***to set up a strong institution, led by a Euro area Finance Minister, to fully coordinate national fiscal and structural policies.***

In economic terms it would help internalize negative externalities (e.g. demand spillovers, or financial contagion) from asymmetric shocks across jurisdictions, as well as optimize positive externalities between fiscal and structural policies. In political terms it would help make the Euro area more than the sum of its parts. Jean Monnet famously declared that ***"nothing is possible without men, but nothing lasts without institutions."*** The mandate of this decision-making institution must be to achieve the strongest, sustainable and balanced growth.

II. How we should define concretely the tasks for a Euro area Finance Minister

I see four of them***.*** First, the Minister would be ***in charge of preparing the euro area-wide collective strategy to fulfill the mandate I just described***. It would be essential for the euro area to collectively agree on overall economic policy objectives, and on the division of tasks through the setting of individual performance targets for Member States. Such an agreement could be reached following a two-step process:

- A ***preparation*** phase would require assessing: (i) potential growth, with a quantified ambition to raise it; (ii) the euro area output gap; (iii) the sustainable fiscal and external stances for the euro area as a whole, as well as the sustainable distribution of these positions across countries.
- In a ***decision*** phase, the euro area Finance Minister would propose a strategy, consisting of the collective objective and – as far as necessary – its country specific translations in terms of reforms and policy stance, bearing in mind of course the rationale for subsidiarity. This proposal, subject to formal opinions from the Fiscal and Competitiveness Councils, would then have to be adopted at simple majority by the Eurogroup, and further to be endorsed by the European Parliament.

Second, the Finance Minister would be responsible for ***supervising the implementation of the collective strategy***, using adequate instruments to provide symmetric incentives. Negative incentives would of course include the effective implementation of existing sanction mechanisms. They could be broadened in contractual procedures, already put forward in the 2013 Franco-German contribution on EMU, or in Chancellor Merkel's[2] "binding reform contracts" proposal, and including positive incentives. One of them would be the access to a euro area "Convergence Fund", through which Member States could benefit from common funding. In addition, conditioning the participation in economic governance on compliant implementation could provide strong incentives.

Third, the Finance Minister would be responsible for ***implementing centralized crisis management***. A Finance Minister for the euro area would naturally be in charge of overseeing European Stability Mechanism operations.

Last, while moving towards further integration, the Minister could be given the authority for ***managing a euro area Convergence Fund, evolving towards a Euro budget***. We are touching here on the issue of a common fiscal capacity, promoted recently by Pier Carlo Padoan[3]. As successfully done in the past, it could be built in three stages. In the first stage,

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[2] Angela Merkel's first parliamentary speech of the third term, 18th December 2013.

[3] Pier Carlo Padoan, A Shared European Policy Strategy for Growth, Jobs, and Stability, February 2016.

Member States would be free to join, and the Convergence Fund would be allocated to financing common goods such as European infrastructure investment or refugee settlement. In a second stage, this budget could become a stabilisation instrument, centralising a well-defined set of policy instruments, such as a European layer of unemployment insurance. The third and final stage of fiscal integration would only be achieved if agreement can be found both on financing (direct revenue-raising capacity and common debt issuance) and on the desirable level of business cycle synchronization. This perspective would be a powerful incentive for national discipline and commitment as shown during the march to the Euro.

How to set up a legitimate institution with a genuine administrative capacity?

Further integration and democratic accountability should progress together, as discussed in my recent article with Jens Weidmann. We need to enable the European economic administration to be more efficient, while establishing strong enough political legitimacy to ensure balance between liability and control. These institutional changes obviously require a new Treaty.

First, we need a legitimacy-enhancing appointment process. The Finance Minister could thus be appointed for a five-year period by the European Council acting by qualified majority on a proposal from the president of the EU Commission. The new appointment would be subject to the formal approval of the European Parliament, and the Finance Minister would be member of the Commission, as well as chair of the Eurogroup. The Minister would thereby have the legitimacy to represent internationally the euro area in Economic and Financial fora, alongside the President of the ECB.

Second, the euro area Finance Minister would need to be backed by a genuine Treasury administration, which could include staff from the Commission's Economic and Financial Directorate General, the ESM, and the Economic and Financial Committee Secretariat. Such a civil service would also benefit from the public advice of two independent bodies, the European Fiscal Board and the Competitiveness Council.

Last, if we succeed in implementing further integration, we will need stronger democratic control over euro area affairs. To this end, we will need to consider institutionalising a euro area format of the European Parliament. Relationships between euro area MPs and national parliaments will also need to be enhanced, through an inter-institutional agreement, or by creating dedicated commissions.

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To conclude, let me quote Robert Mundell[4], father of the theory of optimal currency areas and a famous analyst of international spillovers. He did acknowledge that the euro area was far from optimal. Yet he remained confident, saying: "it will be achieved because, for Europe, it isn't just the best game in town, it's the only game." Economic policy as a whole, not central banking alone, is indeed the only game in town.

What the world will look like in 2050 will be partly shaped by the future of Europe; and the future of Europe depends on the decisions we take now. Of course, we always face the risk of failure when conducting far-reaching reforms. Yet we cannot afford another missed opportunity and we have to act swiftly without losing a longer term view. For the Euro area, for its citizens, 2016–2017 is the decisive time to act.

4 Interview of Robert Mundell by Laura Wallace, « Ahead of his time », Finance and Development, IMF, September 2006, vol 43, n° 3.

ANNEX : SELECTED REFERENCES

Authors	Date	References
J-C Trichet (speech in Aachen)	Jun. 2011	*Building Europe, building institutions*
Franco-German contribution to the June 2013 European Council	May 2013	*Together for a stronger Europe of Stability and Growth*
IMF (Staff Discussion Note)	Sep. 2013	*Towards a Fiscal Union for the Euro Area*
Glienicker Gruppe	Oct. 2013	*Towards a Euro Union*
M. Draghi (speech at SZ Finance Day)	Mar 2015	*From integration to convergence, from rules to institutions*
J. Pisani-Ferry (France Stratégie)	May 2015	*Rebalancing the governance of the euro area*
IMF (Staff Discussion Note)	May 2015	*Reforming fiscal governance in the EU*
Bruegel (A. Sapir, G. Wolff et al.)	Sep. 2015	*EU to DO 2015-2019, Memos to the new EU leadership*
J. Delors Institute (H. Enderlein, J. Haas)	Oct. 2015	*What would a European finance minister do? A proposal*
European Parliament In-Depth Analysis (D.Gros and C. Alcidi)	Nov. 2015	*Economic policy coordination in the euro area under the European Semester*
Bruegel (Z. Darvas, Al. Leandro)	Nov. 2015	*The limitations of Policy coordination in the euro area under the European Semester*
I. Visco (Banca d'Italia)	Nov. 2015	*European Union: progress or regress?*
Conseil d'Analyse Economique (A.Bénassy-Quéré, X. Ragot, G. Wolff)	Feb. 2016	*Which Fiscal Union for the Euro Area?*
P. Padoan (MEF Italy)	Feb. 2016	*A Shared European Policy Strategy for Growth, Jobs, and Stability*
B. Cœuré (ECB)	Mar. 2016	*A budgetary capacity for the Euro area*