François Villeroy de Galhau: Europe at a crossroads – how to improve economic governance and growth performance of the Eurozone?

Presentation by Mr François Villeroy de Galhau, Governor of the Bank of France, at the German Institute for Economic Research – DIW Berlin, Berlin, 8 June 2016.

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I am delighted by the opportunity, kindly offered by DIW, to share some remarks on Europe here in Berlin.

As you may know, I have strong ties with Germany. In particular, I completely share the German culture about the importance of responsibility and long-term vision.

At this juncture we probably all agree on two things – and my focus today will be that these two things are closely intertwined:

- Monetary policy cannot be the only game in town.
- Although Monetary Union is a success, Economic Union remains to be built.

I want to pay tribute to Helmut Schmidt, who said in October 2011: "There was a failure to set the economic rules of the game for the currency union. A powerful authority with responsibility for fiscal and economic policy was not set up."[1]

I will first argue that monetary policy has been doing its fair share (I). I will then discuss the need for a "full coordination" of national economic policies in the Euro area, and discuss what concrete progress can be made (II). Finally, turning to private risk-sharing in the Eurozone, I will focus on the importance of building an efficient Financing and Investment Union (III).

I. Monetary policy is doing its duty, and has already done a lot

I am well aware that some recent monetary policy decisions of the Governing Council are hotly debated in Germany. The expression of such criticism reflects, at a minimum, the need to explain our monetary policy decisions better. However, I'd like to argue that our recent monetary policy decisions are very much in line with the principles of stability that German culture incarnates so well. Let me elaborate on three of these principles.

First, independence. The divergent inflation performance of the major industrialized economies after the collapse of the Bretton Woods system had a profound effect on the subsequent conduct of central banks. On the practical side, Germany was seen to have navigated the so-called stagflation episode of the 1970s considerably better than others. The Bundesbank was role model for the independence of other central banks.

Second, a clear mandate for price stability. The Eurosystem was built on these foundations as enshrined in the Maastricht treaty. We also adopted, as early as 2003, a transparent quantitative definition of price stability as an inflation rate close to but below 2% over the medium term – very close to the present definition of the US Fed, the BoE or the BoJ: so this is nothing new or specific to the ECB.

From 1999 to 2011, the HICP inflation rate averaged 2% in the euro area, remarkably consistent with the objective.

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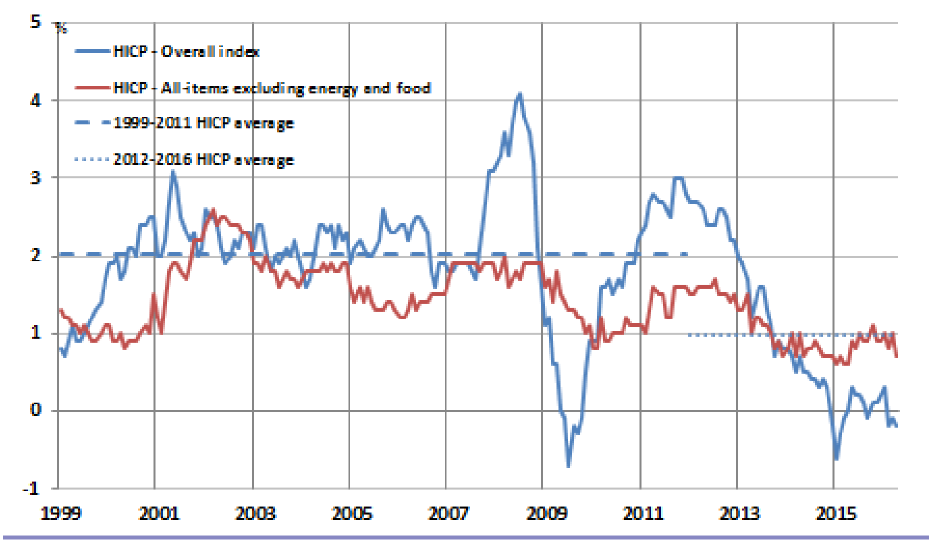
[1] Helmut Schmidt; Remarks at the Farewell event for the ECB President Jean-Claude Trichet; October 19, 2011.

HICP and Core Inflation in the EA



But since then, the Eurosystem has struggled to match this performance. Inflation has been well below 2% for 3 years now – with exactly the same phenomenon in Germany itself – and this fall cannot be explained completely by the decline in oil prices. At the same time, inflation expectations have gradually drifted down over the last three years. Our mandate imposes a duty to react, in order to protect the Eurozone economy – including the German one – from the lethal danger of deflation.

Third, patience within a medium to long-term perspective. In this volatile world we live in, our policy reactions are not the result of short-term economic fluctuations, market overreactions, media headlines or poll results. Our credibility is also symmetric. If we tolerate long deviations of inflation under 2% now, there is a risk that in the future, when inflation wanders above 2%, our determination to bring it back to close to but below 2% lacks credibility. As Romer and Romer, two US monetary economists, forcefully argued in a recent paper[2], the most dangerous idea for central bankers is to indulge in the idea that monetary policy can do little against shifts in the output gap, be they negative or positive. In retrospect, there is sound evidence now that the Great Depression in the 30's and the Great Inflation of the 70's were sustained by this belief. Credibility and anchored inflation expectations require that we do not give credit to the past "toothpaste" view of monetary policy – contractionary policy cannot fight inflation once it is out – nor symmetrically to the current "string" view of monetary policy – whereby accommodative policy cannot fight deflation.

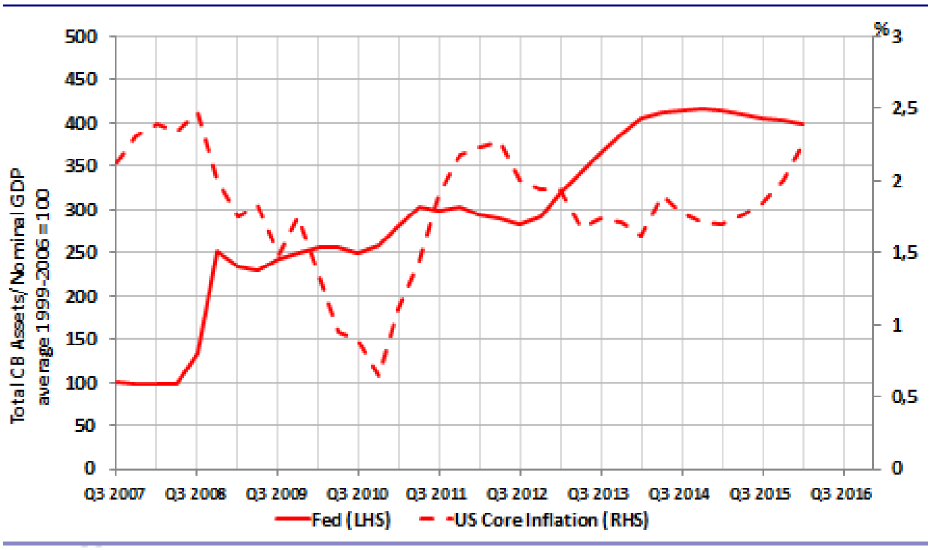
So, our results have to be judged over the medium term. We are only fifteen months after the real start of QE in the Eurozone but we can already see some positive effects. According to Eurosystem staff assessments, without the APP (Asset Purchasing Program) inflation would have been negative in 2015, more than half of a percentage point lower in 2016, and around half of a percentage point lower in 2017.

If we pursue our program, what should we expect down the road? The US Federal Reserve has shown us the way, taking a series of very important steps to increase monetary stimulus even after it brought its policy interest rate to zero. The Fed issued forward

[2] C. Romer and D. Romer "The Most Dangerous Idea in Federal Reserve History: Monetary Policy Doesn't Matter" *American Economic Review: Papers & Proceedings* 2013, 103(3): 55–60.

guidance to signal a protracted period of low interest rates and began QE. The US logically leads the way as it was the first epicenter of the Great recession.

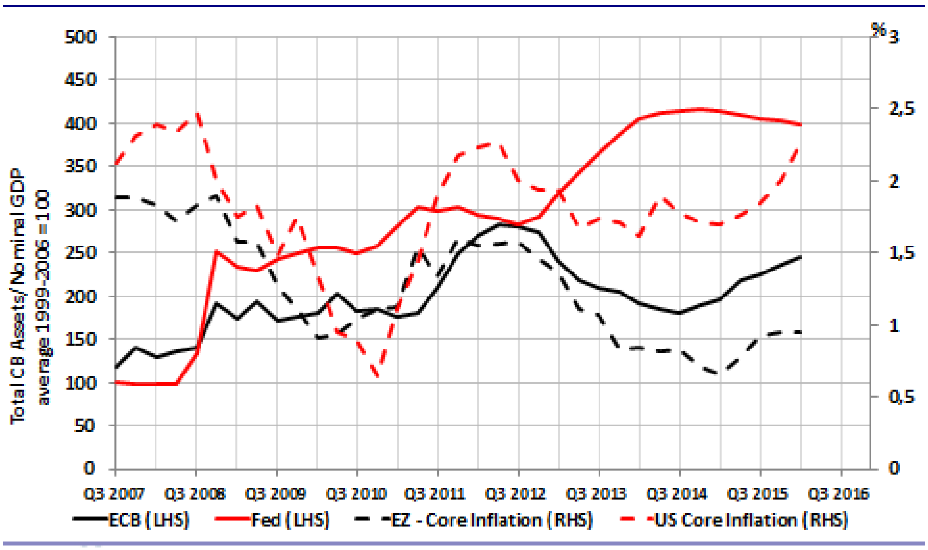
US policy leads the way



The US QE began in November 2008 and core inflation troughed in October 2010. Unemployment has steadily fallen since then and the inflation rate has returned towards 2%, which is the Federal Reserve's inflation target. Only then could the FOMC stop increasing its balance sheet, raise the Federal Funds rate from its floor and so initiate an exit strategy.

Obviously we, in the Eurozone, are not at the same point of the business cycle but we are travelling along the same road for monetary policy.

US policy leads the way



Some consider these unconventional policies in the euro area are counterproductive because ultra-low interest rates hurt savers and banks. ***However, we have monitored closely banks' profitability and – taking into account ALL elements of monetary policy***

– there is in 2015 no evidence that this is doing harm overall. Moreover, the global long-term real rate of interest has been falling for around 30 years reflecting an imbalance between a strong desire to save and a relative scarcity of those willing to borrow to invest. As we all know, this imbalance is extremely acute in Germany where this surplus is in the order of 8 % of German GDP.

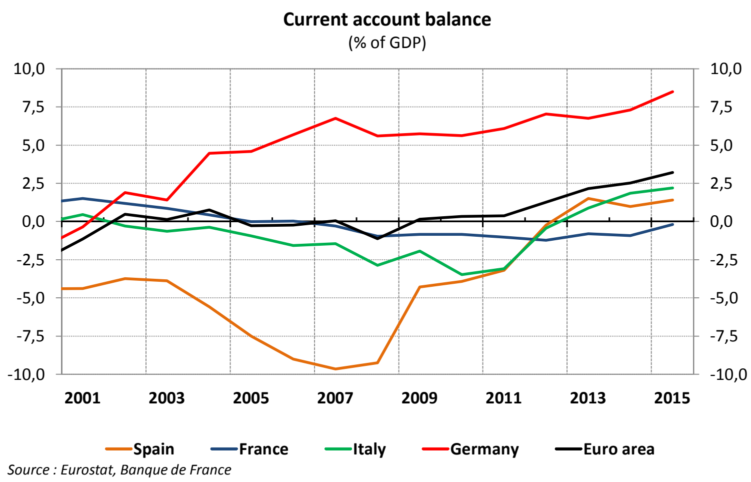
Above all, we cannot base our decisions on their outcomes for particular groups but on the common good. Economic activity does not depend only on savers but also on entrepreneurs, workers, homebuyers and borrowers who benefit from low interest rates. Eventually, these policies will lead to levels of inflation more consistent with our mandate and will call for higher interest rates both in nominal and in real terms. In order to have sustainably higher interest rates tomorrow, we must have them low today.

That being said, not all unconventional instruments are legitimate. There are limits on how negative interest rates can go, as Mario Draghi stressed it. So this type of unconventional measure, although useful, should be used with care. And I think that so-called ***"helicopter money" would bring more harm than good***: we do not need it and it is not on the table***.***

The real issue is that monetary policy cannot do everything. We have done our bit but cannot create the lasting economic growth which underpins prosperity, including for savers. For this we need other policy makers to act.

At a time when the euro area is experiencing both a negative output gap and a large external surplus – i.e. an excess of savings over investment, we must reflect on how abundant European savings could be put to the most productive use for investment in Europe.

Abundant Savings in the Euro Area



This is why we need to foster ***more extensive private risk-sharing in the Eurozone***, which requires a more integrated financing and investment framework. As the so-called Fratzscher report on *Increasing investment in Germany* puts it: "the key to a sustainable recovery in Europe lies in faster growth that must be bolstered first and foremost through a joint investment and modernization campaign ". I will come to this issue.

But we also need ***to achieve better coordination of public policies.*** To that effect, we need to think through the concrete role of a euro area Finance Minister could play.

II. Why we need a "full coordination" institution in the euro area, embodied by a finance minister

Clearly***, monetary policy cannot be a substitute for economic policy coordination or for the lack of reforms***. If only for that reason central bankers need to take part in this debate, although taking action will obviously remain a decision for political leaders. This is why our focus should be on the Eurozone economic governance and coordination.

We know there is deep political resistance to sharing fiscal resources and sovereignty, as well as a rising Euroscepticism. This is why we need to make the economic case. This discussion is not about "more Brussels", but it is very concretely about more growth and jobs in Europe.

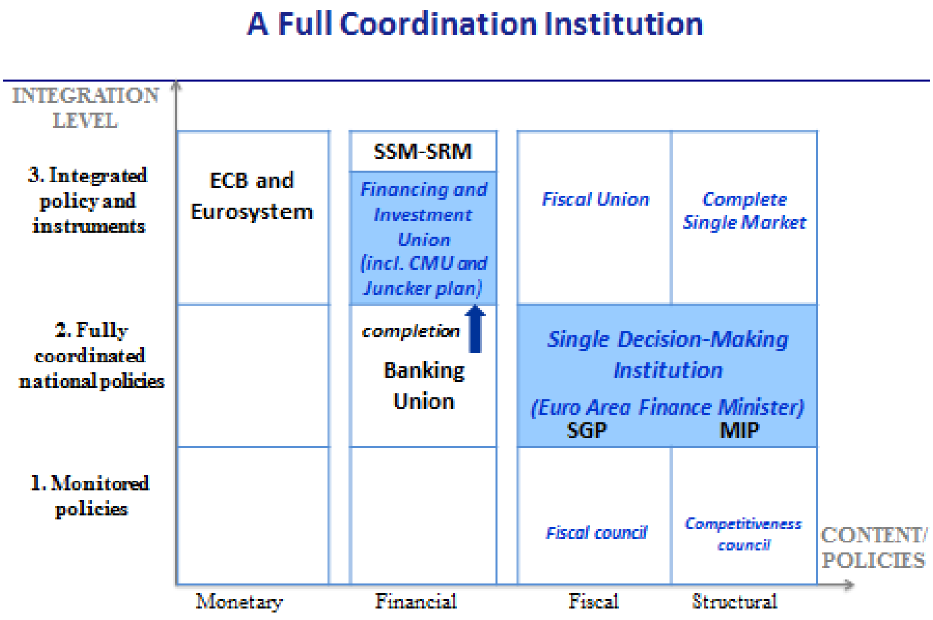
The euro crisis has revealed how unprepared we were. ***The absence of coordination has indeed a genuine economic cost***. Several approaches point to a significant cost of non-coordination, in the order of ***2 to 5 % of GDP*** since the crisis, and therefore millions of jobs.

To bring the debate forward, some principled choices have to be made.

First: making ***parallel progress*** on both domestic reforms ***and***, [not "or"], European coordination. This is the cornerstone of, for instance, 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 bringing together ***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***, as underlined by Mario Draghi while discussing the fundamental difference between a monetary policy institution and fiscal rules. To bolster policy consistency and coordination, we admittedly need simpler rules. But they should be supported by strong institutions with discretionary powers.

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



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, as it is currently the case for national fiscal policies in Europe and which is clearly lacking teeth. And I don’t think we are ready for a fully-fledged fiscal union with a common fiscal capacity and the great mutual trust it requires.

In addition to the completion of banking union, the needed part of EMU reform is ***to set up a strong institution to fully coordinate national fiscal and structural policies.*** It would help to 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 idea of ***a Finance Minister of the Euro area*** is not new: Marcel Fratzscher and the DIW for instance recently advocated for “a joint finance minister”, aware that a single currency “requires an economic convergence process and close coordination of economic policy with common rules”[3]. But let me specify her/his concrete tasks. I see four of them.

First, the Minister would be ***in charge of preparing the euro area-wide collective strategy to fulfill its sustainable growth mandate*** and collectively agreeing the division of tasks through the setting of individual performance targets for Member States. Nobody seriously disputes that a collective strategy involving more structural reforms in some countries including France, and more public investment in others including Germany would make for a better policy mix for sustainable growth and employment in Europe.

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 include the existing sanction mechanisms, and could be broadened in contractual procedures, already put forward in the 2013 Franco-German contribution on EMU, or in Chancellor Merkel’s[4] “binding reform contracts” proposal. A positive incentive could be for instance the access to a euro area ”Convergence Fund”, through which Member States could benefit from common funding.

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, progressively evolving towards a euro budget***.

Further integration and democratic accountability should move forward in parallel. These institutional changes obviously require a new Treaty.

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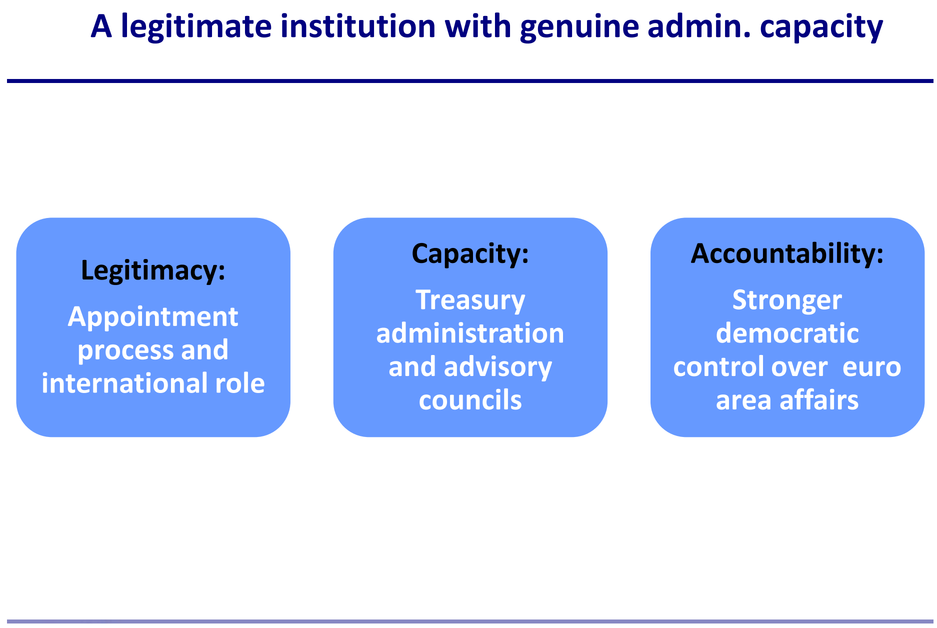
[3] Marcel Fratzscher, *Lessons for Europe from German Monetary Union,* DIW Economic Bulletin 27.2015

[4] Angela Merkel’s first parliamentary speech of the third term, December 18 2013.



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.

Second, the euro area Finance Minister would need to be backed by ***a genuine Treasury administration***. 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 a euro area format of the European Parliament. Relationships between euro area MPs and national parliaments will also need to be enhanced.

As I said, not only do we need to better coordinate public policies, but we also have to foster private risk-sharing throughout the Eurozone. To recall Wolfgang Schaüble, European leaders need to show "that balanced budgets, growth and investment are not mutually exclusive, but rather go hand-in-hand"[5].

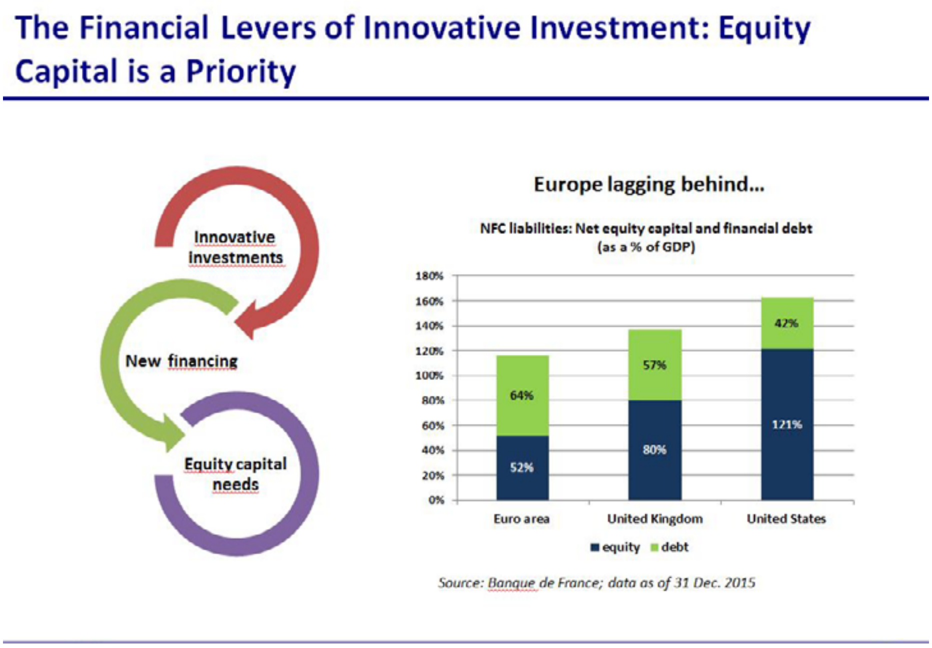
[5] Wolfgang Schaüble, "Managing Europe – What is Germany's responsibility?", speech at the LSE, March 3 2016.

III. Building an efficient financing and investment union for tomorrow

We need to improve investment financing in the EU. Our efforts should be directed towards financing growth and innovation, and towards finding the right mix between debt and equity financing, while still preserving financial stability and consumer protection. In the EU, the European Commission has launched the Investment Plan – so called Juncker Plan – and the Capital Markets Union (CMU).

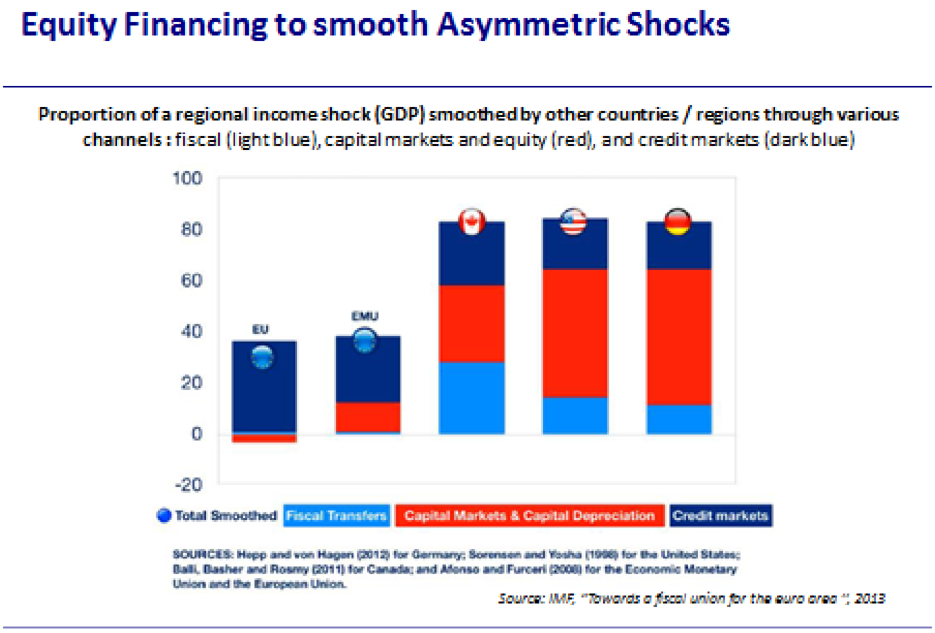
Until now, these initiatives have shown results, but they are not enough. A more ambitious approach would ***bring together*** the CMU, the Banking Union and the Juncker Plan. This is why I suggest to think of a ***Financing and Investment Union.*** It is essential to clarify ***two objectives***: (i) the diversification of financing for firms, and (ii) the strengthening of the euro area. As we argued in our joint article with Jens Weidmann in February, this Financing and Investment Union – including more equity financing – seems to be the best way to match the abundance of savings and the lack of appropriate investment financing.

First, let's focus on the ***diversification of financing***. The starting point should be firms' needs. New financing of business investment, which is one of the keys to innovation, must be enabled. There should be above all, ***more equity financing***.



- It is an essential fact that the equity share of corporate financing in Europe is half as large as in the United States: 52% of GDP in the EA, vs. 121% in the US.
- This is unfortunate because equity financing is the best way to share risks and opportunities, as well as to support innovation. "Catch-up" growth, as in many Emerging Markets, can be financed by debt. But an economy standing at the technological frontier, as in the U.S. or hopefully as in Europe, is better financed by equity: as innovation is more risky, its funding must have an upside.
- The Commission's Innobarometer survey suggests that funding is the main barrier for promoting R&D and innovation in Europe. What can we actually do? Among others, taxation policies could be revised in favor of equity funding. Innovative schemes also need to be developed at European level, such as European venture capital funds, in order to support the creation and growth of new businesses.

Furthermore, a Financing and Investment union is about strengthening the euro area. Short term banking flows have risen after the introduction of the Euro, but the financial crisis demonstrated that the capital markets' channel of risk sharing was still underdeveloped in the euro area. From the reality of financial fragmentation and its negative economic consequences, we can draw ***one obvious conclusion: equity*** financing is clearly the instrument that best allows to smooth asymmetric shocks in a Monetary Union. Its benefits are many (ECB Financial Integration Report 2016): it is less volatile that debt financing and it enhances the companies' resilience to adverse conditions.



The integrated US equity market for instance cushions about 40% of a state-specific economic shock, as a company's profits and losses are distributed to owners all over the US. In the euro area, this form of risk-sharing is virtually non-existent.

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To conclude, let me quote Robert Mundell[6], father of the theory of optimal currency areas. 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.

We cannot afford another missed opportunity for Europe, for the good of its citizens, 2016–2017 is a decisive time to act.

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