Benoît Cœuré: Exchange of views with members of the High Council of Public Finance

Introductory remarks by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, prior to an informal exchange of views with the High Council of Public Finance, Paris, 17 July 2019.

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Thank you for inviting me to the High Council of Public Finance. It is a pleasure to engage in an informal exchange of views with you on the monetary policy of the European Central Bank (ECB) and more broadly on Economic and Monetary Union (EMU), with a specific focus on issues of relevance to fiscal policy.

Allow me to start by briefly discussing the economic situation of the euro area.

The euro area economic outlook

The euro area economy grew by 0.4%, quarter on quarter, in the first quarter of 2019, following an increase of 0.2% in the fourth quarter of 2018. However, incoming economic data and survey information point to somewhat weaker growth in the second and third quarters of this year. This reflects the ongoing weakness in international trade in an environment of prolonged global uncertainties, which are weighing in particular on the manufacturing sector.

Looking ahead, the euro area expansion will continue to be supported by favourable financing conditions, the mildly expansionary euro area fiscal stance, further employment gains and rising wages, and the ongoing – albeit somewhat slower – growth in global activity. This assessment is broadly reflected in the June 2019 Eurosystem staff macroeconomic projections for the euro area, which foresee annual real GDP increasing by 1.2% in 2019, 1.4% in 2020 and 1.4% in 2021.

The risks surrounding the euro area growth outlook continue to be tilted to the downside, on account of the prolonged presence of uncertainties related to geopolitical factors, the rising threat of protectionism and vulnerabilities in emerging markets.

According to Eurostat's flash estimate, euro area annual HICP inflation was 1.2% in June 2019, unchanged from May 2019. Based on current futures prices for oil, annual HICP inflation is likely to decline over the coming months. Adjusting for the temporary factors behind the recent volatility, measures of underlying inflation remain generally muted.

Looking further ahead, underlying inflation is expected to increase over the medium term, supported by our monetary policy measures, the ongoing economic expansion and stronger wage growth. This assessment is broadly reflected in the June 2019 Eurosystem staff macroeconomic projections for the euro area, which foresee annual HICP inflation at 1.3% in 2019, 1.4% in 2020 and 1.6% in 2021.

The ECB's monetary policy and its impact on the euro area economy

The benefits of our monetary policy measures have been sizeable and tangible. Lending rates for euro area firms and households are at historic lows and have converged across the euro area, while growth in bank lending volumes has recovered significantly since the beginning of 2014, thereby supporting investment and job creation.

There are now 10.8 million more people in employment in the euro area than there were in the second quarter of 2013, when the number of people in work fell to its lowest point during the crisis.

However, against the backdrop of a decline in the pace of the euro area expansion and the prolonged presence of uncertainties, the ECB's Governing Council in June took a number of policy decisions to ensure that inflation remains on a sustained path towards levels that are consistent with our inflation aim – a rate of inflation which is below, but close to, 2% over the medium term.

First, we updated our forward guidance on the key ECB interest rates and now expect them to remain at their present levels at least through the first half of 2020, and in any case for as long as necessary to ensure the continued sustained convergence of inflation consistent with our inflation aim.

Second, the Governing Council reaffirmed its intention to continue reinvesting, in full, the principal payments from maturing securities purchased under the asset purchase programme. This will continue for an extended period of time past the date when we start raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

Third, we decided on the modalities of the new series of quarterly targeted longer-term refinancing operations (TLTRO III) that was announced after our March meeting. We decided that the interest rate will be set at a level that is 10 basis points above the average rate on our main refinancing operations, but for banks whose eligible net lending exceeds a benchmark, the rate applied can be as low as the average deposit facility rate plus 10 basis points. This new series of TLTROs will help preserve favourable bank lending conditions and the smooth transmission of monetary policy.

Looking ahead, the Governing Council is determined to act in case of adverse contingencies and also stands ready to adjust all of its instruments, as appropriate, to ensure that inflation continues to move towards the Governing Council's inflation aim in a sustained manner.

Completing Economic and Monetary Union

To reap the full benefits from our monetary policy measures, other policy areas must contribute decisively to raising the longer-term growth potential of the euro area and reducing its vulnerabilities.

Sound fiscal and economic policies at the national level are the first line of defence to make the euro area stronger. Economic reform needs to be substantially stepped up in euro area countries to increase resilience, reduce unemployment in a lasting way and boost productivity.

On the fiscal side, Member States often fail to make sufficient use of economic upswings to build fiscal buffers. This leaves those with fragile fiscal positions ill-prepared to face economic downturns.

At the current juncture we expect the aggregate euro area fiscal stance to be mildly expansionary in 2019, which provides welcome support to economic activity at a time when growth has decelerated. However, the aggregate picture masks the suboptimal differentiation across countries. In particular, countries with high levels of debt are, with few exceptions, not building fiscal buffers, thereby risking a repeat of the mistakes of the pre-crisis period. Countries with fiscal space could use some of it to strengthen public investment and increase their growth potential.

The European Fiscal Board has recently issued a report[1] recommending a broadly neutral euro area fiscal stance for 2020, based on the expectation of a gradual pick-up in economic activity as of the second half of 2019. This is also our baseline scenario, but we are aware that it is surrounded by a multitude of downside risks. If those risks were to materialise, additional fiscal support may be needed. To be clear, such support should come from countries that have fiscal space. But while not all countries have the space to spend more, all have the opportunity to spend better.

The euro's benefits, however, will not fully materialise for as long as the architecture of EMU remains incomplete.

Material progress has been achieved in recent years. The European Stability Mechanism provides an important safeguard and reforms currently under discussion will strengthen its precautionary and crisis resolution toolkit.

The creation of banking union, meanwhile, has considerably strengthened the resilience of the euro area financial sector and, together with the Bank Recovery and Resolution Directive, has created instruments to combat banking crises in a swifter and fairer way.

Banks directly supervised by the ECB have built up strong capital positions in recent years, with a Common Equity Tier 1 (CET1) ratio of 14.3% in the first quarter of 2019 compared with 11.3% at the end of 2014. They have also substantially reduced their non-performing loan ratio, which stood at 3.7% in the first quarter of 2019 compared to 7.5% in the second quarter of 2015. These are important steps forward as euro area firms rely heavily on bank credit to finance growth and investment.

So what more should be done at the European level?

First, the ability of the financial sector to contribute to economic stabilisation should be strengthened. During the crisis, financial integration in the euro area reversed and it has only gradually recovered over the past few years.

The creditworthiness of banks remains linked to that of national governments. Unlike in the United States, cross-border investment is not a significant buffer against economic shocks. The euro area still lacks genuinely integrated capital markets, which hinders the efficient allocation of European savings, private cross-border risk-sharing to smoothen consumption during idiosyncratic shocks and the use of the euro as an international currency.

Recent legislative steps are commendable but do not measure up to the initial ambition of the capital markets union project. Brexit will further accentuate the need to develop and integrate the EU's capital markets. A large number of banks and investment firms are in the process of establishing or expanding their euro area presence, possibly resulting in the development of a multi-centric European financial system.

While the landscape may evolve further in the future, in a financial system with a number of increasingly important hubs, as opposed to one dominant hub in London, it will be more important than ever for these hubs to be able to efficiently interact with one another and to avoid differences across Member States providing opportunities for regulatory arbitrage.

Second, the banking union needs to be completed. In particular, a fully fledged European deposit insurance scheme (EDIS) is a key missing element. In this context, the ECB has proposed that EDIS could be accompanied by risk-based contributions by banks linked to their sovereign holdings.

Third, further efforts are needed to deepen fiscal union in the euro area.

European fiscal rules are complex, opaque and plagued with exceptions and exemptions which have accumulated over time. They rely excessively on measures of cyclical positions which are controversial and prone to manipulation[2]. Simpler and more credible and effective rules are needed to ensure that euro area countries safeguard fiscal sustainability and build the necessary buffers to create room for countercyclical stabilisation in economic downturns. Recent proposals to focus the fiscal framework on a debt anchor complemented by an expenditure rule deserve further consideration.[3]

EMU also needs a central fiscal stabilisation mechanism to enhance countercyclical stabilisation during severe recessions. Past experience shows that the aggregate fiscal stance in the euro area is often suboptimal. During the European debt crisis, for example, it was strongly contractionary, thereby reducing the effectiveness of an expansionary monetary policy stance.

While the euro area budgetary instrument currently under discussion is a welcome step to support convergence, it is not designed to fulfil this stabilisation function. Work on the fiscal architecture of EMU therefore needs to continue to ensure that fiscal policies can play an effective stabilisation role.

Conclusion

Let me conclude.

The euro, which celebrates its 20th anniversary this year, enjoys broad support among European citizens, with three in four people in the euro area in favour of it. Its growing popularity is testimony to the fact that people have trust in the currency and in the ECB's strong commitment to price stability, which supports investment and job creation.

To preserve this trust, we need to step up our efforts at both national and euro area level to strengthen the architecture of the single currency. Much has been achieved but some of the failings that caused and perpetuated the crisis remain unresolved.

At a time of heightened global uncertainty, completing the euro area's architecture is also necessary for Europe to be able to achieve its other objectives. Europeans won't be able to foster cooperation on security and defence, or to speak with one voice on international affairs, or to complete the Single Market if they repeatedly have to tackle economic crises which are largely of their own making. A sound and sustainable euro area will help redirect political capital where it is most needed.

Thank you.

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1 See the European Fiscal Board's latest Assessment of the prospective fiscal stance appropriate for the euro area, published on 25 June 2019.

2 See B. Cœuré (2018), "Scars that never were? Potential output and slack after the crisis", speech at the CEPII 40th Anniversary Conference, Paris, 12 April.

3 See, for instance, Christofzik, D.I., Feld, L.P., Reuter, W.H. and Yeter, M. (2018), "Uniting European Fiscal Rules: How to Strengthen the Fiscal Framework", *German Council of Economic Experts Working Paper*, No 04, and Darvas, Z., Martin, P. and Ragot, X. (2018), "European fiscal rules require a major overhaul", *Les notes du conseil d'analyse économique*, No 47, September; Eyraud, L., Debrun, X., Hodge, A., Lledó, V. and Pattillo, C. (2018), "Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability", *IMF Staff Discussion Notes*, 18/04.