Benoît Cœuré: Consolidating the euro area's economic recovery

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 European Affairs Committee and the Finance Committee of the National Assembly, Paris, 13 May 2015.

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Madam Chairman,

Mr Vice-Chairman,

Ladies and Gentlemen of the National Assembly,

Thank you for the opportunity to address you today.

The National Assembly, like all of the national parliaments, plays a vital role every day in the necessary interaction between national and European institutions. The effectiveness of our policies is in the balance: our economies are too interdependent for us to turn our backs on one another. Our legitimacy is also in the balance: European strategies and decisions that require national political involvement cannot be effectively implemented unless they are fully understood and supported by the Member States.

I know that your committees pay close attention to economic developments in the euro area and to the European Central Bank's decisions. These will be the crux of my introductory remarks. I also want to hear what you have to say and take your questions, because Economic and Monetary Union is an ongoing project. The crisis showed us that we need more coherent economic policies and a stronger institutional foundation for the euro area.

1. The ECB's monetary policy during the crisis

During the crisis, the European Central Bank was confronted with considerable challenges.

The first was to maintain confidence in the single currency amid tremendous financial instability and uncertainty.

The second was to maintain price stability despite financial fragmentation in the euro area.

And the third was to combat the risk of prolonged weakness in inflation at a time when all of the ECB's conventional instruments had already been used.

These challenges guided our actions in pursuit of our price stability objective.

This led to an unprecedented accommodative stance in our monetary policy, a stance carried out via a wide range of measures, some conventional and others unconventional.

As you know, the principal channel used to implement conventional measures, those used by central banks in normal times, is the interest rate channel. In response to weak growth and inflation, we lowered our key interest rates to their lower bound. By doing so, we reduced the cost of borrowing in order to support investment and consumption.

To amplify the impact of the rate cuts, we also issued forward guidance on the likely path of key interest rates. This transparency allowed us to keep short-term interest rates in the euro area low and stable, which suited conditions in the euro area, despite the pressures seen on international capital markets.

However, the lack of confidence in certain Member States in the financial system and in the solvency of sovereign borrowers was an impediment to the transmission of monetary policy to the broader economy during the crisis. In countries gripped by financial difficulties, financing conditions remained restrictive, despite the easing of monetary policy.

To restore uniform monetary policy transmission and tackle the risks to price stability, the ECB thus needed to combine conventional measures with unconventional measures tailored to the particular situation in the euro area. The ECB pursued this strategy throughout the crisis.

We initially sought to make sure that banks could refinance themselves under good conditions so that they could continue to finance the economy. The Governing Council, for example, decided to supply banks with unlimited liquidity at a fixed interest rate, to significantly extend the maturity of our refinancing operations and to expand the list of assets eligible for use as collateral.

When fears regarding the euro area's integrity surfaced at the height of the crisis, in August/September 2012, the Governing Council created Outright Monetary Transactions (OMTs). These monetary transactions made it possible to intervene, if needed, in secondary sovereign debt markets in the event of a speculative attack, notably one linked to single currency fears. They were conditional on the establishment of a financial aid programme under the European Stability Mechanism, which would constitute an indication of confidence in the economic convergence and fiscal viability of any country in which we would be called upon to intervene. This decision led to a dramatic decline in the risk premia on sovereign yields, notably those of Italy and Spain. Thus, it contributed to the efforts undertaken in the euro area, which also involved the creation of the banking union, to break the vicious circle of sovereign risk undermining banks' stability and thus their ability to finance the real economy. The OMT tool has not been used, but it still could be if fears of the single currency's integrity resurface.

More recently, to help stimulate the flow of financing to the economy, the Governing Council decided on new unconventional measures to support the provision of credit. We gave banks access to five-year refinancing operations on the condition that, in exchange, they boost their lending to the real economy. In September 2014 we also established a programme to buy covered bonds and asset-backed securities directly linked to the financing of the real economy.

Together, these measures have already helped – and continue to help – ease financing conditions in the euro area.

2. Expanded asset purchase programme

Despite this progress, the growing threat of prolonged weakness in inflation has made new measures necessary. As a result, in January 2015 the Governing Council decided to launch an expanded asset purchase programme.

At a time of weak domestic inflationary pressures, the steep drop in oil prices from mid-2014 onwards caused inflation to weaken further. Moreover, an extended period of excessively weak inflation can affect inflation expectations and thereby become self-perpetuating.

A firm monetary response was needed.

Thus, we decided to expand our asset purchase programme.

The combined purchases of public and private sector debt will amount to €60 billion per month. They began in March and are expected to continue until the end of September 2016. In any event, they will continue until the Governing Council sees a sustained adjustment in the path of inflation that is consistent with its goal of achieving rates below, but close to, 2% over the medium term.

How does this asset purchase programme affect the real economy, and thereby, inflation?

The first transmission channel is that of confidence. The purchases put inflation back on a path consistent with a pace of close to 2% over the medium term and give the confidence boost needed for a recovery in private investment, which remains too far from its pre-crisis level (16.8% of GDP in 2014 compared with 19.9% in 2007 in the euro area).

A second transmission channel involves lowering sovereign bond yields, which are used as a price-setting benchmark for a wide range of private sector financial instruments, such as bank loans to households and businesses.

Thirdly, the large amounts of liquidity injected through these purchases will allow private investors (banks and non-banks) to undertake portfolio shifts into other financial assets, particularly loans to the economy. This will lead to more favourable conditions for all instruments used to finance the economy.

Lastly, the easing of financing conditions also influences the exchange rate, although this is not an objective in and of itself.

Where do we stand with respect to the programme's implementation? We have begun purchasing securities with no major difficulties, and the pace of monthly purchases is consistent with the stated target. The positive impact of our most recent measures on the financing of the real economy can already be seen. Bank lending rates have fallen by 40 to 50 basis points since summer 2014, and they should continue to fall, in the wake of the steep drop in sovereign yields.

Lower financing costs for businesses and households are expected, in turn, to support growth in lending and investment. In fact, the contraction in lending appears to be reversing in the euro area. Bank lending to non-financial corporations grew 1% year on year in the first quarter, compared with a 2% decrease the year before. In France, year-on-year growth in lending to businesses came to around 4% in March, compared with just 1% a year earlier.

In light of these improvements, euro area growth projections and inflation expectations have both been revised upward. The macroeconomic projections produced by ECB staff in March 2015 predicted euro area growth of 1.5% in 2015, 1.9% in 2016 and 2.1% in 2017. Growth will be supported by rising external demand, lower oil prices and the accommodative monetary policy stance. The first-quarter euro area growth figures released on 13 May confirm this trend. Inflation is expected to gradually return to a level below, but close to, 2% by 2017. This trend reversal is already evident in the upswing in inflation expectations seen on financial markets.

3. Finishing the job: from a cyclical recovery to a structural recovery

Despite these positive signs, the recovery remains insufficient and uneven.

The factors supporting growth today are temporary in nature. Serious risks remain at the international level. The recovery is chiefly supported by the euro's depreciation and lower energy costs, whose effects will diminish over time. This is also true of monetary policy, which cannot have a lasting impact on an economy's long-term growth trend. It is up to euro area governments to act so that the recovery is more than a flash in the pan and long-term growth takes over from cyclical support factors.

The euro area's unemployment rate remains very high, at 11.3% in March, and has reached unacceptable levels in several countries. In some countries, more than half of young people in the labour force are out of work. This situation is largely structural in nature[1] (structural unemployment is now over 10%). Furthermore, given the low level of potential growth,[2]

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[1] On this point, see "Unemployment in the euro area", a speech by Mario Draghi, President of the ECB, to the annual central bank symposium in Jackson Hole, 22 August 2014.

[2] On the prospects for economic growth potential, please refer to Anderton, R. et al., "Potential output from a euro area perspective", *ECB* Occasional Paper Series, No 156, November 2014; European Economic

strongly undermined by the crisis and estimated at under 1%, there are clear priorities for reform from the ECB's standpoint: encourage productive investment, improve employment rates and training, and restore the overall productivity of inputs by reducing barriers to entry and to innovation and by improving economic conditions for companies. These are the priorities that the Governor of the Banque de France laid out in his letter to the President of the French Republic.[3] It is not the role of the ECB to say specifically how these reforms should be designed and implemented.

A chief complaint is that structural reforms hurt growth and employment in the short term. I would counter that if reforms are ambitious, complementary and credible,[4] they will elicit expectations of a sustained period of higher income, encouraging households to increase consumption and businesses to invest.

Recent European Commission forecasts show that euro area countries that have pursued the most ambitious reforms, such as Spain, are now experiencing stronger growth. The countries that reform the most will benefit the most from our accommodative monetary policy.

In terms of fiscal policy, here again it is not the role of the ECB to say specifically what countries should do, but I want to remind you of three simple tenets that we think are extremely important.

First of all, the Economic and Monetary Union is a community of interest founded on a capacity for joint action and the application of rules. Rules can change, a point I will come back to, but first they have to be applied. It is a question of mutual trust, and in this the larger countries must set an example.

Second, managing macroeconomic conditions in the euro area means paying just as much attention to the fiscal situation in each country to which the rules apply as we do to the area's overall fiscal situation: "all for one and one for all". From this standpoint, our recommendation is clear. The fiscal stance of the euro area as a whole (measured, for example, by the change in the structural budget balance) is neutral overall, and in our view is suited to the current economic situation, but the room for manoeuvre in individual countries differs greatly. Countries in excessive deficit situations must continue their efforts, and those with some leeway can use it, particularly to encourage investment.

Lastly, the composition of the fiscal adjustment is of the utmost importance. Better targeted spending, notably on investment, the public sector portion of which fell during the crisis (from 7.1% of public spending in the euro area in 2007 to 5.5% in 2014), will create more growth and more jobs.

4. Strengthen the euro area's institutional foundations

In countries that share a single currency, economic policies are a point of common interest. This is in the economic interest of the Member States and is also a legal obligation: the Treaty on the Functioning of the European Union is clear on this point. This is a necessary condition if we want to fully benefit from monetary union and, at the same time, remedy the structural, fiscal and financial weaknesses within the euro area: the crisis showed us that local fragilities quickly become everyone's problem. On the flip side, our monetary policy and banking union have shown the power of joint action. It is a lesson we must not forget.

Forecast Spring 2015, European Commission; and "Where are we headed? Perspectives on potential output", in World Economic Outlook, International Monetary Fund, 2015.

[3] Christian Noyer, "Introductory Letter to the Banque de France's Annual Report", 4 May 2015.

[4] Anderson, D., Barkbu, B., Lusiyan, L. and Muir, D., "Assessing the Gains from Structural Reforms for Jobs and Growth", in Schindler, M., Berger, H., Bakker, B. and Spilimbergo, A. (eds), *Jobs and Growth: Supporting the European Recovery*, International Monetary Fund, 2014.

The crisis has already led to major progress on institutional matters, such as the establishment of the European Stability Mechanism or the banking union, with a Single Supervisory Mechanism and a Single Resolution Fund based on common rules. These two achievements have played a key role in strengthening monetary union during the crisis.

The establishment of the banking union is also an example of an institutional process allowing the sharing of risk, which followed several steps.

First: political agreement on European legislation laying down common rules and putting an end to bank sector abuses. I am thinking specifically of strengthening capital at systemically important banks, bail-in rules that will eventually rid the banking sector of the practice of "privatising profits and socialising losses", and – I hope – application at European level of the principle of bank structural reform, which the ECB supports.[5]

Second: shared institutions incorporating national institutions that ensure the credible implementation of those rules for the prevention and resolution of crises. The ECB is a demanding bank regulator, freed from the hindrance of national interests. Third: a transparency and convergence exercise aimed at resolving the fragilities of the past. And finally: clear political legitimacy and an obligation to answer both to the European Parliament (for the President of the ECB and the Chair of the Supervisory Board) and to the national parliaments (for the competent national authorities).

It is now important to identify the areas where additional progress is required in order to ensure the coherence and cohesion that is necessary for the effective functioning of Economic and Monetary Union. In particular, I believe it is essential that monetary union is more resilient when faced with shocks and fosters all of the potential benefits of integration in terms of European prosperity. This means moving towards more effective economic structures,[6] but also exploiting the economies of scale and risk-sharing that are made possible by integration.[7] Such economic risk sharing involves chiefly the development of larger and more stable internal markets,[8] as well as rules that protect European consumers and workers within these larger markets, and lastly, a more ambitious fiscal union.

It is true that this development implies sharing our sovereignty. But sharing sovereignty does not mean losing it; in fact, it is a way of regaining it. And a shared European sovereignty on the basis of democratically accountable common institutions allows us to go beyond a system based on rules by recreating a space for political debate.

It is not the task of the ECB to lay down the details of these reforms, whose nature is eminently political. But it is our duty to warn that the construction of the euro area is incomplete. We are only half-way there. Stopping now would mean that we would be responsible for leaving our Economic and Monetary Union in a lasting state of fragility, which the economic recovery could only temporarily conceal.

The "Four Presidents Report" (by the Presidents of the European Council, the European Commission, the European Central Bank and the Eurogroup), which is in the process of being prepared, will reflect on the progress that needs to be made with Economic and Monetary Union. I hope that this report will set out an ambitious vision of the future of

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5 "Opinion on a proposal for a regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions", 19 November 2014.

6 "Investing in Europe: towards a new convergence process", speech by Benoît Cœuré, member of the Executive Board of the ECB, Athens, 9 July 2014.

7 "The political dimension of European economic integration", speech by Benoît Cœuré, member of the Executive Board of the ECB, at the 19th Université d'automne de la Ligue des droits de l'Homme, Paris, 23 November 2013.

8 As regards capital markets, for example. See, in this regard, "Completing the single market in capital", speech by Benoît Cœuré, member of the Executive Board of the ECB, Paris, 19 May 2014.

Economic and Monetary Union, without neglecting the pragmatic steps that are possible in the short term without Treaty change, notably to improve economic policy coordination and the functioning of the European Semester.

We must now seek to put this to its fullest possible use. I know that some have construed the European Semester, and especially its country-specific recommendations, as the European Commission meddling in national economic and fiscal policy, which they equate with a loss of sovereignty. I do not share their view. In an Economic and Monetary Union that is still incomplete, it is vital that authorities at both the national and the European level take responsibility for treating economic policies as a question of common interest. The objective is not coordination for coordination's sake. It is an open debate among the Member States on the areas in which each of them must make progress to strengthen the Economic and Monetary Union as a whole and, finally, a joint decision by the Member States on what to recommend to each of them. However, it must also be clear that once the decision is made by the Council of Ministers, all participants at both the European and national level have a responsibility to make sure that the recommendations are fully incorporated into the legal and regulatory framework. Previous efforts have been disappointing in this respect, and I hope that the 2015 round, which begins today with the announcement of planned recommendations by the European Commission, will be different.

The National Assembly has an essential role to play in this context and in the process of strengthening Economic and Monetary Union.

Thank you for your attention. I am now at your disposal for questions.