

François Villeroy de Galhau: Euro area monetary policy and businesses

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Vereinigung der Bayerischen Wirtschaft, Munich, 26 January 2017.

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I am very pleased to be here with you and wish to thank you for inviting me. It is the second time in recent months that I have had the pleasure of visiting Bavaria. In September, here in Munich, I had the great honour of receiving the Montgelas prize, presented by Minister Erwin Huber, in remembrance of one of your great statesmen. If I may add a personal note, I am here as a committed European and a friend of Germany. I am French but my roots are in Saarland where my family has lived since the end of the 18th century and where its porcelain manufacturing company Villeroy & Boch forms part of the German “*Mittelstand*”. I feel close to your country and admire its success, particularly that of its business enterprises. Bavaria illustrates this success. It is currently one of Europe’s major economic centres. I will also have the pleasure later of meeting Dr Theo Waigel, who, alongside other German political leaders, has played such a key role in the construction of our solid common currency, the euro.

Our growth forecasts for the euro area are for growth of 1.7% in 2017, the same as in 2016. This confirms the economic recovery, which is good news, but the situation is not yet satisfactory. The euro area as a whole must aim for stronger and more lasting growth. Monetary policy naturally plays a vital role: it ensures the price stability required for growth; this is my first point. However, on its own, it can never be enough. To accelerate growth, the other economic policy levers must be brought into play; I shall come back to this later. Lastly, I will share some thoughts on the new international environment that heightens the urgency of taking action in Europe.

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1. Our monetary policy is an asset for the euro area.

I am perfectly aware that the ECB’s monetary policy is the subject of lively debate in Germany. I would first like to explain the reasons for this policy and what the situation is today.

a) **Why have we been pursuing this monetary policy?** Our European Central Bank, it should be remembered, was constructed on solid foundations shaped according to the model of the Bundesbank and its successes. And I sincerely believe that our present monetary policy is very much in accordance with the German values that I fully share: independence, respect of the Treaties, price stability and a long-term approach. Contrary to what some critics suggest, our monetary policy is not some sort of Latin fantasy. It is decided collectively by the Council of Governors and we take the mission entrusted to us – ensuring price stability – very seriously. This means ensuring that inflation is neither too high nor too low. Overly high inflation would have disastrous consequences for the economy – as German history shows. Excessively low inflation would have exposed us to deflation, a mortal danger as we know from the 1930s. In practice, price stability was defined by the Council of Governors as from 2003 as an inflation rate of close to, but below, 2% over the medium-term. This definition has not changed and is now widely shared by all the central banks in developed countries, including the United States and the United Kingdom. Up to recent years, the stability of prices in the euro area was remarkable. However, as from 2013, inflation dropped to well below the 2% mark. Our mandate required us to respond so as to bring inflation back to healthier levels for our economies.

b) **What is the situation today?** Inflation is gradually recovering in the euro area, as we had announced: we have gone from a fall of 0.2% in April 2016 to a rise of 1.1% in last December. This is partly due to the rebound in energy prices but is also the result of our monetary policy: it

has enabled us to ward off the risk of deflation which was still a threat in 2015. Now in contrast, some seem to fear a resurgence of inflation; this is very exaggerated. We have not yet reached our 2% target and “core” inflation – excluding energy and food – is of only 0.9%. The other question mark concerns the differences between countries, with inflation of 1.7% in Germany. However, following a temporary peak in the first quarter, German inflation is expected to remain under 2% on average throughout 2017. Moreover the inflation differences between countries are consistent with their different national economic situations: growth and employment are also stronger in Germany; and these differences could even contribute, via their impact on relative wages, to correcting the imbalances, hence achieving greater convergence within the euro area.

I can naturally grasp the concern of German savers in the face of low interest rates. It is not our aim to keep interest rates low for too long: low interest rates are not a goal in themselves; they are merely the necessary condition today for gradually returning towards our inflation target, and ensuring lastingly higher interest rates in the future, as Mario Draghi himself has put it. This movement has already started for long-term interest rates, with the 10-year Bund gaining nearly 60 basis points since the end of September. In December, in view of the progress achieved, we decided to reduce the volume of our monthly asset purchases from 80 to 60 billion euro. I also repeat that although I am convinced that negative interest rates have their use, they have clear limitations. But, although QE will obviously not last forever, we clearly did not discuss tapering or any exit strategy. Our monetary policy decisions have indeed given predictability for the whole year to come, and we will during this period look through transient inflation changes to focus on the medium term inflation outlook for the euro area as a whole. Lastly, interest rates do not depend on monetary policy alone, they also stem from economic growth. It is therefore in the savers’ interest that growth should be more vigorous in Europe.

Yet, as my colleague, Jens Weidmann, said last spring, “people are not just savers” [*“Menschen sind nicht nur Sparer”*]. In Germany and in Bavaria, businesses, employees, consumers and home buyers benefit from the ECB’s low interest rates. Our measures create particularly favourable financing conditions for businesses and households. Lending has grown significantly: in Germany, lending to businesses had grown by 3.5% year on year in the 12 months to November 2016. Moreover, borrowing costs less as bank interest rates have fallen steadily. As has been confirmed by several studies, monetary policy has also boosted GDP growth – for more than 1.5 percentage points from 2015 to 2018. The definitive stability of exchange rates within the euro area and the more favourable effective rate observed outside the euro area are clear advantages for German and Bavarian exporters, from Airbus to Dräxlmaier or BrauKon. The economic studies all agree: the benefits linked to the euro have been good for all the member countries but it is the German economy that has benefited most from belonging to the euro area. And regardless of the debate surrounding our monetary policy, it is in Germany that support for the euro is strongest, and still growing: 81% at the end of 2016. Support is also strong on average in the euro area (70%) and in my own country (68%). However, we are all agreed that monetary policy alone is not enough to ensure stronger growth.

2. To achieve stronger growth, our countries must reform and Europe must rapidly bring two supplementary levers into action.

The first growth lever for the euro area is **more reform in our countries and a better collective economic strategy**. Growth and employment would be stronger in Europe with more structural reforms where they are a priority, such as in France, and more public investment for instance and fiscal support in those countries with room for manoeuvre, such as Germany.

Regarding reform, like you, I would like France to accelerate; I say it frequently in my country. These reforms are compatible with the European social model that we share; many successes in Europe have demonstrated this. But you must not consider your French neighbour to be “unreformable”. France has not been immobile over the past few years. Pensions have been reformed. Reforms such as the CICE tax credit, the Responsibility Pact and the so-called “El

Khomri” labour law have substantially reduced the burden for businesses. France has met its deficit reduction targets for the past two years. This fiscal credibility must continue to improve in 2017. All this is not enough, but you should not doubt France too much, even in this election year. The soundness of our political institutions and majority system represent lasting advantages.

From its significantly more positive economic situation, Germany should also continue with reform: demographic change is likely to result in a decline in the working population – and the present inflow of refugees will not change this to any significant extent. This means that growth will slow in the long term. However, it is obviously not for me to advise measures for your country. At European level, our competitiveness will depend in particular on creating a large digital single market.

I know that when the French speak of coordination in Europe, Germans sometimes suspect it to be a new trick to avoid reform. We must break out of this dead-end: we need *both* national reforms and European coordination. As Helmut Schmidt repeated frequently, we must build economic union as well as monetary union. But this does not in my view mean a “Union of Transfers”, which Germany quite legitimately refuses.

The second growth lever: create in parallel what I call a “**Financing and Investment Union**” (FIU). Why? Because numerous businesses in Europe wish to invest and innovate but are unable to find appropriate financing. Still, the funds are by no means lacking: the euro area has a savings surplus of 350 billion euro, i.e. more than 3% of GDP. The FIU would facilitate the mobilisation of these abundant savings towards investment. To achieve this, we must develop synergies between the existing initiatives: Capital Markets Union, the Juncker Plan and Banking Union. But we must also go still further, with two clear goals. Firstly, diversification of financing to meet businesses’ needs. Equity financing, rather than debt financing, is better adapted to risk taking and therefore to innovation. But Europe currently lags very far behind in this area: equity financing of businesses is less than half that in the United States (67% of GDP in the euro area compared with 125% in the United States). Secondly: increased resilience of the euro area thanks to integrated capital markets. As Jens Weidmann and I wrote last year, this manner of sharing private risks is the best way to counter asymmetric shocks within a monetary union. In the United States for example, private equity is capable of absorbing around 40% of an economic shock specific to a State.

3. The new international environment makes action more urgent.

Some of those around us seem to no longer believe in the benefits of the European Union. The new US president has stated this very clearly, and the British chose to leave the union. These changes bring us face to face with our responsibilities: we can no longer afford to wait and see. But how should we respond? Not by less Europe. That would be a mistake if we wish to have collective control over our destiny in this new world. We should respond with a “**better**” **Europe**, less distracted by details, more focused on its priorities and more efficient. There is no point in just talking about it, we must take the necessary measures to achieve concrete results. There are, of course, non-economic areas such as defence, border security, climate change and youth education and training, to mention just a few. But in economic matters, there is also a lot that remains to be done. We in Europe have three major assets: our single currency, our single market and our common European social model. I wish to stress the extent to which this “*soziale Marktwirtschaft*” is a response to the questions raised in the Anglo-Saxon world. Germany, like many other European countries, proves that economic success can go hand in hand with social welfare and less inequality. Now is not the moment to haul down the European flag: it is time to build on our assets more actively, including by achieving a better economic union, which I spoke of earlier.

I wish to add a few words about **Brexit**. It is not something we wanted and it is obviously bad news, first and foremost for the United Kingdom and its economy. I note that the victory of Brexit

has brought the official growth forecast for Britain down to below that of the euro area, at only 1.4% in 2017. Our priority is to manage the consequences as smoothly as possible and reduce uncertainty as much as we can. The British prime minister's speech last week provided some clarifications but it is essential to bear one clear principle in mind: the single market is not divisible; access to the single market is inseparable from respecting its rules. This makes a simple free trade agreement such as that proposed by Theresa May very difficult and there can be no cherry picking with regard to Europe. The German Chancellor has quite rightly stressed that it is essential for all 27 Member States to be united on this matter.

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I will conclude by sharing my conviction with you. In the face of US and global uncertainties, I want the euro area to be an area of relative stability and growth. But now more than ever, France and Germany must act together. As a central banker, our duty is to implement the best possible monetary policy for the euro area, in keeping with our mandate. But this monetary policy neither can, nor should, do everything. It is also my responsibility to make proposals for more effective economic policies. I have outlined some ideas to you with my conviction as a European and I am now happy to answer your questions.