François Villeroy de Galhau: European Central Bank monetary policy and the resilience of the eurozone

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at Columbia University, New York City, 19 April 2017.

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Accompanying slides.

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Thank you for inviting me to Columbia University and your School of International and Public Affairs (SIPA). Columbia University is well-known as an institution of excellence. What might be less well-known is that Columbia has a unique relationship with France and with my institution, the Banque de France. Let me say from the outset that I will not comment on the current events in France and on our presidential election: I would just like to remind you that there are two rounds, the first one on Sunday and the second one on 7 May. Especially in moments like these, it is worth looking past the present, with a long-term view.

The Maison Française on the campus was created 100 years ago. Your French department is one of the best in the United States. Moreover, the Banque de France has always followed very closely and valued Columbia academic production, including two concepts that I will use today: the research of Robert Mundell on Optimal Currency Areas and the research of Mike Woodford on Forward Guidance. Lastly, Patricia Mosser, now a Senior Research Scholar here at SIPA, used to work at the New York Fed, and a number of Banque de France staff have had the privilege of working with her over the years. So, Patricia, allow me to thank you warmly for organising this lecture on the ECB's monetary policy and the resilience of the Eurozone. In Europe, the euro construction process is pretty well-known, while the ECB monetary policy is often debated. In the United States, it may be the reverse: the monetary policy is often better understood than the euro construction process. Thus I will deal successively with both issues before turning to the future and a call for action in Europe.

1. The euro has strong foundations.

Political foundations

As you know, the single currency was officially launched with the Maastricht Treaty in 1992 and introduced in 1999. But Maastricht and the euro are naturally **part of a broader history**: the history of Europe, and its singular achievement of making the transition from war to peace. As early as 1946, Josef Müller, who was a leading figure in the German resistance to the Nazis and the founder of the Bavarian CSU, acknowledged that "we need[ed] a European currency, because countries that share a currency will never be at war". The euro has indeed provided us with a strong symbol of unity among European nations. It is true that there is currently some euro-skepticism and a surge of populism, but, [slide] **a clear majority of euro area citizens support the euro today**. This is the case in all member states despite the severe economic downturns that some countries have experienced. From 12 at the start, the number of participating countries has risen to 19 today. 7 additional countries have decided to join the euro since 1999 – the most recent one being Lithuania in 2015 –, and none has wanted to leave it. The euro is not a technocratic utopia: it is a political and democratic decision, supported 25 years on, with hindsight, by a clear majority of citizens.

Economic and institutional foundations

Our foundations are partly political; but **the European edifice has also sound economic and institutional foundations**.

When reflecting on the euro at Columbia University, the first thinker who comes to mind is naturally **Robert Mundell and his theory of Optimal Currency Areas** which has been used by numerous economists to analyse the European Monetary Union and its chances of success. Mundell himself has remained an ardent supporter of the euro.[1] He put forward a number of theoretical arguments to respond to the critics – including financial integration and capital mobility –, although recognising that the EMU remains suboptimal (like, to some extent, the American monetary union). As Mundell said in 2012: *"The euro is more than just the icing on the cake on the single European market and the European Union (EU), it is the glue that keeps the core of Europe together."*

Still, an argument frequently heard against the euro is that a currency cannot exist without a state. True, the government prerogative of coinage came to be accepted as an essential attribute of sovereignty, tying the state to the money supply; but actually the state may manipulate the unit of account to the benefit of its own finances, for instance by monetising the debt, and such manipulations were not always, to say the least, in the interest of the people. As a result, it seems to me that the key ingredient of monetary stability is not the state but the independence and credibility of the issuing institution: the central bank – and this principle is firmly established in the euro area, as well as in French law for the Banque de France.

However, safeguarding our independence requires more than a series of legal provisions. As any political construct, the euro will thrive if and only if the citizens of the euro area member states are convinced that the Eurosystem delivers, year after year, on its mandate, which is to preserve price stability. This is also the reason why we are subject to **accountability** rules, requiring regular testimonies to the representation of EU citizens, namely the European Parliament and the National Parliaments, and the publication of our minutes and our results. In a nutshell, independence ensures that the ECB *can* act in line with its mandate. Accountability ensures that the ECB *does* act in line with its mandate.

Economic benefits of the euro

The fact is **the euro has already delivered material benefits**. Let me mention three of them. First, in line with our mandate, inflation has been kept under control. This directly benefits household purchasing power and helps build confidence in the value of the currency. Let us take a historical perspective. [slide] In the 18 years preceding the introduction of the euro (1981–1998), inflation gradually declined but remained at 4.6% on average, with major disparities across countries. In the 18 years since the euro (1999–2016), inflation has been much more stable, averaging 1.7%, and the disparities across countries have narrowed.

Second [slide], better controlled inflation means a lower cost of financing, because it reduces risk premia. All economic players benefit from lower interest rates: households, when they purchase a property, companies when they invest, but also governments and hence taxpayers. Spreads may temporarily react to political uncertainties, but remaining in the euro continues to be our best protection against such fluctuations.

Third, the euro has helped consolidate the European single market, by eliminating currency fluctuations for corporates, simplifying day-to-day life for citizens and promoting capital market integration. Moreover, the economic size of the euro area and the stability of its currency have enabled the euro to play an important international role. Today, the euro accounts for 20% of international reserves, second only to the dollar. An internationally recognised currency generates economic gains: financial markets are more attractive to domestic and foreign investors, more liquid, and thus more efficient. But it also carries a political weight: when Mario Draghi speaks at the G20, the whole world listens to Europe attentively, just as when Janet

Yellen speaks for the United States.

Overall, this list of benefits is impressive, particularly when you think that the euro is only 18 years old. More importantly, we have come this far despite the global financial crisis, which triggered the deepest recession in three generations, and despite the euro area sovereign debt crisis a few years later.

2. Let me now turn to monetary policy: the euro has passed the stress test of the crises.

a. Monetary policy

Successful crisis management

The Eurosystem has deployed **an innovative and resolute monetary policy strategy**, which has helped stabilise the euro area economy and reduce the costs of crises. Let me briefly recall what we have done [slide]. We had first to face, like you, the consequences of the collapse of Lehman Brothers. Like many other central banks, we reacted promptly by offering unlimited liquidity to financial intermediaries, sharply lowering our main refinancing rate and providing international swap lines. Yet, this was only our first challenge. The Lehman episode paved the way for the euro area sovereign debt crisis and its amplification through the “bank-sovereign” nexus. To counter these centrifugal forces, we notably launched an unlimited provision of liquidity for a maturity of three years at our main refinancing rate and against a larger range of eligible collateral in December 2011. Proof of our credibility in keeping Mario Draghi’s word to do “whatever it takes to preserve the euro” (July 2012), the simple announcement of our Outright Monetary Transactions programme was sufficient to alleviate financial market strains.

More recently, beginning 2014, we had to react to the risk of **sliding into deflation**, which was due to a combination of factors: the slowdown in global growth, the collapse of commodity prices and the persistent weakness in domestic demand. That is why we implemented a set of vigorous measures, including three main ingredients: asset purchases, forward guidance – both of which are measures that the Fed also put in place – and negative interest rates. The **asset purchase programme** – or QE – included first private debt instruments and then also public sector debt. Since April 2017, and till December 2017, purchases amount to EUR 60 billion per month, having been reduced from EUR 80 billion. The perhaps most unconventional policy is the use of negative interest rates. I emphasise this measure as the most unconventional because for most people, as well as in all economic models that I am aware of, nominal interest rates are positive. The ECB’s Governing Council made the decision to put in place negative interest rates on their deposit facility (DFR) in June 2014 and to lower them to their current level of –0.4% in order to further ease monetary and financial conditions. Perhaps precisely because taking such steps was unusual, they helped us convince markets that our commitment to our mandate was very firm. On the other hand, negative interest rates clearly have limitations: they are difficult to accept by households and SMEs, and so impossible in practice to pass through to them. And thus they are believed by many to deteriorate the profitability of financial intermediation. We monitor carefully that maintaining our DFR at its current level does not lead banks to reduce their supply of credit.

What effects?

I very much believe that our package of non-standard measures has worked and still continues to do so. **Inflation is gradually recovering** towards our target of below but close to 2% over the medium term: as of March 2017, the year on year euro area HICP inflation is 1.5%. It was only 0.2% in 2016. **Financial conditions have eased considerably** [slide]. According to our in-house assessment, our monetary policy has contributed to a decline of about 100 bp in long-term interest rates. This is very significant. In normal times, we could have needed a cumulated decline in the short-term interest rate of about 3%[2] to bring about such a reduction in the long term interest rate. We have also seen a significant cut in bank retail interest rates combined with a rise in loan volumes. Since 2014, bank lending rates to firms have dropped by more than 100 bp on average in the euro area [and by as much as 130 bp in Italy; and the spread between Italy and France decreased by 60 bp between January 2014 and February 2017]. The growth rate of bank loans to non-financial corporates has increased from –4% in late 2013 to +2% today. Bank loans to households have also gone from negative to positive growth rates. In addition, **the economic recovery is currently firming and broadening**. Growth has been steady for, as I speak, 14 quarters in a row and 5 million jobs have been created since mid-2013 in the euro area, although unemployment is still too high at 9.6%. This recovery is neither fast nor vibrant enough but it has prevailed in spite of a number of global and domestic shocks. [slide] Growth in the euro area was slightly higher than in the United States in 2016, and should not be very far off in 2017.

Next steps for monetary policy

So **what should we do next?** It is clear that the current macroeconomic environment does not call for a recalibration. **Our current monetary policy stance remains fully appropriate based on current information**, as Mario Draghi has stressed, and should not be adjusted before we see more concrete signs that inflation can be sustained at levels closer to our target. For the future, on the most appropriate way to reduce the intensity of our accommodation when it becomes warranted, two principles should in my view guide us: these are **prudence and effectiveness**.

We need to be prudent, because the recovery is still fragile. This amounts to asking whether the adjustment of inflation towards our target of below, but close to, 2% would continue without our monetary stimulus. At present, the ECB’s Governing Council does not think this is the case. Underlying inflation, without oil and food prices, remains below 1% and should, according to our forecasts, gradually pick up to 1.8% in 2019 according to the pace of wage increases.

We also need to be effective, in the sense that, among our combination of various instruments, we should withdraw last the measures that are mostneeded to secure a sustained adjustment in the path of inflation consistent with our target. We will continue to assess the situation with great pragmatism. There is no predefined split between the doves and the hawks on the Governing Council, as is sometimes claimed. I am confident that our future strategy, as the present one, will be the result of a collective discussion and a cohesive decision.

b. Institutional framework

In parallel, the institutional framework of the euro area has been improved in response to the crisis. Member states have secured key steps to reinforce the resilience of the euro area for the future. With the **European Stability Mechanism** (ESM) introduced in October 2012, they have established a powerful crisis management mechanism for the euro area. With its effective lending capacity of EUR 500 billion, this backstop gives euro area countries in distress time to implement measures to restore fiscal sustainability, competitiveness and financial stability in the medium term. Besides the ESM, the **Banking Union** is a major progress towards further European financial integration and therefore a more performant currency union. It is now operational, based on two pillars. The first one, since end 2014, is the **Single Supervisory Mechanism**. It gives the ECB the responsibility, in cooperation with the national supervisors, to oversee banking supervision in the euro area, and ensure the consistent application of regulations across the region. The second pillar, since January 2016: the **Single Resolution Mechanism**. It ensures that banks across the euro area can be resolved according to the same rules and with minimal costs for taxpayers and to the real economy.

Yet, we also have to look at what is still to be done. Further important steps for the Banking Union are under discussion, with a priority to completing an efficient resolution pillar. Moreover, there are still some issues with certain banks, in particular regarding non-performing loans in Italy and Portugal. These are manageable but now need to be addressed seriously and quickly. That said, we should not judge the European financial sector only on the basis of its difficult cases, or those "trailing at the rear". Overall the euro area banking system is now far more resilient: in terms of capital for instance, the Common Equity Tier 1 ratio of significant euro area banking groups has risen from less than 7% in 2008 to more than 14% today. In this context, and within the banking union framework, we need to allow more cross-border bank mergers. These will enable banks to better shift savings across national borders towards where investment needs are. And obviously we should preserve and complete international financial regulation on both sides of the Atlantic. Cooperation on regulation has been a win-win game. Competition on regulation would be a destructive one.

3. How I see the future of the euro area: a call for action.

This leads me to the question of the future of the euro area. Let me be blunt here: I see it as promising, if we act. Obviously there are challenges today, be they domestic – euroskepticism and unemployment – or global – uncertainty in the West (US and UK) as well as in the East. But I am convinced that the answer to the current challenges is not "less Europe". Less Europe would be a mistake if we want to remain in control of our common destiny. That said, there is room for further improvement, for a "better Europe". Twenty-five years ago, we spoke of an "Economic and Monetary Union". Since then, we have made a success of **Monetary** Union, but we have not been very effective with regard to **Economic** Union. The rather good economic performance in the euro area on average still conceals individual heterogeneities. [slide] And so, first and foremost, some countries, like France and Italy, need to accelerate domestic structural reforms to improve the functioning and flexibility of their economies. And let me be clear, it is in our national interest: we currently have lower economic growth and employment than some of our neighbours, such as Germany, Spain and the Netherlands, which have succeeded in carrying out the necessary reforms.

In order to achieve a "better Europe", we need to complete these domestic reforms with what I call the "growth triangle" [slide]. It calls, at European level, for two concrete projects, in addition to domestic reforms: a "Financing Union for Investment and Innovation" (FUII) and a collective economic strategy.

The first project, to be started immediately, is **a "Financing Union for Investment and Innovation",** because the financial crisis has led to a persistent "investment crunch" at the European level. And yet it is not for lack of resources: the euro area has a savings surplus of more than EUR 350 billion, equivalent to more than 3% of GDP. That is huge. Several initiatives are already in place: the investment Plan of the European Commission ("Juncker plan"), the Capital Markets Union and the Banking Union which is now underway; but they do no deliver sufficient results. It is now necessary to make these initiatives converge into the FUII. Europe needs a better sharing of private sector risk, in order to channel its abundant savings more effectively towards productive investment. And the equity financing of businesses, across European borders, must be a priority. Europe is lagging far behind in this area: such financing only represents 67% of GDP in the euro area compared with 125% in the United States.

The second project, on which we could make progress after the French and German elections that will take place this year, is a **collective economic strategy in the euro area**. Growth and employment will be stronger in Europe if we combine more structural reforms where they are a priority – in France and Italy for instance –, and more fiscal or wage support in countries with room for manoeuvre – Germany and the Netherlands.In practice, for such a collective economic strategy to exist, the euro area needs to overcome the current sense of distrust; it needs what I would call "a trust deal". This is why I have proposed, as have others, the creation of an institution to foster confidence, which could consist of a euro area "finance minister".

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Let me conclude. Jacques Delors, who was President of the European Commission in the late 1980s – early 1990s, used to say that in Europe "we don't just need firefighters, we need architects". The Eurosystem has been a very efficient firefighter during the crisis and is doing its best to contribute, within its mandate, to building a more dynamic growth path for the euro area, through its monetary policy. However, the success of monetary policy still needs to be complemented with a genuine economic union to achieve the European project. This is now the responsibility of the architects, including the next governments in France and Germany.

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1 business.financialpost.com/fp-comment/robert-mundell-euro-is-here...

2 If we take the rule of thumb once used by John Williams, the President of the SF Fed.