François Villeroy de Galhau: The euro – which way to go?

Keynote speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the EconPol Europe (European Network for Economic and Fiscal Policy Research) Founding Conference and first Annual Meeting "The Euro - Which Way to Go?", Brussels, 9 November 2017.

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Mr President, Ladies and Gentlemen,[1]

It is a pleasure to be in Brussels today, which doesn't happen so often for a central banker… who has just arrived from Frankfurt. I welcome the fact that you at EconPol Europe have chosen the euro as the theme of your founding conference, and invited me to give this keynote speech. Since Maastricht 25 years ago, we have succeeded in building a Monetary Union. However we have not delivered on Economic Union. To avoid overburdening monetary policy, our Union must stand on two feet rather than just one: that is why it is legitimate that we, as central bankers, propose ideas on this subject, even if we are not those who legitimately make decisions. It is now urgent to make concrete progress on Economic Union, all the more so as the economic context is now favourable, as confirmed today by the European Commission. Euro area growth of 2.2% in 2017 should be the highest rate in 10 years, and as strong as in the United States. It could be for France even slightly higher than forecasted (1.6%), if we look at our Banque de France forecast for Q4 published this morning – at 0.5%. It will be sustained in the next two years thanks to strong investment and increased convergence among countries. These forecasts, including a positive but still subdued inflation, confirm the adequacy of the gradual normalisation of our monetary policy we are engaged in.

There is a risk, however, that the debate will continue to revolve around two long-standing divisions: "German rules" vs "French expenditure" and "community methods" vs "intergovernmental methods". Too many fears and suspicions have been inherited from the past, but we are living in a new era – which is also thanks to the acceleration of reforms in France – and in a time of unique historic opportunity. In Rome, on 25 March of this year, the Member States all expressed their clear will for "the completion of the Economic and Monetary Union". We are in agreement on the "**why**": greater **stability**, to counter the risk of a new crisis befalling an unprotected euro area; and greater **growth**, to catch up our past lag on the United States and finally treat the fatal disease of mass unemployment in Europe.

But **how** can we achieve this shared objective? We should trigger four accelerators: a macro accelerator, which would consist of a collective economic strategy shared by all euro area Member States; a micro accelerator, which would take the form of a Financing Union for Investment and Innovation, going beyond the CMU (Capital Markets Union); a fiscal accelerator, which would draw on a euro area budget. The fourth is not an accelerator in substance, but rather a "facilitator" for the first three: on institutions, a euro area Finance Minister and Parliament.

These accelerators would contribute to the functions of economic policy, as described by Musgrave:[2] allocation, stabilisation and distribution. The allocation function aims at making sure that resources are used in an efficient way. This would obviously be the role of the micro accelerator, but also of the fiscal one – through the financing of European common goods. The stabilisation function consists in the smoothing of the cycle and cushioning of the impact of crises, and this could be ensured mainly by the macro accelerator, but also by the micro one, thanks to enhanced private risk sharing, and possibly by the fiscal one. Finally, the distribution function is to foster an equitable sharing of income. This role could possibly fall to the fiscal accelerator but its implementation would require increased trust and greater economic convergence between euro area Member States in order to avoid a "transfer union" which would be a one-way budget: in that case, I would understand German fears.

So these four accelerators are needed, but this does not mean they all have to be implemented at the same time. The latter two accelerators, fiscal and institutional, would indeed require Treaty changes, unless they were to be very limited. However, this must not stop us from taking steps straight away on the first two accelerators, macro and micro, on which I will insist today. I would like to share with you some personal reflections – useful for the proposals that the European Commission will make in December and for our debate today. To be more specific, I will focus on one part of each of these two accelerators, where progress can be made quickly: I will first dwell on the creation of a Stabilisation Lending Instrument (SLI) as part of the macro accelerator, and I will then elaborate on the completion of the Banking Union as part of the micro accelerator.

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I. A macro accelerator, including a Stabilisation Lending Instrument (SLI) and perhaps a European Monetary Fund

The macro accelerator is premised on one simple fact: economic growth and employment would be stronger in the euro area if we combined more reforms in countries where they are needed, like France or Italy, and more stimulus in countries with leeway for it, like Germany or the Netherlands. To achieve this collective economic strategy, euro area Member States have to seal a deal, which could be prepared and adopted as early as 2018.

In addition to this commitment, I also suggest creating a Stabilisation Lending Instrument at the euro area level, and I would like to detail some key aspects regarding its objectives and operational efficiency. I will then talk more broadly about a possible European Monetary Fund.

Let me start with the **objectives**. The SLI would provide loans to euro area Member States faced with an asymmetric economic shock, in order to support their countercyclical policies. Finland for instance was faced with a triple asymmetric shock in the late 2000s, due to the collapse of Nokia, the decline of the paper industry and the aftermath of the Russian crisis – real GDP contracted by 9% in 2009. Such a shock could also stem for instance from temporary political uncertainty – as long as it is not fuelled by inadequate economic policies – from natural disasters or from an irrational loss of confidence in the financial markets resulting in excessive pressure on the sovereign spread. The SLI would be a complement to and not a substitute for national stabilisers. It would help Member States not to abandon their longlterm investments, especially by preventing an unwarranted widening of their financing conditions.

Beyond this Stabilisation Lending Instrument, the creation of a “rainy day fund” with fiscal resources could be considered at a later stage once confidence and economic convergence between Member States have increased.

On the **operational efficiency** of the SLI, access to the instrument should be simple, subject to carefully chosen macro-financial criteria. Minimum conditions would be first that Member States actually abide by common rules – the Stability and Growth Pact and the Macroeconomic Imbalances Procedure – and second that they actually conduct policies consistent with the euro area collective economic strategy. However, contrary to the ESM instruments that have been used so far, access to the SLI should not be conditional on the implementation of an adjustment program. Its design would be such that it does not involve a stigma for Member States.

The issue of **governance** brings me to a broader reflection on the idea of a European Monetary Fund (EMF). An EMF would only make sense if its scope of action and its governance went beyond those of the current ESM. Otherwise, why would we give it a different name? The scope of action of a potential EMF should not be limited to crisis management. We should entrust it with the role of crisis prevention in a broad sense, including contingent lending through the SLI. This would require decision-making processes that would not be tied up by veto-based governance.

As President of the Eurogroup and Member of the European Commission, the Finance Minister of the euro area would logically chair the Board of Governors of an EMF and play a stronger role in situations that require Board level judgement. In due course, it would be beneficial to bring an EMF into the fold of the Community method, which means anchoring this institution in the framework of Union law [the Commission has suggested proceeding on the basis of art. 352 of the TFEU]. Within this framework – and only within it – it would make sense to entrust an EMF with a broader surveillance mission, including the task of monitoring compliance with the common rules, a role that is today assigned to the European Commission.

II. A micro accelerator, including the completion of the banking union

Let me now turn to the micro accelerator for the Economic Union: a Financing Union for Investment and Innovation. The aim is to better steer the euro area's EUR 350 billion annual savings surplus towards productive investment, notably by shoring up equity which is the key to an innovation economy. Thanks to unified governance, this Financing Union would help circumvent bureaucratic barriers and foster synergies between the existing building blocks: the Juncker Investment Plan, the Capital Markets Union and the Banking Union. Yet, for this Financing Union to be effective, progress is still needed in four key areas: first, providing incentives for cross-border investments – mainly in equity – through accounting, taxes and insolvency laws; second, developing pan-European long-term saving products – with a key role for the insurance sector – and investment vehicles like European venture capital funds; third, completing the Banking Union; fourth, controlling financial activities and risks that are of vital importance for the euro area, such as supersystemic CCPs. And so, we could reach significant gains for digitalisation, SME's scaling up or energy transition. Today, I will focus on the third area: completing the Banking Union.

The Banking Union is a major step forward for the euro area and is now operational, based on the single rulebook and already two pillars: the Single Supervisory Mechanism (SSM) since end-2014; and the Single Resolution Mechanism (SRM), since the beginning of 2016. Those two pillars will have to be complemented by a third pillar about Deposit Insurance, where we could find practical and reasonable compromises. But in addition, I will elaborate on two challenges that are less often mentioned: consistency, and consolidations.

The first challenge is to **achieve better consistency between regulation, supervision and resolution**, at three levels:

- First, in the **concrete mechanisms**: finalising and simplifying the resolution pillar should be a priority. The case of the Italian banks has illustrated just how complex it is to combine the resolution regime laid down in the Bank Recovery and Resolution Directive (BRRD) with the State aid framework for orderly liquidation. In addition, confidence in the Single Resolution Fund (SRF) and its capacity to intervene has to be bolstered. The setting-up of a common backstop, as mentioned in the European Commission's communication of 11 October, is a promising avenue, which could take the form of a credit line granted by the ESM. Furthermore, the issue of the **liquidity** of the newly resolved entities – mainly the "good banks" – is not sufficiently clearly addressed: liquidity support by public sources beyond what can legitimately be expected from the Eurosystem should be clarified.
- Second, consistency in the **legal framework and requirements**: faced with the accumulation of new and "separate" requirements, we need to adopt a holistic and consistent approach in order to avoid a prudential overload. In particular, the TLAC requirement resulting from the new international framework requires a consistent adaptation of the European minimum requirement for own funds and eligible liabilities (MREL). In the same vein, the consequences of an internationally-agreed Basel III package – if and when it comes – should be carefully taken into account, as it would lead to increased risk-weighted assets, which will in turn impact the MREL. All this, combined with pillar II capital requirements, could lead to over-calibration: each individual decision may be warranted; but

their somewhat disorderly accumulation is not. And obviously, we must not jeopardise the level playing field between euro area banks and their international competitors.

- Third, in the **interaction between authorities**, which should be improved: the case of Banco Popular, although it was a success, has also demonstrated the importance of swift and close cooperation between supervisory and resolution authorities, both at European and national levels. In this respect, there is still a need to better coordinate the roles of the different European authorities – SSM and ECB, SRM, Commission, and EBA – in order to have a clearer “pilot in the plane” in crisis management. At a later stage, we could even consider establishing a single banking authority for our single Banking Union, acting to bolster the robustness of the European banking sector.

The second challenge is **to support cross-border bank consolidations in the euro area.** The head of the SSM too, Danièle Nouy, insisted on this point a couple of days ago. We still lag far behind the American market in this respect: the market share in the United States of the top five banks is more than 40% whereas the market share in the euro area of the top five banks is less than 20%. Sound and safe cross-border consolidations would make banks better able to diversify their risks across the euro area, and channel savings more effectively towards investments across borders; this would foster the Financing Union I talked about.

From a supervisory point of view, it involves supporting an approach on a consolidated basis by granting more waivers on liquidity and capital so as to allow more flexible capital allocation and limit ring-fencing. Swift execution of cross-border transactions is also essential: the implementation of a fast-track process by the SSM would address this issue. From a resolution point of view, internal MREL requirements could be a tool to facilitate the resolution of institutions, but they would become meaningless if calculated on a national basis. Indeed, having internal MREL in all countries could be an obstacle to the single market and European banking cross-border mergers. Finally, we should address business and legal impediments to cross-border mergers: information asymmetry, non-performing loans (NPL) or anti-takeover legal structures in different countries. As a first concrete step, I suggest that the EBA publish a comprehensive stock-taking of all the regulatory and supervisory obstacles to cross-border activities and mergers. The aim is crystal clear: within a Monetary and Banking Union, a cross-border merger must not be more difficult and cumbersome than a “domestic” merger. The logic of the banking union is that it should be considered for banking purposes as a unique jurisdiction.

I would like to conclude by quoting one of the founding fathers of Europe. On 10 December 1951, Robert Schuman, declared before the Assembly of the Council of Europe: “If we do not make up our minds in time, Ladies and Gentlemen, we shall run the risk of letting slip the last chance of salvation for Europe and for our countries". In a post-war context, he was well aware of the urgent need for action in Europe. In the current context, we should draw from this feeling of unique opportunity. There are of course non-economic projects: to name a few, climate change or youth education and training – in this respect an Erasmus Pro programme should be a priority for the unskilled and unemployed youth. But in the economic area which is my focus today, it is now or never: this is the right time to step up the pace in Europe. Thank you for your attention.

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[1] I would like to thank Marine Dujardin, Jordan Granata, Simon Laplace, Olya Ranguelova, Bérengère Rudelle, Caroline Varlet and Edouard Vidon for their help in preparing this speech.

[2] Musgrave, R. and Musgrave P., *Public Finance in Theory and Practice*, McGraw Hill, 1989.