

François Villeroy de Galhau: The sustainability of European Monetary Union and institutional reform

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at The ECB and Its Watchers XIX Conference, organised by the Institute for Monetary and Financial Stability, Frankfurt am Main, 14 March 2018.

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Accompanying [slides](#).

Ladies and Gentlemen,

In order to make the European Monetary Union sustainable in the medium term, we have to make it more resilient to future crises. The current economic cycle is admittedly in a very robust phase today, but this will come to an end at some point. If we do not want to overburden monetary policy during the next recession, we need to strengthen our Economic Union. These objectives should be, including here in Germany, two sides of the same coin. To ensure monetary policy does not remain “the only game in town”, we have to arm ourselves with stronger economic instruments at the European level. There is a serious risk, however, of missed opportunities as the present debate over the future of the euro area seems to be getting bogged down in never-ending arguments such as on the European Deposit Insurance Scheme (EDIS) or sovereign debt restructuring. We should rather focus our efforts on the many other proposals that are more consensual. In my remarks today, I will elaborate on the three old clichés that are paralysing the debate and that we must put behind us to move forward in the euro area. But before that, let me say a few words about our monetary policy.

Our monetary policy is doing its part, thanks to its persistence and patience, as Mario Draghi stressed this morning. Past questions about its effectiveness and our exit strategy seem to have receded – and rightly so. We confirmed last week our course of gradual normalisation, with the removal of the so-called “easing bias” on the APP. What we see now is a welcome alignment of the stars: against the economic background of a robust expansion with gradual progress on inflation, there is a broad convergence of market expectations with the views within our Governing Council. At present, there is very little debate among us. But this convergence doesn’t preclude vigilance. We’re closely watching the somewhat slow pace of inflation – I believe the Phillips curve is still at work, although with a time lag – and the global risks, starting with US trade policy and the evolution of the exchange rate.

Let me now turn to the core of my message: the need to strengthen our Monetary Union by making concrete progress on Economic Union. There is currently a window of opportunity: the economic recovery is robust, and many euro area reform proposals point in the same direction, including the Commission roadmap of December 2017, President Macron’s speech at the Sorbonne last September and, more recently, the European chapter of the German coalition agreement. The outcome of the recent elections in Italy shows that we can’t waste any more time with theoretical debates. We as central bankers are concerned here with avoiding overburdening monetary policy by the next recession, but it is of course the responsibility of politicians to act.

1/ **The first cliché** that emerges when we talk about reforming the euro area is the **opposition between vision** – be it French or otherwise – **and pragmatism** – seen as a northern European virtue. We must be practical, and take real needs and particularly those of businesses and entrepreneurs as our starting point. At the same time, we need a political ambition if we are to act – call it a “vision” if you wish. Today, the key to growth in the euro area is investment and innovation. But to innovate, in digital technology or in the energy transition for example, companies need to be able to take more risks, which requires more equity financing over the

long term, rather than debt financing. The euro area is seriously lagging behind in this respect: equity capital amounted to only 73% of GDP in the third quarter of 2017, compared to 123% in the United States. This brings me to my first solution for strengthening our Economic Union: a European-level **"Financing Union for Investment and Innovation"**, which would better channel the euro area's EUR 350 billion savings surplus into equity financing for innovation, in digital or renewable energy technologies. This Financing Union should bring together existing initiatives and, as a priority, the Capital Markets Union, but also the Banking Union and the Juncker Investment Plan.

There is no tremendous political obstacle on this rather technical agenda. Within the Governing Council of the ECB, we all find it extremely regrettable that the Capital Markets Union is currently being overlooked and last Thursday we urged that "specific and decisive steps" be taken in that field.

2/ The second cliché is the complacent idea that **action at the European level would be a substitute for national reforms**. Let me say on the contrary that national reforms are a prerequisite for any enhancement of the Economic Union, and France is well aware of this. I say this in my capacity as a totally independent central banker: the new government is acting with impressive speed on structural reforms. National reforms are necessary but they are not sufficient as our challenge is this: how to ensure stabilisation and better allocation at the euro area level. Regarding stabilisation, I see two avenues. First, a better **collective economic strategy** in the euro area. Member States are responsible for their economic policies, but the euro area will indeed be better off with more reforms in countries where they are needed, like France, and with more fiscal or wage support in countries with room for manoeuvre, like Germany or the Netherlands. Second, a **precautionary stability-oriented instrument** in order not only to manage crises ex-post, but to prevent them ex-ante. Such an instrument already exists, in theory, in the ESM toolbox in the form of the 'Precautionary Financial Assistance'. Yet, it has never been used, and could probably be improved, with clear rules and some form of automatic prequalification system, to avoid a stigma effect. This enhancement of the crisis prevention instruments could form part of a broader transformation of the ESM and its governance into a European Monetary Fund (EMF).

The issue of **allocation** should also be seriously addressed. In order to boost potential growth in the long term, expenditure on investment and on our future are vital, including on education and training and, of course, new technologies. This is true of national budgets, but we could amplify the effect through a **euro area investment budget**. This budget could be used to finance, for the benefit of all euro area Member States, certain "common goods" such as digital technology, energy transition, security, and external border protection. As all countries would benefit from this budget, it would be precisely the opposite of a transfer union. In a nutshell, what I have elaborated on so far are the accelerators of the Economic Union: micro, macro and fiscal [slide].

3/ This leads me to the third and last cliché: we should stop pitting **risk reduction against risk sharing** or, to put it another way, responsibility against solidarity or, in a complementary perspective, rules against discretion. These oppositions create a sterile division between northern Europe and southern Europe. To work well, our Union needs both: risk reduction mechanisms and risk sharing. As I just said, for crisis prevention to be credible, we should implement fiscal discipline – including the present rules of the Stability and Growth Pact – but we should also have the instruments needed to cushion the effects of asymmetric shocks that may arise suddenly, regardless of all the efforts a Member State can make. It is time to forget about ideological trench warfare. Let me share with you four areas where practical progress is needed:

- ♦ First, bolstering **private risk sharing**. The simple and obvious way to achieve this is to build the Capital Markets Union within the Financing Union that I mentioned earlier. We are still lagging far behind the United States where capital markets are capable of absorbing around 40% of a state-specific shock. What is more, a genuine Financing Union would further

increase the efficiency of monetary policy by ensuring better circulation of liquidity in the euro area.

- ♦ Second, **EDIS**. We have made significant strides with the first two pillars of the Banking Union, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). We still need – and it should be our priority – to strengthen the SRM with a sovereign backstop to the Single Resolution Fund and a simplified decision-making process tailored for emergency cases of resolution. Now, there needs to be some form of compromise to move forward on the third pillar, EDIS, as well. A suitable and pragmatic approach could be a first step focused on providing the liquidity needs of the national deposit guarantee schemes, as proposed by the European Commission last October. We don't need from the start an integrated European guarantee.
- ♦ Third, **sovereign debt restructuring**. It is legitimate and important to ask ourselves how to make the euro area better able to withstand sovereign debt crises in case they happen. In this regard, enhancing market discipline can be part of the solution – the proposals to set up a sovereign debt restructuring mechanism build on this idea. However, we have to be very cautious and make sure that it does not become part of the problem. When rules are rigid, market expectations may prompt sudden chain reactions or speculative attacks and put financial stability at risk. And nobody should underestimate the “transition problem” on the existing debts if such a policy were to be announced.
- ♦ Fourth, **the institutional architecture of the euro area**. If we make progress on the substance (the three instruments I mentioned), there is a strong case for a euro area Finance Minister in order to implement them. He would be President of the Eurogroup and a member of the European Commission, as mentioned in the European Commission's proposals published in December 2017. As a compromise between rules and discretion, this Finance Minister could rely on the expert advice of an independent institution such as a strengthened European Fiscal Board.

Let me sum up. It is high time we took pragmatic and decisive steps, beyond the three old clichés which are impeding progress towards a more sustainable European Monetary Union. They draw a pointless distinction between vision and pragmatism, European-level action and national reforms, and between risk reduction and risk sharing. There are three solutions: first, a “Financing Union for Investment and Innovation”; second, better coordination of economic policies supplemented by a stability-oriented instrument within the ESM (or EMF); and third, a euro area investment budget for the financing of common goods. Thank you for your attention.