François Villeroy de Galhau: What are the economic prospects for the euro area?

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Conference at LUISS University, Rome, 29 November 2018.

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Ladies and Gentlemen,

I am delighted to be here with you this evening at LUISS University, in the magnificent ballroom of the Villa Blanc, and I would like to extend by warmest thanks to Vice President Paola Severino. LUISS University is renowned for the high standard of its teaching and one of your illustrious former presidents, Guido Carli, who gave his name to your university, was also a signatory to the Maastricht Treaty in 1992.

I am here to speak to you today as a friend of Italy, a country which I hold very dear. For several years in my professional career, I made monthly visits to Rome and had the pleasure of learning your language. I am pleased to see my friend Governor Ignazio Visco here, as he is also my closest neighbour in Frankfurt: we sit next to each other on the Governing Council. I am also here as a committed European, one who is familiar both with Germany and Belgium. This commitment is also shared by Sylvie Goulard, who is here today in her capacity as Deputy Governor of the Banque de France. I am very much aware of the challenges facing Italy today – including, until very recently, the flow of migrants – all the more so because of our shared culture and history, and, today, our shared institutions and challenges. As a central banker, however, I am going to focus on the economic issues, and notably on our shared currency and the euro area.

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To start with, let me just remind you of some stylised facts about Italy, which are often too quickly forgotten. **Italy has many strengths**: it is the euro area's second largest manufacturing economy, after Germany and ahead of France. Its export performances have improved in recent years, thanks notably to an increased specialisation in high-end products[1] and to the talent of its *imprenditori*, from Brescia to Bologna. Moreover, thanks to the reforms undertaken by successive Italian governments since 2012, its macroeconomic position is on the whole solid [slide]. To highlight just a few key figures: its net external position is almost balanced (-5% of GDP in 2017), and better than France's; its current account has been in surplus since 2013 (2.8% of GDP in 2017); and its private sector debt is lower than the euro area average. Yes, Italy – just like Europe – has much more to be proud of than people say. Pride means that we can be more serene, without being aggressive. But it should not prevent us from being lucid.

Italy **is indeed expanding at a slower pace than it should be** [slide]. Real GDP has still not returned to its pre-crisis level. As for real per capita GDP, it is lower now than it was in 2007. This weak growth is one of the main factors behind the high public debt ratio, which has been rising since 2008. Another consequence of feeble growth is the high unemployment rate, particularly among the young (32% in September 2018 for 15–24 year-olds). The tragedy of the *scoraggiati*, especially in the south, should be seen as our tragedy too.

It is with this image in mind that I want to shed some light now, here in Rome, on the economic prospects for the euro area. I would like to share with you two firm beliefs:

- with regard to the challenges we face, the euro is one of the solutions, not one of the problems;
- but in order to build a more solidarity-based euro area, we need to have an Italy that is

committed.

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I. The euro is one of the solutions, not one of the problems.

There is still a temptation to blame the euro for this weak rate of growth. Proponents of this idea see the single currency as a German-imposed straitjacket, managed by "Frankfurt" strictly for Germany's benefit. It is always legitimate to have a debate, and we should not shy away from this one. But **in reality the euro is one of the solutions, for four reasons.** Two are linked to the long term, to the past 20 years of the euro that we will celebrate on 1 January: the historical will; the economic results. And two are linked to the very nature of the economic policies being pursued today: the single monetary policy; and the decentralisation of other policies.

1/ First, let me just give you a brief **historical** reminder: from the outset, it was Italy and France that wanted the euro, much more than Germany. I remember Rome in December 1990 and the Palazzo Montecitorio, where we opened the Intergovernmental Conference on Economic and Monetary Union – chaired as it happens by Guido Carli. We then built the euro together, step by step – and since then, it has been managed much more by the French and the Italians – from Tommaso Padoa-Schioppa to Mario Draghi – than by the Germans.

Yes, Frankfurt is in Germany… just as Brussels is in Belgium. But Italy and France now carry much more weight than before in the decision-making, because, in practice, at the time of the franc and the lira, our monetary policies had to more or less conform to Germany's. We only had one freedom left: the freedom to periodically devalue our currencies; that was also humiliating, and above all left our people financially worse off. Although devaluation provides short-term benefits linked to the fall in export prices, in the medium term these are potentially outweighed by the negative effects, which we have tended to forget: inflation caused by higher import prices, a fall in the value of the country's wealth and an increase in its external debt. Italian creativity, your commercial ingenuity, dating back to Venice, Genoa and Florence, all count much more than the ease of a weak lira.

2/ The second reason is the economic results. For the past 20 years, Italy and France have reaped substantial **benefits from the single currency**:

- price stability [slide], in other words a contained level of inflation that preserves household purchasing power. Before the euro, inflation sometimes reached very high levels in Europe: it averaged 8.1% in Italy in the 20 years before the euro, compared with 1.8% in the last 20 years.
- stable financing conditions, due to a marked reduction in interest rates and a narrowing of spreads between countries [slide]. The spread between Italy and Germany, for example, has more than halved: it averaged 5.1% over 1986–92 – a period when we had a single market without a single currency, between the Single European Act that followed the Milan European Council, and Maastricht – compared with 1.9% in 2017–18, even though it has widened again recently due to the re-emergence of uncertainties. And in France, it went from 1.9% to 0.4%. Assuming, then, that one of our countries were to go back to pre-euro times – a scenario I see as very unlikely – there would be a heavy price to pay in terms of the financing of public debt, as well as household and corporate debt. For Italy, it would ultimately mean an increase of more than EUR 70 billion a year in the government's debt servicing cost, which is more than the country's total education budget.

Our citizens are therefore strongly attached to the single currency: today, 61% of Italians and 70% of French people support the euro.[2] And it is this broad-spread, popular support that is one of the euro's greatest achievements.

3/ The last two reasons relate to the **very nature of the unique system** that unites the 19 euro area countries: monetary policy is shared; all other economic policies are decentralised. Let's start with our **monetary policy**: the Eurosystem's commitment since the 2011 crisis **has been decisive in reducing fragmentation** between euro area countries. [slide] Interest rates have fallen further in Italy than anywhere else – for firms, households and the government – and Italian banks have received more liquidity than those in other countries. This has led some to argue that our monetary policy is now being conducted for the benefit of Italy: they're wrong. Monetary policy is not conducted for any one country, be it Germany, France or Italy. The Governing Council takes its decisions collectively and independently, free from outside influence, and its position is clear: no country's national fiscal policy should influence our single monetary policy, either now or in the future. In keeping with the mandate entrusted to us democratically, we should maintain a single focus: price stability throughout the euro area, with inflation below but close to 2% over the medium term. This is how we can contribute to sustainable growth, by managing the economic cycle and guaranteeing low interest rates.

4/ All of this brings me to the fourth reason: in the euro area, **fiscal and structural policies are the responsibility of individual governments**. We have built a system based on the principle of subsidiarity, where a maximum number of decisions are taken at the national level. This is good news for democracy. The counterpart to this decentralisation, however, is that governments have to abide by a minimum number of rules, including the Stability and Growth Pact.

But following these rules is also in the national interest. If public deficits and debt were the keys to growth, then our two countries would be the growth champions of Europe: unfortunately, that's not the case. In the short term, a bigger deficit will not necessarily have a positive impact on growth if it's also accompanied by a higher risk premium on interest rates. The *Financial Stability Report* published very recently by the Banca d'Italia notably estimated the cost to Italian firms and households of the transmission of wider sovereign spreads, via higher interest rates and lower lending volumes.[3] In the longer term, no country can allow its public debt to rise indefinitely. Aside from the risk of bankruptcy, there's also a question of fairness: it is a burden that's passed on to future generations.

Obviously, it's not my place to comment on Italy's choices – it's up to you to find the right solutions. Italy has succeeded in modernising itself in the past. Perseverance often proves to be a difficult virtue for both our countries. But achieving widespread and lasting reform appears to be the key to growth, as the examples of our European partners have shown [slide]. The success stories can be seen in the north of Europe, but also in the south, with Spain and Portugal; and all have proved compatible with the social model we all share and support.

Both our countries have persistent weaknesses, especially in the labour market, with an unemployment rate that is too high. But the weakness we most share is our lag in training and education. Around a quarter of adults in Italy and France have poor reading comprehension skills,[4] and the results of the PISA survey are no better. In total, nearly a quarter of 18 to 24 year-olds in Italy and 19% in France are NEETS (Not in Employment, Education or Training) – well above the OECD average of 14%. Therefore, we have no greater priority today than developing skills, apprenticeships and professional training.

As well as this need for the right reforms in our two countries, the decentralisation of the euro area has another consequence: we need **a more symmetrical adjustment**, with wage increases and fiscal stimulus in those countries that have the room to manoeuvre, such as Germany and the Netherlands. Fortunately, this process has already begun, with the fiscal plans set out by the coalition governments elected in 2017, and the pick-up in wage growth as these countries get nearer to full employment. The excessive external surpluses in the euro area are also a sign of poor resource allocation. The Macroeconomic Imbalance Procedure carried out by the European Commission must therefore be symmetrical.

II. To construct a more solidarity-based euro area, we need an Italy that is committed.

At the same time, the euro area also needs to be improved: although Monetary Union is a success, the weaknesses of the Economic Union continue to pose a problem. We need to find a "tightrope" that combines **responsibility and solidarity**. Since Meseberg last June, France and Germany have put forward some initial proposals. I know that the subject is a sensitive one in Italy... but I would like to say this as a friend: you should agree to examine and discuss the substance of these proposals, before worrying about the very principle of Franco-German discussions, which are often necessary but never sufficient. Rest assured, we very much want Italy to join us at the negotiating table, and you will, I think, find it in your interest **to increase public and private solidarity**.

1/ The first priority is to **increase private risk-sharing**. Our starting point here should be the real needs of the economy, and especially those of firms and entrepreneurs. In order to invest and innovate, for example in the digital economy or the energy transition, firms must to be able to take greater risks. This means more equity financing, which has a longer-term horizon, as opposed to debt financing. The euro area is already lagging far behind in this respect: equity financing was equivalent to just 77% of GDP in France in mid-2018, compared with 124% in the United States. And yet we have abundant resources: a savings surplus of around EUR 350 billion in the euro area. [slide] We therefore need to build a **"Financing Union for Investment and Innovation"** in order to channel these resources to where they are needed.

This Union would be a combination of two existing initiatives, first of all the **Banking Union**, which must at last be finalised. The priority now is to complete the "second pillar" – the resolution of failing banks – with the establishment of a common backstop to the Single Resolution Fund. This should go hand in hand with a sufficient reduction in risks; however, we should not allow ourselves to be held back by layers of rigid quantitative criteria. It is also vital that we remove the obstacles to sound cross-border consolidations, which would allow banks to move savings more freely across borders. But this financing union must also build on **the Capital Markets Union**. There is a political consensus for this, but we now have to make concrete progress on revising bankruptcy laws and strengthening ESMA.

In addition to private risk-sharing, there is also a vital need for **a common public solidarity mechanism** [slide]. One aspect of this is the reinforcement of the **European Stability Mechanism** (ESM), in particular its **precautionary tools**: credible crisis prevention means not just ensuring fiscal discipline, but also having the necessary tools in place to help Member States cushion asymmetric shocks, which can appear suddenly despite all efforts to avoid them. To be efficient, precautionary tools should, in my view, be based on objective and simple ex ante criteria [such as abiding by certain rules], rather than on the current burdensome conditionality system which is too similar to an assistance programme. The euro area budget proposed by France could also play a stabilising role, by supporting investment, especially in education and training, and of course in new technologies, when national finances are constrained. Discussions over the ESM have raised another issue, which I know is a sensitive topic in Italy: the **restructuring of sovereign debt**. France also believes that we need to tread carefully here. We should avoid adopting a mechanical approach, because when rules are automatic, market expectations can trigger sudden chain reactions and pose a threat to financial stability. On the other hand, it might be useful to hold technical discussions on ways of implementing collective action clauses (CAC).

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I would like to conclude by quoting President Luigi Einaudi, who wrote this in 1954: "In the life of nations, the mistake of not seizing the moment is usually irreparable. The need to unify Europe is evident. [...] This is not a problem of choice between independence or union, but of choice between existing in unity or disappearing."[5] In a world marked by growing uncertainties – many of which, unfortunately, also stem from the United States – the need to preserve and reinforce the unity of Europe is stronger than ever. This does not mean ignoring the problems, but rather working together, as French and Italians, to achieve what we want: a more efficient and solidarity-based Europe. Thank you for your attention.

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[1] See Bugamelli et al. 2017, "Back on track? A macro-micro narrative of Italian exports", *Banca d'Italia Working Paper* No. 399.

[2] Standard Eurobarometer 89, Spring 2018.

[3] Banca d'Italia, *Financial Stability Report* No. 2 – 2018.

[4] Results of the OECD's PIAAC survey.

[5] "Sul tempo della ratifica della CED" 1 March 1954 in Einaudi, *Lo scrittorio del Presidente (1948–1955)*, Giulio Einaudi Editore, Torino, 1956.