The Bridge Forum Dialogue conference – Luxembourg, 10 January 2019

Twenty years after the introduction of the euro, what are the economic prospects for Europe?

Speech by François Villeroy de Galhau,

Governor of the Banque de France[i]

Press contact: Mark Deen (mark.deen@banque-france.fr).

Ladies and gentlemen,

I am delighted to speak before you this evening here in Luxembourg, one of the founding capitals of Europe and a bridge between France and Germany for 180 years. I would like to extend my warmest thanks to my friend and colleague Gaston Reinesch for his invitation to the Bridge Forum Dialogue. I stand before you as a committed European: this month – January 2019 – we celebrate 20 years of the euro, the common currency of 340 million Europeans. The three principles on which we have built this success (I) must guide us in addressing Europe's challenges in the face of 2019's uncertainties and in working towards the progress that we still need to make (II).

**

I. The euro's success was built on three principles that are now more vital than ever

As to whether the euro has been a success; there are few among us this evening who would have any doubts. It is more interesting to look back on the reasons for this success, which, to my mind, was built on three founding principles: the Eurosystem's **mandate** of maintaining price stability; the **means** employed to carry out this mandate, i.e. independence; and the **spirit** that drives its action – general European interest.

A. The mandate: price stability

The Eurosystem has been entrusted with a very clear mandate by the European treaties:[ii] its primary objective is to "maintain price stability", in other words to avoid prolonged periods of excessive inflation – as seen in Germany after World Wars I and II – or deflation – seen following the crisis of 1929 –, which have consistently negative effects on the economy. Price stability preserves household purchasing power; and more than that, it builds confidence in the value of the currency and consequently reinforces the confidence of economic players in all their decisions for the future, from investment to contract conclusion. Some observers would have preferred a "dual mandate" to target both inflation and growth or full employment, as is the case with the US Federal Reserve (the Fed), for example. However, this would be politically unattainable given German culture and not particularly different in economic practice.

In 1998, the ECB established a quantitative definition of price stability that it went on to clarify in 2003: to maintain inflation rates below, but close to, 2% over the medium term. Other major central banks such as the Fed and the Bank of Japan followed the example of the ECB, in 2012 and 2013 respectively, and also adopted the same 2% inflation target. This "conceptual convergence"[iii] is remarkable. Incidentally, even though exchange rates are not a monetary policy target, we should note that the euro traded at USD 1.17 on 1 January 1999 and at USD 1.14 at the end of December 2018, with an average rate of USD 1.21 between 1999 and 2018.

With regard to our mandate, the results are tangible [**slide 1**]. During the 20-year period prior to the introduction of the euro (1979-98), average inflation in the euro area was at 4.9%, compared with only 1.7% during the 20 years that have followed. What's more, better controlled inflation means lower financing costs as risk premiums are reduced. Interest rate differentials and sovereign spreads have consequently narrowed significantly [**slide 2**]. The France-Germany spread fell from an average of 1.9% between 1986 and 1992 – the period of the single market without a single currency, between the Single European Act and Maastricht – to 0.4% in 2017-18. The Italy-Germany spread has narrowed by 3 percentage points. If, **theoretically**, one of these countries wished to leave the euro, it would in all likelihood experience an immediate at-least-equivalent increase in its public financing costs as well as its private financing costs to households and businesses.

Furthermore, in terms of growth **[slide 3]**, euro area per capita GDP has improved almost as rapidly as in the United States since the euro was introduced (an annual average of 1.1% in the euro area between 1999 and

2017, compared with 1.2% in the United States), with the gap between the two only widening slightly during the 2011-12 European crisis.

B. The means: independence

The means employed to carry out this mandate is the independence of Eurosystem central banks. Beyond the initial example of the Bundesbank, this independence became established in economic research[iv] after the Great Inflation of the 1970s: governments hope that by accepting a little too much inflation they can prolong the growth cycle; but this hope is illusory as economic players rationally anticipate this "inflationary bias" – and thus amplify it. Empirical evidence[v] confirms that as a country's central bank is granted greater independence, its inflation decreases. Nevertheless, **independence** is still contested in our democracies, starting unfortunately with the greatest of them all. Independence **only has real value if there is a clear mandate** – price stability – and **robust performance-based accountability** to the country's citizens and their representatives: every year the President of the ECB is summoned to four hearings before the European Parliament and gives eight press conferences (i.e. twice that of the Fed up to this year), while the Governing Council has published its accounts since 2015. At the same time, the ECB must take heed of economic and social players.

Independence is not only secured in legislation, but also by the people that have embodied it for the past 20 years: Wim Duisenberg, Jean-Claude Trichet, and today, Mario Draghi. I would go so far as to talk of a threefold independence: from national governments of course, but also from pre-existing camps (the hawks and the doves) or schools of thought, even if all three of them have their own well-established economic background. Consequently, they have been able to take a pragmatic approach to innovation: for example, when Jean-Claude Trichet addressed bank liquidity risk through the Fixed Rate Full Allotment in 2008 or introduced the first security purchases with the SMP in 2010; and of course when Mario Draghi gave his "whatever it takes" speech in July 2012 or began expanding non-standard instruments in 2014.

And finally, independence from trends in the media and short-termism, which I shall come back to later.

C. The spirit: general European interest

These three men have also upheld the European spirit, through their culture and their convictions. Far from being a technocratic arrangement, initially the euro was actually a political aspiration advocated by Helmut Kohl, Jacques Delors and François Mitterrand in parallel with German reunification. And it is now supported by **75% of euro area citizens**, the highest approval rating since 2003, and as much as 85% of Luxembourgers and 81% of Germans [**slide 4**]. This popular support is our greatest success and our greatest asset. And it proves that the concept of **Europe is popular as long as it stops being abstract and takes the form of concrete projects**.

However, during the past 20 years, the euro area has essentially forged ahead through crises, with the creation of the European Stability Mechanism – located in Luxembourg – to help Member States following the Greek crisis in 2012 or the Banking Union in 2014 in response to the Spanish or Irish crises. As it appears that a financial crisis is increasingly distant, general European interest has now waned. This is a serious problem: until now, we have not been able to properly take advantage of the more favourable economic climate in order to prevent a new crisis. And this takes me to our challenges for 2019.

II. <u>Our challenges in the face of 2019's uncertainties</u>

A. A slowdown rather than a downturn, in a more fragile environment

A word first on the **economic environment**. At both the global and European level, activity is decelerating, but we are still a long way from experiencing a downturn. In 2019, global growth should at best be in line with 2018's level – 3.7% according to the IMF – subject to a downside risk. In the euro area,[vi] according to our latest projections, growth should come out at 1.7% compared with 1.9% in 2018. Although revised downwards, our baseline scenario remains relatively favourable. That said, at the start of 2019, we face three challenges: uncertainty, impatience and isolationism.

The most immediate one is **the uncertainty** over the outcome of the **Brexit** vote. Even if we don't want it, prudence requires that we prepare ourselves for the possibility of a no-deal Brexit, the impact of which would be more significant for the United Kingdom than for the euro area. However, any consequences for financial stability must and can be managed. But there are also considerable uncertainties outside Europe. The **US cycle** appears to be reaching maturity after an expansionary phase that began in mid-2009, but it is still far too early to worry about a recession. Growth should remain robust at around 2.3% compared with 3% in 2018, although at the expense of an ill-timed fiscal stimulus. There are greater uncertainties overshadowing the **Chinese economy**. The latest activity indicators have been weak. An escalation in trade tensions could lower Chinese GDP growth by up to 1.5 percentage points[vii] over a two year horizon. The slowdown could also encourage authorities to stimulate the economy, leading to increases in already high levels of corporate debt (155% of GDP compared with 106% in the euro area)[viii] and in the risks to financial stability.

Our second challenge is **impatience**. Thirty years ago, independence was conceived as a response to the temptation to make trade-offs between growth and price stability. But the real temptation, which is even stronger today, is to trade off long-term interests in favour of the short term. Financial markets are frequently characterised by short-termism and bouts of extreme volatility. But, more importantly, there is a political pressure towards it, driven by populist impatience that would like to have a lot, right away. For a number of years this impatience has been hindering long-term efforts in the form of fiscal consolidation and structural reforms, and these have unfortunately slowed in G20 countries. When we compare the performances of our different European Member States, it is clear that debt and public spending are not the engines of growth. There is a need today for fiscal stimulus in those countries that have surpluses, and for structural reforms across the board: without this there can be no sustainable growth. On this issue, I would just like to say a word on France, which has stood out as a positive exception over the past two years: the *gilets jaunes* (yellow vest) crisis provided justification for an emergency "package" to bolster purchasing power; but I do not think it should or even could halt the transformation efforts already underway.

Lastly, and this is our third challenge, **isolationism**, characterised by the escalation of trade tensions, constitutes the biggest short-term threat to global growth. Even before the tariff hikes, the uncertainty caused by protectionist stances, essentially on the part of the United States, already appears to be threatening growth via its impact on business investment. More broadly, uncooperative economic strategies – including within Europe – are on the rise. If each country seeks only to protect its own national interests, then everyone risks losing out – a phenomenon economists call "the prisoner's dilemma". According to a Banque de France study, a more collective fiscal and structural strategy could have boosted euro area GDP growth by between 2 and 3 percentage points in the 2011-13 period. [ix]

B. Achieving a gradual normalisation of our monetary policy, based on our three fundamental principles

Against this backdrop, I am convinced that the normalisation of our monetary policy – which has already begun – remains desirable. But it must be gradual, and consistent with the three principles that have sustained us for the past 20 years.

1. **We need to keep our options open in the face of the current uncertainty**: we are predictable, but not precommitted. This is also an aspect of our independence, at a time when many are pressing us to provide further details

For the past 3 years, we have published guidance roughly every 9 months on how we intend to conduct our net purchases over the subsequent 12 months, and we have always stuck to this forward guidance. As a result, the end of our net purchases at the start of January, despite being a major decision, caused no negative reaction whatsoever in the financial markets. Our past credibility gives us a certain amount of freedom with regard to the future.

I would also add that we have now clearly outlined **the sequencing of our normalisation**: first a rise in key interest rates, which will not come until at least through the summer, and in any case for as long as necessary to ensure sustained convergence of inflation towards our target – I shall come back to this later; then, and only then, after an extended period, a gradual reduction in the reinvestment of the stock of acquired assets. In my view therefore, we do not need to give additional guidance on the timing or other details of the process until next spring, when we could be more precise about the sequencing according to the latest economic data.

Nor do I see any need at present to review the future operational framework of our monetary policy: because this question will only arise once we have actually achieved normalisation, and because the tools of our monetary policy are already well known. The range of tools was expanded considerably over the course of the crisis; we will no longer use them all once we have reached the "new normal", but it is in our interest to keep them all to hand. Clearly, our monetary policy will remain accommodative for as long as necessary to achieve our inflation target.

2. A better understanding of the path of inflation

Of course, our main focus remains price stability. In 2019, the fall in oil prices will have a significant downward impact on inflation. After peaking at 2.2% in October 2018, euro area inflation could fall to around 1% in some months of this year, before rising again gradually to 1.8% in 2021 according to the latest Eurosystem projections.

Beyond these temporary fluctuations, the key trend to watch is core inflation. The improvement in the labour market has already led to a substantial acceleration in wage inflation. Growth in average compensation in the euro area has thus risen from 1.2% in 2016 to 1.6% in 2017 and will probably reach 2.2% in 2018. However, this wage inflation has not yet been passed through to core inflation [**slide 5**]. Until now, the acceleration in the inflationary pressures linked to unit labour costs since the fourth quarter of 2017 has been offset by the improvement in terms of trade and the decline in corporate profit margins. In our forecasts, these downward factors have a **temporary** lagging effect: core inflation should gradually increase towards a rate of 1.8% in 2021 (after 1.0% in 2018, 1.4% in 2019 and 1.6% in 2020).

However, certain observers have stressed that this lagging effect appears to be durable, and has caused inflation to fall repeatedly short of Eurosystem projections. Inflation excluding energy and food remained subdued at 0.9% in November, as well as in December according to the Eurostat flash estimate. This possible weakening in the link between wage rises and price rises could be attributable to more structural factors, which are also being discussed in the United States: we shall pay close attention to how data on this issue evolve.

3. Relentless efforts towards a stronger Europe

Monetary policy cannot be the only game in town. I understand and share German concerns on this... and that is why we need to push relentlessly for a strengthening of our Economic Union. Allow me to mention a great Luxembourger, Pierre Werner. At the end of the 1960s, he dared to suggest in his report that the monetary area needed a common budget, that its decisions should be endowed with democratic legitimacy or that unions should be given an active role. In this respect, the advances made by the Eurogroup in December 2018 constitute limited progress that needs to be extended. With regard to the Banking Union, its success will be predicated on the establishment of a solid and effective resolution mechanism, more than on the deposit insurance scheme. We need to pave the way for the backstop to be implemented as soon as possible. Moreover, in the interests of financial stability, we should consider extending the maturities on the credit lines and reach a definitive agreement on how to make emergency decisions. Unfortunately, there was almost no progress at all on **the Capital Markets Union** in the 4 December agreement. It is more important than ever that we make concrete headway, notably on harmonising bankruptcy regimes and strengthening the role of ESMA as a supervisory authority. More broadly, I can only express my regret that the reinforcement of the ESAs proposed by the Commission has been blocked by the Council.

The Banking Union and Capital Markets Union are the key components for a genuine "Financing Union for Investment and Innovation": I have put forward this idea as a way of better channelling our abundant resources – our EUR 350 billion private savings surplus – towards the concrete needs of the economy: the energy transition, SMEs or digital innovation. Jean-Claude Juncker's investment plan was a first successful step towards this. With regard to the **ESM**, it's not just about managing crises ex post, but about preventing them from happening in the first place by reinforcing our precautionary tools: the principle of ex ante criteria and the absence of an assistance programme are both welcome elements. However, we need to avoid having ex ante criteria that are so strict that in practice they prevent the ESM from being used preventively, as is the case today.

Beyond these institutional reforms, and with the United States and China increasingly asserting their dominance, it is vital that the European Union be given genuine strategic autonomy. Our currency, the euro, already plays a significant role at the international level, and this could be expanded even further [**slide 6**]. Despite being the world's second most important currency, it is still used to a far lesser extent than the dollar. It accounts for 20% of **global currency reserves** compared with 63% for the dollar; by contrast, 36% of the total value of payments (including intra-euro area payments) is settled in euro, compared with 40% for the dollar. This is why the European Commission's communiqué in December was particularly opportune. The initiatives promoting the role of the euro, notably in the energy sector, need to be examined carefully. Europe has built its **monetary** sovereignty thanks to the euro; it needs to preserve its sovereignty with regard to **trade**; and we still have a long way to go to build our **economic** sovereignty, so that we can meet the challenges of innovation in artificial intelligence or of the energy transition.

**

I would like to conclude my speech with this almost prescient quote from Pierre Werner in 1965: “Any economic union involves periods of flagging, of disaffection, of misunderstandings [...]. But we are also aware that, in these situations, we need to hold onto the progress made, [...] to concentrate firmly on the formal commitments already entered into [...], in other words, to persevere.” [x] Far from discouraging us, the scale of the challenges and uncertainties facing Europe at the start of this year should motivate us to persevere in our ambitions. That is my wish for Europe for 2019. Thank you for your attention.

---

[i] I would particularly like to thank Olivier de Bandt, Chahinez Benmissi, Laurent Ferrara, Rémy Lecat, Bérengère Rudelle, Giulia Sestieri and Édouard Vidon for their help in preparing this speech.

[ii] See Article 127 of The Treaty on the Functioning of the European Union.

[iii] Jean-Claude Trichet, 2014: "Central Banking in the Crisis: Conceptual Convergence and Open Questions on Unconventional Monetary Policy" *Business Economics*, Palgrave Macmillan; National Association for Business Economics, Vol. 49(2), pp. 74-84, April. http://www.perjacobsson.org/lectures/101213.pdf

[iv] Kydland, F. and E. Prescott (1977) “Rules rather than discretion: The inconsistency of optimal plans”, *Journal of Political Economy*, 85(3), pp. 473-92.

[v] Alesina, A. and L. Summers (1993) “Central bank independence and macroeconomic performance: Some comparative evidence”, *Journal of Money, Credit and Banking* 25(2), pp. 151-162.

[vi] December 2018 Eurosystem staff macroeconomic projections for the euro area.

[vii] OECD *Economic Outlook*, November 2018.

[viii] Bank for International Settlements: Credit to non-financial corporations from all sectors at market value - Percentage of GDP. March 2006 – June 2018 (unconsolidated data).

[ix] “The cost of deficiencies in euro-area economic policy coordination” *Quarterly Selection of Articles* No. 46, Banque de France, summer 2017.

[x] Address given by Pierre Werner, Luxembourg Prime Minister and Foreign Minister, on 30 September 1965 to the Belgian Chamber of Commerce in New York.