Seminar at the Banco de Portugal – Lisbon, 22 February 2019

The challenges of the euro area at the dawn of 2019

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, [*meus caros amigos*],

It is a real pleasure to be with you in Lisbon – *Cidade da Luz e Rainha do Mar* [City of light and Queen of the Sea] – the first bridge between Europe and Asia thanks to the audacity of your *descobridores* [explorers]. And still today, your country is an inspiring example of economic recovery thanks to its courageous reforms. I wish to express my warmest thanks to my friend and colleague, Governor Carlos Costa, for his invitation. Before focusing on our challenges for 2019, let me start my speech on a more positive note, as this same year marks the 20th anniversary of the euro, and elaborate a bit on its success.

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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 today 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. Some observers still advocate a "dual mandate" to target both inflation and growth or full employment, as is the case with the US Federal Reserve, for example. This would have been politically unattainable given the traumatic history of inflation in some European countries. Besides, let me recall two elements:

- price stability is to be maintained "over the medium term". As stressed inter alia by F. Smets, there is an "equivalence between the length of the policy horizon and the weight on output gap stabilisation", [iii] and hence employment.
- as stated by the treaty, "without prejudice to the objective of price stability", the Eurosystem should support "the general economic policies in the Union"

Let me add that the more precise and focused the mandate, the more accountable the ECB can and must be. Yet, those who advocate a broader mandate are often the same people who quite inconsistently are quick to criticise the lack of accountability of the ECB.

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"[iv] is remarkable.

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 premia are reduced: interest rate differentials and sovereign spreads have narrowed significantly [**slide 2**]. The France-Germany spread fell from an average of 1.9% between 1986 and 1993 – the period of the single market without a single currency, between the Single European Act and Maastricht – to 0.4% in 2017-19. The Portugal-Germany spread narrowed by 5.5 percentage points over the same period.

Furthermore, in terms of growth [**slide 3**], and unlike a common misperception, euro area per capita GDP has improved almost as rapidly as in the United States since the euro was introduced. It increased at an annual average of

1.1% between 1999 and 2017, compared with 1.2% in the United States, with the gap between the two widening only temporarily during the 2011-12 European crisis.

B. The means: independence

We are all aware of the strong academic and empirical evidence in favour of independence of Central banks since the Great inflation of the 1970s.[v] Nevertheless, independence is still contested in our democracies. On both sides of the Atlantic, the governments that are currently most critical of independence are the very same that most demonstrate its necessity: their unsustainable fiscal policies, without the anchor of a credible central bank, would pose a threat to price stability. **Independence is not for the protection of central bankers; it is for the protection of the citizens, and their collective confidence in the currency.** But independence **only has real value if there is a clear mandate** – price stability – and accordingly a **robust performance-based accountability** to the country's citizens and their representatives: every year the President of the ECB testifies four times a year at the European Parliament and gives eight lengthy press conferences (compared with four press conferences for the Fed up to 2018). At the same time, the ECB must increasingly take heed of economic and social players.

Independence is not only secured in legislation, but also by the people [its *grandes homens*] 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 threefold independence: from national governments of course, but also from short-term trends in the media or financial markets, and last from entrenched camps (the hawks and the doves) or schools of thought, even if all three of them had 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 policy in 2008 or introduced the first security purchases with the SMP in 2010; and of course when Mario Draghi

gave his famous "whatever it takes" speech in July 2012 or began expanding non-standard instruments in 2014.

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 among others in parallel with German reunification [**slide 4**]. And it is now supported by **75% of euro area citizens** – the highest approval rating since 2003 – and as many as 77% of Portuguese and 81% of Germans. 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 to help Member States in 2012 – supporting among others Portugal – or the Banking Union in 2014 in response to the Spanish or Irish crises. As distance grows with the last financial crisis, general European interest has nowadays waned. This is a very serious problem: in 2017 and 2018, in what might be seen as the sunny summer of the economic cycle, we, Europeans, proved unable to fix the roof. And this takes me to our challenges for 2019.

II. Our challenges in the face of 2019's uncertainties

A. A slowdown and not a recession.

A word first on our economic environment. At the global level, activity is clearly decelerating, but we are not heading towards a recession. According to the IMF, global growth could stand at 3.5% in 2019 after 3.7% in 2018. The main explanation for this slowdown is the increase in general uncertainty due to geopolitical risks, starting worldwide with trade tensions initiated by the US administration and in Europe with the prospect of a **hard** Brexit, very

damaging but unfortunately less and less implausible. Uncertainty is depressing business confidence and possibly investment by fostering a wait-and-see attitude **[slide 5]**. [vi] For instance, in France, manufacturers' expectations on the overall economic outlook have turned down earlier and more significantly than their expectations on their own production. And in the US, there is a divergence between weaker soft data like the ISM manufacturing survey index and still rising hard data on industrial production. Hence, restoring confidence should be the priority and it is the responsibility of political leaders: the best antidote to the current slowdown is to reduce geopolitical risks, more than changing economic policies.

The French economy has been slowing down but less than in some other European countries, due to increasing purchasing power and resilient domestic demand. In 2019, French growth is expected to be higher than that of Germany and close to the euro area average. Beyond internal demand, the second pillar of European resilience should be the extension of domestic reforms. I would like here to take the example of the Portuguese recovery since 2014, after a severe crisis and courageous adjustment efforts: GDP is now growing at 2.1% in 2018. Ambitious reforms have improved cost competitiveness, boosted export performance and led to a sharp fall in the unemployment rate, which has more than halved since 2013. This clearly demonstrates that, in Europe, reforms do have a positive impact.

B. Our monetary policy is able to combine clarity and flexibility.

Let me turn to the consequences for our monetary policy: to deal with uncertainty, we have to combine clarity and flexibility, as we did in our December's chained guidance. I will come back to this. In the present context, we should favour state-dependent analysis over time-dependent variables. In other words, we should pay close attention to the economic data in coming quarters and in particular we need to assess the extent to which the recent deceleration in growth and the current drop in inflation are temporary phenomenon or more structural in nature:

- Regarding **growth**, the current slowdown in the euro area is partly driven by temporary factors, such as disruptions causing contraction in the German manufacturing output, and the impact of the yellow vest movement in France. If these drags fade away, and if geopolitical risks recede, GDP growth could rebound from next spring or summer. Indeed, consumption remains solid and continues to be supported by rising wage growth especially in the core countries. But should a downturn last beyond that horizon – a less plausible scenario but one which cannot be excluded – we would be ready to adapt our monetary policy guidance.
- Regarding **inflation**, the fall in oil prices will have a significant downward impact in 2019. After peaking at 2.2% in October 2018, euro area headline inflation currently stands at 1.4% and will fall to around 1% in some months of this year. 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. However, it has not yet been passed through to core price inflation. Though we are recording some early signals of a price acceleration – such as the services component of the HICP estimated at 1.6%[vii] in January –, we observe a weakening in the pass-through from wages to prices: here also, is this weakening temporary – due to an increased time lag – or attributable to more structural factors? We have to consider this issue carefully, which is also currently at stake in the United States.

In this context, I still believe that the gradual normalisation of our monetary policy is desirable. Our chained guidance of last December has been less noticed than the successful end to our net asset purchases. But it is efficient in combining **clarity** about the sequencing – full reinvestments will last for an extended period after a first rate-hike – and **flexibility** about the timing of each step. Consequently, financial markets tend to adapt their calendar expectations – and hence financial conditions – to the perceived outlook: our chained guidance already provides some stabilisation function, without prejudice to our future decisions.

Beside flexibility in the calendar, let me stress another capacity of our monetary policy: pragmatism in its intensity, thanks to the powerful "trio" of instruments at our disposal: the reinvestments of assets, interest rates and liquidity.

Concerning this third instrument (provision of liquidity), everybody is aware of the forthcoming expiry of the TLTRO-2 programme, starting in June 2020. The Governing Council will decide about this in due time, with two prerequisites. As Mario Draghi stressed, "there should be a good case for monetary policy"[viii] for the euro area as a whole: our policy cannot be designed according to the specific needs of some banks or jurisdictions. And secondly, we should look at the whole spectrum of possible tools, including various forms of LTRO, to decide about the recalibration of conditions and maturities.

Regarding interest rates, I have often stressed in the past the usefulness but also the obvious limits of negative interest rates. Let me quote what I said as early as 2017: "they are difficult to accept by households and SMEs, and so impossible in practice to pass through to them"[ix]. And thus they are believed by many, if maintained for too long, to weigh negatively on the profitability of financial intermediation with possible adverse consequences for the smooth transmission of monetary policy. Hence, **if** we had to use negative rates for a longer period than expected, we should study pragmatically how to contain their possible adverse effects on the bank transmission of our monetary policy.

C. Relentless efforts towards a stronger Europe

Let me come back to the European spirit I pleaded for. Today, it is also an economic requirement: faced with the slowdown and the uncertainties, monetary policy cannot be the only game in town. This is a German worry I fully share with many others. But then, we need to push relentlessly for a strengthening of our Economic Union. The commitment of Mario Centeno, as Chairman of the Eurogroup, is essential. The advances made by the European Council in December 2018 are a step in the right direction but clearly need to be strengthened and built upon.

The success of the **Banking Union** will depend on the establishment of a solid resolution mechanism, – probably even more than a full common deposit insurance scheme. Regarding the backstop of the Single Resolution Fund, in the interests of financial stability, we should consider extending the maturities on the credit lines. And we will not achieve an effective and profitable Banking Union without cross-border consolidation in Europe: there are still too many roadblocks and not enough cross-border restructuring. Unfortunately, there was almost no progress at all on the **Capital Markets Union** in the December agreement. Let us finally move on from a rhetorical consensus in principle to concrete headway, notably on harmonising bankruptcy regimes and strengthening ESMA. Both the Banking Union and the 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 340 billion private savings surplus – towards the concrete needs of European economy: the energy transition, SMEs' equity or digital innovation.

But the strengthening of the euro area should also include **public** mechanisms of solidarity. Regarding the ESM, it should not be just about managing crises ex post, but about preventing them ex-ante above all by reinforcing our precautionary tools. We need to avoid having ex ante criteria that are so strict that in practice they prevent the ESM from being used preventively. These actions should also be supplemented by a common fiscal capacity: these words are probably less contentious than a common "budget", but as the President of the ECB wrote last week, we shouldn't shy away from its stabilisation function. If so, it would support the single monetary policy and price stability.

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I will conclude by quoting President Mário Soares, one of the key actors of Portugal's accession to the European Community: "Recent history has shown that rather than deferring crises we must confront them head on, with a

determination to overcome them[x]". Let us face the challenges for 2019 with this determined spirit: Brexit and the European elections as well as national domestic elections including in Portugal, and now in Spain. Our role as European central bank is to be faithful to our mandate while remaining totally independent. But we also have to be more attentive than ever to our environment: we have to be ready to react in response to economic uncertainties, and we must plead for a sensible strengthening of European sovereignty. Thank you for your attention.

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[i] I would particularly like to thank Chahinez Benmissi, Pavel Diev, Anne Duquerroy, Christina Jude, Antoine Lalliard and Bérengère Rudelle for their help in preparing this speech.
[ii] See Article 127 of The Treaty on the Functioning of the European Union.
[iii] Hartmann, Philipp, Smets, Frank, "The first twenty years of the European Central Bank: monetary policy", ECB Working Paper Series, No 2219, December 2018.
[iv] 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
[v] See Kydland, F. and E. Prescott (1977) "Rules rather than discretion: The inconsistency of optimal plans", Journal of Political Economy, 85(3), pp. 473-92 and 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] See Nicholas Bloom (2009), "The Impact of Uncertainty Shock", *Econometrica*, Volume77, Issue3, Pages 623-685
[vii] The final version is scheduled for publication on 22 February 2019.
[viii] Press conference given by Mario Draghi, 24 January 2019.
[ix] "ECB Monetary Policy and the Resilience of the Eurozone", Columbia University, New York, 19 April 2017, speech by François Villeroy de Galhau, Governor of the Banque de France.
[x] Address given by Mário Soares on the European Community of the future (Lisbon, 19 October 1990).