2016 IIF SPRING MEMBERSHIP MEETING IN MADRID

"COMPLETING OUR ECONOMIC AND MONETARY UNION"

KEYNOTE REMARKS BY GOVERNOR FRANÇOIS VILLEROY DE GALHAU

I am delighted by this opportunity to share some remarks on Europe here in Madrid. In some regard, Spain exemplifies the strength of the European commitment:

- As a country which, in the face of a severe crisis, has shown a strong resolve to embrace European solidarity,
- And as a country in which structural reforms – although painful - have been efficient and successful, from the financial sector to the labor market.
- At the same time, the Spanish experience also shows the absolute necessity of fiscal policy coordination, both before and after the crisis.

With so many distinguished participants reflecting on the future of finance in this conference, I would like to contribute to this discussion by focusing on issues of governance, specifically on the question of how we can improve the Euro Area (EA) economic governance. As said by Joaquin Almunia, former European Commissioner for Economic and Monetary Affairs, in October 2008 when celebrating the Euro's 10th birthday: "EMU is not finished. It is unfinished business. It needs to be further developed."

This is the subject of a loaded but much-needed debate requiring some principled choices and I will argue first that we need a "full coordination" of national economic policies in the Euro area (I). I will then discuss how to make progress on coordination by instituting a strong EA Finance Minister with very concrete tasks I will touch upon (II) Finally, turning to private risk-sharing in the Eurozone, I will focus on the importance of building an efficient Finance and Investment Union (III).

I – WHY WE NEED A "FULL COORDINATION" INSTITUTION IN THE EURO AREA

We probably all agree on two things:

- Monetary policy cannot be the only game in town,
- Monetary Union is a success, but Economic Union remains to be built.

We know there is deep political resistance to sharing fiscal resources and sovereignty, as well as we know there is Euroscepticism. The sad example of the refugee crisis illustrates how European countries so far have displayed little solidarity to find a common solution. This is why we need to make the economic case for stronger governance of the euro area. This discussion is not about "more Brussels", it is very concretely about more growth and jobs in Europe. Clearly, monetary policy cannot be a substitute for economic policy coordination or the lack of reforms. If only for that reason central bankers need to take part in this debate, while taking action will obviously be a decision for political leaders. This is also why our focus should be on the Eurozone economic governance. We should not fear different speeds in Europe. I am strongly in favor of the UK remaining within the EU; yet, irrespective of the outcome of the British referendum, the Eurozone can and should pursue further integration. The euro crisis has revealed how unprepared we were. The absence of coordination has indeed a genuine economic cost. Several approaches point to a significant cost of non-coordination, in the order of 2 to 5 % of GDP since the crisis.

To take the debate forward, three principled choices have to be made. First: making parallel progress on both domestic reforms and European coordination. Not one or the other. This is the cornerstone of, for example, any French-German agreement: to be fair, the French call for Germany to support coordination, and the German doubt about French reforms, have been and are still well-founded. This requires overcoming distrust between countries and bringing together both aspects under the same umbrella, namely a common institution.

Second, we must recognize that institutions with a mandate are superior to rules without institutions. To bolster policy consistency and coordination, we admittedly need simpler rules. But they should be supported by strong institutions with discretionary powers. Mario Draghi pointed out[1] the fundamental difference between a monetary policy institution and fiscal rules, which are exemplified by the track records of the ECB and SGP respectively.

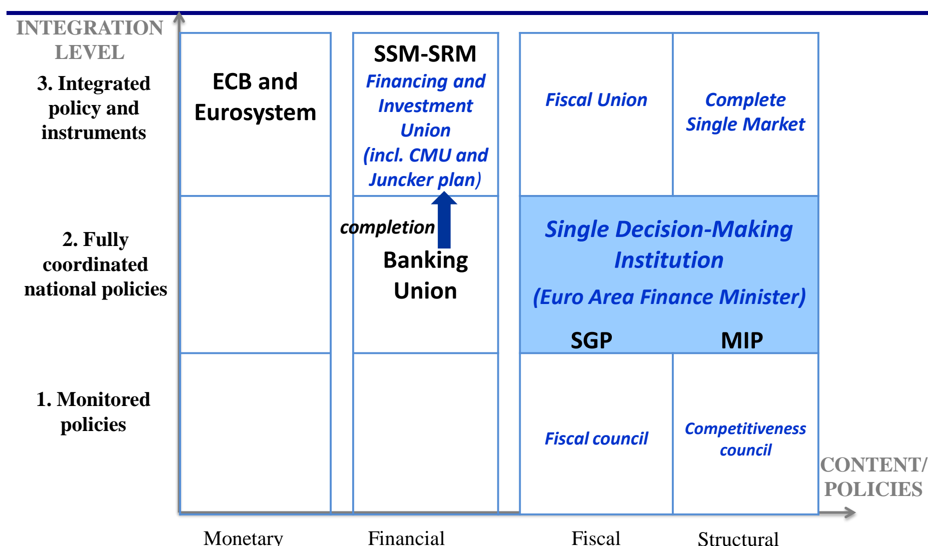
Third, we need not only to achieve better coordination of public policies but also to foster more extensive private risk-sharing in the Eurozone, which requires a more integrated financing and investment framework. Through the crisis and its aftermath, country-level current account imbalances have partly reflected asymmetric adjustment incentives and dynamics. At a time when the Euro area is experiencing a large external surplus i.e. excess of savings over investment, we must reflect on how abundant European savings could be put to the most productive use for investment in Europe. To that effect we need to think through both the concrete role a Euro area Finance Minister could play, and the concrete steps to nudge markets towards enhanced cross-border equity financing.

[1] Speech by Mario Draghi, President of the ECB, at SZ Finance day 2015, Frankfurt am Main, 16 March 2015

II – HOW WE SHOULD DEFINE CONCRETELY THE TASKS FOR A EURO AREA FINANCE MINISTER

There is room for an intermediate level of integration, as shown in a simple but illustrative matrix:

A Full Coordination Institution



I would call it "full coordination of national policies", a presently missing link between integration, as we have for monetary policy decision-making, and rule-based surveillance, such as is currently the case for national fiscal policies in Europe and which is clearly lacking teeth. To be sure, the highest level of policy integration would logically involve building a genuine fiscal union, as well as completing the Single Market (see top right of the chart); but that would surely require more ex ante convergence and resolution of legacies from the past. In addition to the completion of banking union, the most urgently needed part of EMU reform is to set up a strong institution to fully coordinate national fiscal and structural policies.

It would help to make the Euro area more than the sum of its parts. Jean Monnet famously declared that "nothing is possible without men, but nothing lasts without institutions." The mandate of this decision-making institution must be to achieve the strongest, sustainable and balanced growth, through a decisive progress in terms of national macroeconomic policy coordination. To that effect I would like to share with you some thoughts regarding the tasks a Finance Minister of the Euro area would have. The idea is not new, but let me specify her/his concrete tasks. I see four of them.

First, the Minister would be in charge of preparing the euro area-wide collective strategy to fulfill its sustainable growth mandate. It would be essential for the euro area to collectively agree on overall economic policy objectives, and on the division of tasks through the setting of individual performance targets for Member States. Nobody seriously contests that a collective strategy adding more structural reforms in some countries incl. France, and more fiscal expansion in others incl. Germany would make for a better policy mix for sustainable growth and employment in Europe.

Second, the Finance Minister would be responsible for supervising the implementation of the collective strategy, using adequate instruments to provide symmetric incentives. Negative

incentives would of course include the effective implementation of existing sanction mechanisms. They could be broadened in contractual procedures, already put forward in the 2013 Franco-German contribution on EMU, or in Chancellor Merkel's[2] "binding reform contracts" proposal, and including positive incentives. One of them would be the access to a euro area "Convergence Fund", through which Member States could benefit from common funding. In addition, conditioning the participation in economic governance on compliant implementation could provide strong incentives.

Third, the Finance Minister would be responsible for implementing centralized crisis management. A Finance Minister for the euro area would naturally be in charge of overseeing European Stability Mechanism operations.

Last, while moving towards further integration, the Minister could be given the authority for managing a euro area Convergence Fund, evolving towards a Euro budget. We are touching here on the issue of a common fiscal capacity, promoted recently by Pier Carlo Padoan[3]. As successfully done in the past, it could be built in three stages. In the first stage, Member States would be free to join. In a second stage, this budget could become a stabilisation instrument, centralising a well-defined set of policy instruments, such as a European layer of unemployment insurance. The third and final stage of fiscal integration would only be achieved if agreement can be found both on financing (direct revenue-raising capacity and common debt issuance) and on the desirable level of business cycle synchronization. This perspective would be a powerful incentive for national discipline and commitment as shown during the march to the Euro.

How to set up a legitimate institution with a genuine administrative capacity?

Further integration and democratic accountability should progress together. These institutional changes obviously require a new Treaty.

First, we need a legitimacy-enhancing appointment process. The Finance Minister could thus be appointed for a five-year period by the European Council acting by qualified majority on a proposal from the president of the EU Commission. The new appointment would be subject to the formal approval of the European Parliament, and the Finance Minister would be member of the Commission, as well as chair of the Eurogroup. The Minister would thereby have the legitimacy to represent internationally the euro area in Economic and Financial fora, alongside the President of the ECB.

Second, the euro area Finance Minister would need to be backed by a genuine Treasury administration, which could include staff from the Commission's Economic and Financial Directorate General, the ESM, and the Economic and Financial Committee Secretariat. Such a civil service would also benefit from the public advice of two independent bodies, the European Fiscal Board and the Competitiveness Council.

Last, if we succeed in implementing further integration, we will need stronger democratic control over euro area affairs. To this end, we will need to consider institutionalising a euro area format of the European Parliament. Relationships between euro area MPs and national parliaments will also need to be enhanced, through an inter-institutional agreement, or by creating dedicated commissions.

[2] Angela Merkel's first parliamentary speech of the third term, 18th December 2013.

[3] Pier Carlo Padoan, A Shared European Policy Strategy for Growth, Jobs, and Stability, February 2016.

Such institutional features are best left for political leaders to elaborate. But Felipe González put it back in 2010, as Chairman of the reflection group reporting to the Council on Project Europe 2030: "strengthening economic governance in the EU is urgently needed if we are to avoid the asymmetric shocks which derive from the co-existence of our monetary union and single market with divergent economic policies."

As I said, we need not only to better coordinate public policies, but also to foster private risk-sharing throughout the Eurozone. And this is the challenge of a Financing and Investment Union.

III. BUILDING AN EFFICIENT FINANCING AND INVESTMENT UNION FOR TOMORROW

We need to improve investment financing in the EU. Our efforts should be directed towards financing growth and innovation and towards finding the right mix between debt and equity financing solutions, while still preserving financial stability and consumer protection. In the EU, the European Commission has launched several initiatives to serve these objectives, particularly the Investment Plan and the Capital Markets Union (CMU).

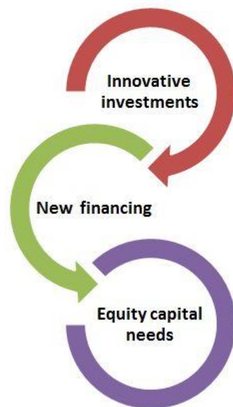
Until now, these initiatives have shown results, but they are not enough. Let's take the example of the Juncker Plan. More than 220 projects have been funded through 25 Member States, but the progression has been slow: from EUR 50 bn mobilised in 2015, the 100 bn threshold has recently been reached, and total investment has yet to reach a third of the 315 billion planned[4].

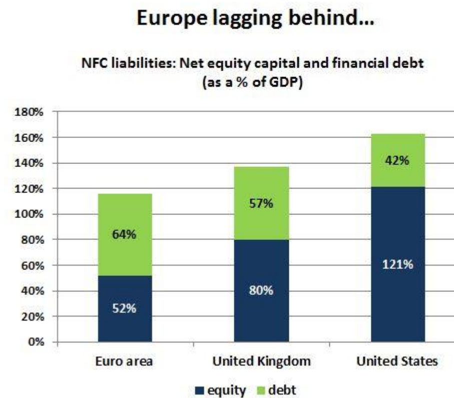
A more ambitious approach would bring together the CMU, the Banking Union and the Juncker Plan. This is why I prefer to think of a Financing and Investment Union. It is essential to clarify three objectives: (i) the diversification of financing for firms, (ii) the redirection of European savings towards the long-term, and (iii) the strengthening of the euro area. As I argued in my joint article with Jens Weidmann in February, equity financing seems to be the best way to match the abundance of savings and the lack of appropriate investment financing.

First, diversification of financing. The starting point should be firms' needs. New financing of business investment, which is one of the keys to innovation, must be enabled. This does not mean that traditional financing through bank loans is no longer necessary. Yet they should be offered a broader spectrum of choices. There should be more un-collateralised lending and, above all, more equity financing.

[4] According to the latest EIB release (as of 19 May 2016)

The Financial Levers of Innovative Investment: Equity Capital is a Priority





- It is an essential fact that the equity share of corporate financing in Europe is half as large as in the United States: 52% of GDP in the EA, vs. 121% in the US.
- This is unfortunate because equity financing is the better way to share risks and opportunities, as well as to support innovation. "Catch-up" growth, as in many Emerging Markets, can be financed by debt. But an economy standing at the technological frontier, as in the U.S. or hopefully as in Europe, is better financed by equity: because innovation is more risky, its funding must have an upside.
- European companies therefore need more equity capital especially for business start-ups and growing businesses. The Commission's Innobarometer survey suggests that funding is the main barrier for promoting R&D and innovation in Europe.
- What can we actually do? The Commission has estimated that the cost of capital through equity was 45% higher than the cost of capital through debt in Europe in 2014 because of taxation[5]. Hence, taxation policies could be revised in favor of equity funding. Innovative schemes also need to be developed at European level, such as European venture capital funds, in order to support the creation and growth of new businesses.

Second, a Financing and Investment union would redirect European savings towards the long-term. Significant amounts of savings are available in the euro area and these should be directed towards long-term assets, as well as to those projects and countries that need them. European savers' lesser "appetite for risk" is no doubt Europe's major difference with the U.S. It has cultural and sociological roots, but it is not our task to explore them and, even less so, to change them. However, I believe that it is useful to distinguish between two aspirations: safety and liquidity. Regarding safety, i.e., the protection of capital, the vast

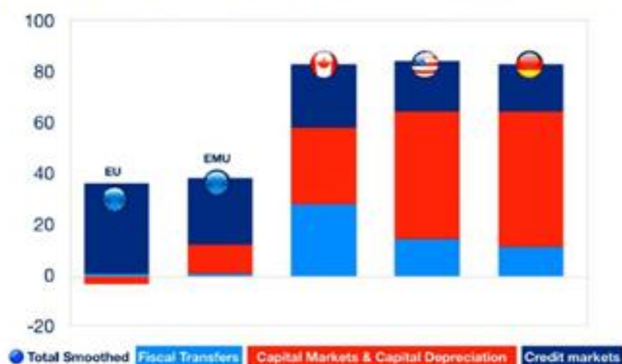
[5] Building a Capital Markets Union, Economic Analysis, European Commission, 2015

majority of European savers seem strongly attached to it. Liquidity is however less necessary to them.

Finally, a Financing and Investment union is about strengthening the euro area. Short term banking flows have risen after the introduction of the Euro, but the financial crisis demonstrated that the capital markets channel of risk sharing was still underdeveloped in the euro area. From the reality of financial fragmentation and its negative economic consequences, we can draw one obvious conclusion: equity financing is clearly the instrument that best allows to smooth asymmetric shocks in a Monetary Union. Its benefits are many[6] : it is less volatile that debt financing and it enhances the companies' resilience to adverse conditions. The integrated US equity market for instance cushions about 40% of a state-specific economic shock, as a company's profits and losses are distributed to owners all over the US. In the euro area, this form of risk-sharing is virtually non-existent.

Equity Financing to smooth Asymmetric Shocks

Proportion of a regional income shock (GDP) smoothed by other countries / regions through various channels : fiscal (light blue), capital markets and equity (red), and credit markets (dark blue)



SOURCES: Hepp and von Hagen (2012) for Germany; Sorensen and Yosha (1998) for the United States; Balli, Basher and Rosmy (2011) for Canada; and Afonso and Furceri (2008) for the Economic Monetary Union and the European Union.

Source: IMF, "Towards a fiscal union for the euro area", 2013

As this chart from the IMF shows, moving towards US levels would make the euro area a far more resilient currency union.

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To conclude, let me quote Robert Mundell[7], father of the theory of optimal currency areas. He did acknowledge that the euro area was far from optimal. Yet he remained confident, saying: "it will be achieved because, for Europe, it isn't just the best game in town, it's the only game." Economic policy as a whole, not central banking alone, is indeed the only game in town.

What the future of finance will look like in Europe, and how it will benefit its citizens will to a significant extent be shaped by the future of European economic policy governance. We

[6] Financial Integration Report 2016, ECB

[7] Interview of Robert Mundell by Laura Wallace, « Ahead of his time » , Finance and Development, IMF, September 2006, vol 43, n°3

cannot afford another missed opportunity and we have to act swiftly without losing the longer term view. For the Euro area, for its citizens, 2016-2017 is the decisive time to act.