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Causes of and answers to the European slowdown

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Ladies and Gentlemen, dear students,

I am very pleased to be with you today. Dear Thomas, both sides of the Atlantic benefit from your skills in economics. The high quality education you students receive here at the NYU Stern Business School will give you the tools to understand and address global challenges. In my introductory remarks today, I will address one of these, the current European slowdown, and quickly elaborate on 3 paradoxes: 1- the causes of the slowdown are mainly outside the euro area, but its effects are very acute on its biggest economy; 2 - the recent monetary policy controversy is of little interest for the future; 3 - the euro area has more policy room than others in the non-monetary domain, but under-uses it.

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I. The causes of the slowdown are mainly outside the euro area, but its effects are very acute on the region's biggest economy

The causes of the slowdown are mainly external to the euro area: uncertainty is undoubtedly the most important; it is mostly man-made, and must also be fixed by man. Due to the escalation of trade tensions we are witnessing a significant slowdown in global trade [Slide]: in its latest World Economic Outlook, the IMF expects the slowest global growth since 2008-2009 [Slide]. The loss of global growth due to the trade war could reach up to 0.8% next year, due mainly to its indirect effects, beyond tariffs: fall in business confidence and investment, decrease in productivity. Similarly, the twists and turns of Brexit have created volatility in UK quarterly growth, and weighed on business investment.

Despite this gloomy context, the French economy is resilient, with growth at 1.3% close to its potential. Purchasing power per capita should accelerate sharply in 2019 (2.3%), due to the strength of labour income – 1 million jobs have been created over the past four years – and the fiscal stimulus. But – as a whole – the euro area is acutely affected, primarily due to the weight of Germany – with growth of only 0.4% expected this year. Of course Germany is highly specialised in the manufacture of capital goods and "overexposed" to global

trade – German exports account for around 50% of GDP. Combined with a radical upheaval of the car industry, these phenomenon nearly constitute an asymmetric shock for the German economy.

II. The recent monetary policy controversy is of little interest for the future

Over the past few years, monetary policy has played its full part in helping Europe weather the storm. Let me pay a warm tribute to the Captain of our vessel, Mario Draghi, as his term soon comes to an end. Thanks to Mario Draghi's leadership, we protected our most valuable asset, the euro, and kept our monetary union together. Thanks to his unswerving determination and readiness to do "whatever it takes", we are still all on board.

Thanks to him, the Eurosystem has deployed a supportive and innovative monetary policy strategy. Over the past five years, the ECB has experimented with a variety of unconventional policy instruments, and it has arguably gone later but further into the toolbox than the Fed or the BoE. And the different instruments can influence different parts of the yield curve.

This policy has been effective in supporting the recovery in the euro area since 2013. As a recent memorandum of the "old guard" apparently missed some positive outcomes of the last years, let me remind them: estimates of the effectiveness of the unconventional monetary policies implemented since 2013 have a broad range but are in the order of 2½ percentage points on growth and 1-1½ percentage points on inflation over the period 2015-2018. In times of heightened uncertainty, the recent strengthening of our forward guidance – which is now strongly "state based" – demonstrates our determination to reach our inflation target. We now expect rates to remain at their present levels of -0.5%, or lower, until the inflation outlook **robustly** converges to a level sufficiently close to, but below, 2%, and this convergence has been consistently reflected in underlying inflation dynamics. Besides, this strengthening of our forward guidance implies the consequent prolongation of the reinvestment

period for the very important stock of QE assets – 2600 billion euros. The tiering system will help us mitigate the possible side effects that negative rates might have on banks' profitability, which is crucial to protect the transmission of our monetary policy through the bank-lending channel.

The Governing Council's discussion at the start of September is now behind us; everyone has expressed themselves legitimately – I have explained my own reservations on one part of the package –; but the decisions were taken equally legitimately, and they provide clarity well into the future. Have no doubt: we are committed, and the whole package will be implemented. We must now look resolutely forward, with three strong elements of consensus around Mario Draghi today and Christine Lagarde tomorrow: we have to maintain an accommodative monetary policy in the face of the economic slowdown and low inflation. Second, a review of our monetary policy framework in this environment will be very welcome. And third, it is very desirable that fiscal policy now prolongs this monetary support, wherever that is possible in Europe. It is time to turn the page, and turn to the future.

III. The euro area has more policy room than others in the non-monetary domain, but under-uses it.

Monetary policy can no longer be the only game in town. Central banks – including the ECB – cannot perform miracles. This paradox is either painful or promising…or both: the euro area has more leeway than the US or the UK, but until now has been much less inclined to use it. This has two dimensions [slide].

1/ The euro area has **a lower level of public debt** (85%) than in the United-States (104 %) or the UK (87%), it has the lowest sovereign interest rates – even often negative –, but it uses fiscal stimulus significantly less. It should now exploit its fiscal leeway where available – especially in Germany – to support cyclical stabilisation, and long-term growth. There is also room to increase wages in countries which have full employment and external surpluses. And it is essential to choose quality expenditure, starting with investment. In this

respect, I welcome the announced creation of a Dutch investment fund targeted to projects in infrastructure, digital, or climate transition. Its magnitude could be up to 7% of GDP: this is food for thought if we transpose this order of magnitude at the European level. **Private debt** – which stands at about 119% of GDP – is also significantly lower in the euro area compared to the US (148%), UK (152%) or Japan (152%). But of course, the “lower for longer” environment requires increased vigilance on financial stability. The IMF just stressed it in its latest “radar” in the GFSR [slide]. On both sides of the Atlantic, we should pay greater attention to non-banks and leveraged debt, and not be shy of activating macroprudential tools, and go beyond the old “separation principle” between monetary policy and financial stability: I advocate a smarter coordination[1].

2/ Furthermore, the euro area has an abundant resource at its disposal: **a savings surplus** towards investment of more than 300 billion euros. The top priority on the European growth agenda should be **a Union for Savings and Sustainable Investment** to achieve two major objectives, as proposed by the “Next CMU report” published last week by the Ecofin Council: (i) offering saving products to serve citizens’ needs and allocating capital to value creating investments in the real, innovating and sustainable economy; (ii) building/strengthening an integrated, competitive, deep and liquid European Capital Market, to maintain the EU as one of the top 2 financial centres of the world [slide]. To achieve this, it is now high time to give the Banking Union and the Capital Markets Union a significant push forward, let us at last, walk our talk!

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To conclude, let me quote one of the Founding Fathers of the United States, Benjamin Franklin: “we must, indeed, all hang together or, most assuredly, we shall all hang separately.” Hanging together is exactly what we should aim for within Europe – to build a more integrated Union – and outside Europe – to work on a renewed multilateralism.

[1] Cf. Speech at the Paris School of Economics, 24 September 2019.