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The future of the European Economic and Monetary Union

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Ladies and gentlemen,

I am very pleased to be here with you and wish to thank you for your invitation. It’s almost like a home from home for me here: I visit Frankfurt at least twice a month for ECB Governing Council meetings! I should add that I myself worked as a retail banker for 12 years. Today I am also speaking to you as a committed European and a friend of Germany. I am French but my family roots are in Saarland. My family has lived there since the end of the 18th century and its ceramics company, Villeroy & Boch, is part of the German “Mittelstand”. I love Germany, its language and its culture.

The impressive number of participants in today’s event is testament to the vitality of the Volksbanken Raiffeisenbanken. Through their ideas, Friedrich Wilhelm Raiffeisen and Hermann Schulze-Delitzsch [founder of the Volksbanken] influenced many cooperative banking initiatives in Europe and throughout the world. The cooperative model has proved its resilience, first and foremost because it inspires confidence over the long term. These two core values of confidence and stability are also what characterise our single currency, the euro. This year it celebrated its 20th birthday. However, to optimise its benefits objectively, we need to overcome four clichés. I shall then turn to your banking industry and its three key challenges for tomorrow.

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I. Overcoming four clichés in order to optimise the euro area.

I am fully aware of the criticisms and debates that exist here in Germany about the functioning of the euro area. Not everything is perfect; but Germany can be proud of having helped to create an internationally recognised currency inspired by its own core values: independence, respect for Treaties, price stability and a long-term approach. The ECB and the euro are the true descendants of the Bundesbank and Deutsche Mark. But today, if we want to move forward with a serene debate, we need to get rid of four clichés.

The first one that needs to be overcome, including by some in my own country, is the somewhat lazy idea that **economic union is a substitute for national reforms**. I want to make this clear from the start: on the contrary, national reforms are a prerequisite for reinforcing the economic union. I am saying this as a completely independent central banker; the current French government is taking reforms very seriously. France has already reaped the first rewards: strong job creation – 1 million new jobs in the past four years – is lowering unemployment; growth – forecast at 1.3% this year – is proving more resilient than in the rest of the euro area. And France has become a very attractive country for foreign investors.[i] We need only look around us: in this regrettably turbulent world, there is no more reliable partner for Germany than France, and for France than Germany.

This is why – and this is the second cliché – we need to stop reducing the debate to an old opposition between **"German rules" and "French spending"**. In the face of German fears, which I understand, I want to make a clear pledge: there is no question in my eyes of creating a "transfer union" that would only benefit certain countries, or of creating *eurobonds* that would equate to a pooling of debt. Need I remind you that France is also a net contributor to the European budget and that its public deficit is well below the 3% ceiling? But in light of the current deterioration in the economic outlook, those countries with the fiscal space should "act in an effective and timely manner", according to the ECB Governing Council which was unanimous on this point in September. Economic studies show that public spending has a bigger impact on the economy when three conditions are met: (i) when spending is focused more on productive public investment, such as infrastructure and R&D, than on current expenditure; (ii) second, when monetary policy is close to the interest rate lower bound, as there is less crowding out of private investment; (iii) and last, when countries have low levels of public debt. These conditions are currently met in a number of euro area countries, especially Germany.

Allow me to add a paradox that is not sufficiently well known: to get out of the current low rate environment, we should not turn instinctively solely to monetary policy – as many do. In advanced economies, the natural rate of interest – the level that equates savings with investment over the long run – has fallen by around 2 percentage points in the last 20 years, and monetary policy has a very limited impact on this rate. Instead, what we need is to change the underlying economic factors driving the decline in the natural interest rate. Changing these factors means spending on investment and on the future, including on training and education, the energy transition and of course new technologies, with the aim of lifting long-term economic growth. If we want higher interest rates in the future, we must not be afraid to rapidly put in place targeted fiscal and structural policies.

This brings us to the third cliché: **other countries have gained more from the euro than we have**. Unfortunately, this cliché is repeated everywhere, including in Germany.[ii] It is also paradoxical given that support for the single currency is currently at an all-time high in the euro area – 76% of European citizens support the euro, and the figure is even 81% for Germany. In reality, the euro has benefited all countries, including – and especially – Germany. German inflation has been lower under the aegis of the ECB in the past 20 years than in the two preceding decades: 2.9% on average from 1979 to 1998 compared with 1.4% since 1999. The permanent stability of exchange rates between our economies is an undeniable advantage for German exporters: in 2018, 36% of German exports were to euro area countries. The low level of interest rates is itself partly a reflection of Germany's large savings surplus. And Switzerland, another country that is in surplus but that is not part of the euro area, has to apply interest rates that are even more negative! Let us be in no doubt: the euro is an asset and not a burden for Germany.

This brings me finally to the fourth cliché: **the ECB's monetary policy has betrayed its mandate**. This idea was propagated in a recent "memorandum" by a number of former central bankers. I have every respect for them as people,

but I disagree with their argument. They unfortunately chose to ignore the positive results of non-standard monetary policies. Jean-Claude Trichet himself, who can hardly be accused of laxity, underlined these benefits, and I would just like to remind you of them: estimates of the effectiveness of the ECB's policies put the impact on growth at around 2.5 percentage points and the impact on inflation at between 1 and 1.5 percentage point for the period 2014-18. What is more, since 2013 the euro area has created 11 million jobs. You may not like low rates; indeed the markets anticipate, reasonably in my view, that short-term rates are close to bottoming out. But there can be no doubt about two very real facts that unite us on the Governing Council. Our decisions are guided solely by our mandate of price stability, in the face of inflation that is currently too low at less than 1%. Given the recent slowdown in economic activity – starting with Germany – these low short-term rates must and will remain in place: it would undeniably be a mistake to raise ECB rates now. We are all realists here, so we should focus on two issues:

- The first is clarifying the definition of the ECB's inflation target, and above all sharing it better with economic agents – businesses and households. This is crucial to allow them to better adjust their inflation expectations; that is precisely the aim of the strategic focus we are going to launch with Christine Lagarde.
- The second issue is limiting the negative effects of low rates on financial stability, and in particular on banks and insurers. We do not lack the tools to do this – you with your strategic adaptation, and us with our "macroprudential" policies. But this brings me to my second part.

II. Meeting three major challenges to strengthen euro area banks.

I would like to share with you a strong belief: Europe needs strong banks. A dynamic economy requires a strong banking industry; it's true in France, and it's also true in Germany. Undeniably, euro area banks are stronger than they were ten years ago. As a result of regulations and of their streamlining efforts, they

were able to significantly shore up their balance sheets. In particular, their solvency and liquidity have improved, while the weight of NPL has drastically declined: their Common Equity Tier 1 ratios (CET1) rose from 9% at end-2009 to 14.6% in June 2019. In addition, the major German banks themselves have seen their NPL amount fall more than twofold over the past five years, sliding from EUR 81 billion at end-2014[iii] to EUR 33 billion at end-March 2019. Euro area banks are nevertheless experiencing a serious problem of **profitability**, which is a cause for concern, both for you and us. I would like to outline three challenges that are often mentioned in this regard: low interest rates, the digital challenge, and consolidation.

Let's start with the subject that is perhaps the most obvious to you: **low interest rates**. Negative rates are not an end in themselves, and we, as central bankers, are aware of the difficulties this represents for banks. However, I would like to qualify this statement. First, the effect of monetary policy on banks is not limited to exerting pressure on the net interest margin. It is broader and also has positive aspects that are too often overlooked: lower financing costs; a lower cost of risk due to borrowers' improved solvency. Furthermore, in September, we decided – and I had advocated this – to set up a mitigation mechanism, known as tiering, which exempts some of your excess reserves from the negative rate. Germany is the euro area country whose banks have the largest liquidity surplus: tiering will therefore first benefit German banks, for several hundred million euros. This is good news; it hasn't been much talked about and this is why I am particularly keen to welcome it with you. I also note that a number of countries – such as Denmark, Sweden and even the Netherlands in the euro area – display negative interest rates, but significantly higher bank profitability ratios than those of euro area banks – an RoE of 9-11%, compared to 6% in the euro area. Negative rates are not the only problem. More structural problems must also be solved.

This brings me to the **digital challenge**. The digital transition is an important strategy for reducing costs. Financial institutions can unleash productivity gains

by exploring even further the possibilities of automation and artificial intelligence. However, in the short term, IT investment costs are significant, while potential profitability gains can only be generated in the medium and long term. This challenge is even more complex for medium-sized banks, and those that do not have sufficient financial capacity. The costs of digitalisation – in investment – are mostly fixed; its gains increase in proportion to size.

This brings me to the third challenge, that of **the consolidation** of banking institutions in the euro area. Because of a still incomplete Banking Union, the European banking sector remains too fragmented compared to the US market: the market share of the five main European banks stands at 20% against more than 40% in the United States. In this regard, I would like to applaud the open approach of the Federal Minister of Finance Olaf Scholz. Beyond the debate on deposit guarantees, which in my opinion calls for a pragmatic compromise rather than a political confrontation, his merits are threefold: first, advocating European financial sovereignty after Brexit; this requires adding a stronger Banking Union and a Capital Markets Union. Second, proposing a common bank liquidation procedure, in order to deal more rapidly and effectively with failing banks. Finally, overcoming the blockages of "host countries" of subsidiaries, in order to facilitate the constitution of European cross-border banking groups, including when the parent company is German. Of course, many things still need to be negotiated, notably the necessary reduction of risks. But the Scholz proposals are putting back in motion this key issue for the solidity of the euro area and the smooth financing of investment.

Of course, there exists a diverse range of consolidation models across Europe, and in this movement, small banks must not relinquish their values. In this respect, your central body DZ Bank seems to me to be a good example of a grouping which ensures a geographical and functional complementarity of activities. I welcome the current debates on how to consolidate networks of cooperative and mutual banks in Europe; the German sector has the means of significantly contributing to these debates.

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Thanks to you, I have discovered Raiffeisen's beautiful phrase: "Several persons have the ability to do what is impossible for one individual."[iv] This phrase perfectly describes the ambition of mutual banks. But it is also, I believe, a model of thought for Europe. In this uncertain world, shaken by the rivalry between the United States and China, Germany and France must, more than ever, overcome their differences. The entry into office of the new European Commission, around Ursula von der Leyen, must be an opportunity to move forward together. It's now, or never. Europeans expect no less. Thank you for your attention.

References:

[i] "Shock Resistant", France's Attractiveness Survey, EY, June 2019.

[ii] Laurent Abraham, Jean-Baptiste Gossé, "The euro: is the grass always greener on the other side?", Banque de France blog, May 2019.

[iii] EBA source and sample.

[iv] "Was dem Einzelnen nicht möglich ist, das vermögen viele."