



Interview with François Villeroy de Galhau – Governor of the Banque de France

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Mister Villeroy de Galhau, when you close your eyes and think about Europe, what do you see, red lines or new horizons?

I prefer keeping my eyes open! We then see that the economic situation is improving. We expect 2.2% growth for the euro area in 2017. Unemployment is decreasing: euro area has created 7 million jobs since the beginning of 2013, and monetary policy has played a significant role in this recovery.

The new French President Emmanuel Macron talked about “new horizons” for Europe and FDP party leader Christian Lindner in Germany before the election set “red lines” for European policy. What do we need?

We should probably have both: red lines and new horizons.

That is a very diplomatic answer.

No, I am convinced about this. Let's - finally - stop pitting "German rules" against "French visions". The Germans stress – and they are right – that we need more reforms on the domestic scenes, starting with in France. But on the European scene, we also need a stronger economic union. Remember what we agreed upon in the Maastricht treaty 25 years ago: it was an economic AND a monetary union. Monetary union is a success, as for the economic union there is still work to be done. This work is necessary to avoid that "monetary

policy being the only game in town", a well-founded German worry. And to reduce unemployment in Europe, still too high at 9%, while strengthening our collective resilience in the event of another crisis.

I would not call the monetary union a success as it nearly broke apart some years ago. But let us talk about the economic union that you say still has to come. What do you mean by that?

As the euro is supported by 81 % of German citizens, and as it resisted to the worst financial crisis, monetary union is clearly a success. As regards economic union, we first need domestic reforms, and we now see that they are being implemented in France. But we also have to strengthen the euro area. There are three suitable accelerators for that: first, a Financing Union for Investment and Innovation, in order to better use European excess savings of 350 billions yearly. We proposed this Financing Union together with my colleague Jens Weidmann, President of the Bundesbank, in February 2016. Second, a better Economic policy coordination: as there are more reforms in France now, there is also room for stimulus in other countries like Germany.

You want to propose a public investment programme for Germany?

The type of stimulus Germany chooses is obviously up to its own choices. It could be public investment as proposed in the unanimous report of the Commission headed by the economist Marcel Fratzscher in 2015. It could be tax cuts for German households, or it could be wage increases as Jens Weidmann mentioned some years ago.

Are the Germans ready for a stimulus?

Each of these possibilities has been raised in internal discussions in Germany, and the IMF also suggested them in its latest report. More broadly, economic policy coordination should mean a better collective strategy in the euro area. In the past, discussions have been somewhat unproductive, between the advocates of domestic reforms, and those of economic policy coordination. The simple truth is that both are necessary.

Beyond economic policy coordination, what about a common budget?

As proposed by President Macron, it is the idea that we have some common goods that should be financed collectively, such as defence, external borders protection, digitalisation, refugees crisis management. Part of it could be financed through private savings: this is what I call the Financing Union for Investment. And part of it will require some common public expenditures, which would benefit to all countries including Germany. So this budget, the third of the three accelerators I mentioned, would be in no way a "transfer union". A transfer union on the contrary would be a one-way budget with the same countries always contributing or the others always benefiting. And if that were the case, I would understand German fears.

In Germany after the elections it will be more difficult for this idea. The FDP is in discussions about forming a government with the CDU and the Green party. And it is opposed to a common budget for the Eurozone and calls it a "collectivisation of debt".

The Banque de France and its Governor have been fully independent for 23 years now. I obviously don't have to comment on German political developments. But I trust our German friends to now go somewhat beyond traditional fears. Germany is very committed to the euro area. Germans are very positive about the euro. According to all economic analysis each country has benefited from the euro, but Germany has benefited the most. France is reforming itself courageously. It is the right time to build for the future: now or never.

Why now or never?

We have an economic recovery, and an alignment of electoral calendars in Germany, France and other countries. And we have some kind of external stimulus: I mean Brexit and what happens in America under Donald Trump. As Chancellor Merkel rightly said, it is time that we Europeans take our destiny into our own hands.

You once proposed something much more radical: a common fund that gives loans to European countries experiencing financial stress – without preconditions.

That is in no way radical, it is a quite simple measure, complementary to - and possibly part of - other proposals such as the idea of a broadened European Monetary Fund. A Common Stabilisation Fund could be used by countries in the Eurozone that face temporary shocks, while implementing appropriate economic policies and respecting the common rules. This fund could borrow on the market and then relend to countries where the interest rates - the "spread"- they have to pay are temporarily much higher than justified by the economic fundamentals. It would help these countries without any budget transfers.

But the loan is money, right?

Yes. But it is not a transfer, it is a loan allowed in specific cases, and it will be paid back.

It would work like an indirect Eurobond.

Not at all! If each time there is a proposal on the table, you heard transfer union or Eurobond, we would not get very far. For me, Eurobonds - the collectivisation of debts- are clearly excluded.

Talking about the future of the Eurozone is important at the moment also because of monetary policy. The ECB is close to exiting the state of emergency it was in for years. When will you decide to stop purchasing government bonds?

First, monetary policy is not only about QE and buying government bonds. It is not a solo, it is a quartet with three other instruments: actual interest rates, forward guidance, and liquidity provisions. Using these instruments, we have developed an unconventional policy over the last years, as the US Fed, the Bank of England and the Bank of Japan had done prior to us. It was our duty in accordance with our mandate of achieving price stability, which means an inflation rate below, but close to 2 percent. And this monetary policy has been efficient: while we had negative inflation two years ago, inflation now stands at + 1.5 percent in the euro area.

That is close to the target.

We have made significant progress, but we are not yet there. As a consequence, there should be an adequate reduction of our net asset purchases, towards their possible end, while we will keep in place a substantial degree of accommodation, through all our other instruments. We have to achieve an adequate reduction because we have progressed towards our inflation target. But we have to maintain a substantial degree of accommodation because we have not yet reached it.

So this is tapering coming up next year... There seem to be two possibilities in October: cutting bond-buying by 50 per cent, but stretching that over a longer period, or cutting it less, but only for six months. Which of these options is better? Is that possible?

These possibilities are debated among market participants, which does not mean they encompass all the options. Be patient! It will be up to the Governing Council to decide, most likely on October 26th. And rather than the alleged gap between "doves" and "hawks", it will be a matter of pragmatism.

Last time we met one and a half year ago and you warned of deflation. When we meet again in one and a half year: will the ECB still be buying government bonds?

We have overcome this deflation danger precisely thanks to our monetary action. I will not make forecasts about the precise tools we will be using in 18 months. But for sure, we will act in full independence and according to the mandate conferred on us by the Treaty: price stability. These are German virtues I completely share, along with "Nachhaltigkeit", this nice German word meaning patience and perseverance. At the same time, we remain vigilant about financial stability, and stand ready to prevent financial market excesses using macroprudential measures if necessary.

What you propose sounds like a very slow reduction. Why not go faster? Are you afraid that markets will overreact?

No! Regarding the pace of the reduction of net purchases, I said precisely "adequate", not "slow": words matter for central bankers. As regards markets, there is one important thing: the asset purchase programme is effective mainly thanks to the stock of bonds that we possess. It is less important how much we buy than how much we have on our books. And the ECB will maintain a high level of stock for the necessary period of time.

That means: You reduce the assets you buy, but will keep the assets you have the same size, so reinvest, if a bond runs out?

Exactly. One day there will be an end to the net asset purchases. But we will still reinvest in order to simply maintain the level of assets on our balance sheet. This "stock effect" is an important part of QE. Look at the US: they are some years ahead of us, and they have only now decided to decrease the stock of assets they are holding. They illustrate the fact that the stock matters.

Will the markets understand that? I have the impression that they are only interested in the question whether Mario Draghi is changing direction.

The markets understand that well I think. And they appreciate that the ECB through Mario Draghi's years as President has been predictable in its policy, and efficient in its results.

Translated into a picture: The ECB takes the foot from the gas a little bit?

The path we are following is an adequate and very gradual normalisation. And this has already started in the decision we took successfully last December, when we reduced our monthly purchases from EUR 80 to EUR 60 billion.

To the normal person on the street: How do you explain that we need inflation at all?

We need price stability for confidence in daily life and adequate decisions by economic actors.

Why then 2 percent? Why not zero inflation?

This definition of price stability dates back from 2003, as Otmar Issing was the Chief Economist of the ECB. And it is exactly the same for the American, British, Japanese central banks. It is a protection against the mortal danger of deflation, a general decrease in prices and activity, which the world economy experienced in the 1930s following the 1929 financial crisis. If you have zero inflation, you do not have enough protection against this danger of deflation. Slightly positive inflation also makes the necessary adjustments in the economy easier.

You have family in Germany and you travel there very often. So you are kind of half-German, half-French...

I am 100 per cent French. But a Frenchman and a European who knows and loves Germany. I have family roots in Saarland and I go there often.

That German-French story makes you a good candidate for European positions. In 2019 there will be an especially interesting vacancy to be filled: the ECB presidency. Are you interested?

“Wenn ich es so sagen darf: das ist alles Quatsch!” It is not a subject for discussion. We have an excellent President of the ECB for the next two years, and I am a busy and happy governor of the Banque de France till 2021.

When you look back on decades of the French-German relationship, at what stage are we at the moment?

The relationship has gone somewhat from heart to mind. In the 1950s and 1960s the reconciliation between France and Germany was created by the heart. Today, the relationship is seen more rationally. There is friendship, but there are also common interests. France and Germany have complementary strengths: demography, defence or services for France; economy, social consensus or industry for Germany. And none of our countries can exercise real influence on the destiny of Europe - and on the international scene - without the

other. It is as simple as that. We need each other, and our alliance has resisted all the political changes on both sides of the Rhine... even though we do not know each other well enough.

Where do you see that?

Usually Germans know France better than vice versa, notably because many Germans spend their holidays in France. Last summer I was at Bodensee and it was wonderful. How many French know Bodensee compared to Germans who know Brittany or the Côte d'Azur?

But some clichés are true, right? Germans like to save, French like a strong state...

We could discuss these clichés, but I'd rather focus on one important similarity: we share the same European social model, with strong public services, a high degree of social redistribution, and dense labour relations. This "soziale Marktwirtschaft" is the core of our common destiny.

You stress the similarities. But are French and Germans not on totally different sides e.g. when discussing the Euro or the idea of a common budget? How do you experience such discussions when you are in Germany?

It is really the time for us to go beyond old suspicions. To put it positively: the German role in Europe is huge and has been growing. German and European interests coincide more and more. You have today with France a reliable partner. So, to my German friends: don't be afraid. Don't be afraid of seizing this unique opportunity.