François Villeroy de Galhau: Central banks between economic soft landing and growing public expectations

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Oesterreichische Nationalbank, the Austrian central bank, and SUERF Conference, Vienna, 11 June 2024.

* * *

Ladies and Gentlemen,

It is a great pleasure to speak today at the 51st OeNB Annual Economic Conference organised in cooperation with SUERF, and I warmly thank my friend Governor Robert Holzmann for his invitation. Central banks operate in a fast-moving environment, be it from a technological, economic or geopolitical standpoint, and this indeed gives rise for "the central bank of the future to opportunities and challenges". I will obviously abstain from any political comment, in the moving environment we are in. But I would like to focus on two aspects that are in fact correlated, as we stand between economic soft landing (I), and growing public expectations (II).

I. An economic soft landing is in sight

We are gradually emerging from the inflationary crisis that has affected our economies and fellow citizens since the Russian invasion of Ukraine. Inflation peaked at 10.6% in October 2022 in the euro area, and has since receded to 2.6% in May 2024.[1] Beyond the reversal of the initial supply shocks, monetary policy has made a major contribution to the disinflationary process – up to 2% inflation avoided this year –, by dampening credit and demand and by keeping inflation expectations sufficiently well anchored. Monthly figures will be volatile this year[2] due to base effects, especially on energy prices. We will of course continue to monitor actual inflation data (in particular those on services[3]), but we will look still more closely at the inflation outlook, all the more since we have regained more confidence in our models and forecasting tools. According to our latest Eurosystem projections, inflation should fall to an annual average of 2.5% in 2024, 2.2% in 2025 and 1.9% in 2026.

Therefore, as we are confident enough about reaching our 2% target, the time had come for a first cut by 25 bp and having a somewhat less restrictive monetary policy. The deposit rate will stand at 3.75% as from tomorrow, while the neutral rate is estimated at between 2% and 2.5% in the euro area. Therefore we are still actively fighting inflation.

The 2% inflation target is in sight, our efforts have been effective, but we are certainly not relaxing our resolve: confidence requires vigilance. As regards future decisions, we are not pre-committing to a particular rate path. We will remain data-dependent and I plead for "pragmatic gradualism", both on the timing of future rate cuts – without haste nor procrastination – and on our terminal rate. We have succeeded so far to achieve both disinflation and a soft landing in the face of supply shocks, something quite unprecedented. The euro area has avoided the recession that had been feared, with a positive growth of 0.6% in 2023, and our updated Eurosystem projections expect growth to pick up to 0.9% in 2024, 1.4% in 2025 and 1.6% in 2026. Reaching our primary target of 2% inflation with a soft rather than a hard landing would be a lot better for the economy, for our European citizens, their income and their jobs, and for the healthy conduct of fiscal policies.

II. Growing public expectations towards central banks

The credibility of central banks' and their resolute course of action have a consequence: they are fuelling growing public expectations. First, because they inspire **trust**, including from the general public: between last autumn and this spring, European citizens' net trust in the ECB reached its highest level since 2009, increasing in 19 out of 20 euro area countries.[4] In addition to our first results in fighting inflation, let me recall the three components of the "golden triangle of trust": independence, accountability and mandate.

Most central banks gained independence from political power in the 1980s and 1990s – including the Eurosystem at its inception in 1999. Independence, which I cherish, does not mean isolation. The context of present uncertainties, shocks and anxiety requires more than ever that we provide as much as possible explanations and clarifications: some light in the dark. This is about accountability: it is central banks' duty to explain for their monetary policy decisions in a comprehensible manner, including to the general public. There is in our democracies growing distrust towards "experts". The right reaction to it is not to renounce our expertise, but to renew our communication, in an accessible and transparent way. A monetary policy which is better understood is better transmitted; and conversely, an incomprehensible expert is no longer respected. Accountability is the natural counterpart for independence; no matter how complex monetary policy can be, the era of sibylline statements belongs – or must belong – to the past. This is the first – and most obvious – growing expectation. Let me now turn to our mandate: price stability, which is a prerequisite for long-term growth, is the primary objective of most central banks, including the Eurosystem. By fulfilling it, we contribute to our secondary objectives of economic growth, social cohesion or the environment- and here I will come to two other increasing public expectations: climate change and coordination with fiscal policy.

Climate change has of course emerged as a major challenge over the last few years, including for central banks given its impact on the economy and the financial cycle – and on inflation. It's not only about long-term risks: think of the droughts in Europe, and of the floods in Brazil, Greece and Germany. All had significant economic costs, as well as fiscal and financial (for insurers). The Eurosystem has strongly committed to taking action wherever possible within its mandate, including by supporting the green transition, and has started doing so in particular through market signalling. The Banque de France[5] is also a spearhead, and has been recognised as the greenest central bank in the G20.[6] Together with others, we set up the Network for Greening the Financial System (NGFS) in Paris at the end of 2017; it now has more than 140 highly committed members – including the OeNB –, and we host its global secretariat. The NGFS has developed seven long-term scenarios with a 2050 horizon to shed light on the "macroeconomics of climate change". In all scenarios, the economic loss in GDP is significant in 2050; but the later the transition, and the more disorderly it is, the higher the loss.

The next vintage of the NGFS scenarios, to be published end-2024, will build on a new estimate of the impacts of physical risks, which are greater than previously thought[7], in line with recent methodological advances in climate economics and climate science, and hence higher economic costs. This estimate will meet the highest academic standards, and will build on the expertise of the NGFS scientific consortium.[8]

Be assured we central banks will incorporate more and more climate change in our economic analysis and forecasts, and in greening our monetary operations. That said, it would be a monetary illusion to think that central banks can bear the bulk of the financing effort of the transition. This is neither economically desirable nor legally possible: pure monetary financing could result in an inflationary surge, and it would contravene the European Treaties, which prohibit the monetary financing of deficits. Central banks – and green finance – cannot replace sound public policies and corporate transition plans. One necessary step for public policies is in my view to put a price on carbon: it would be the only signal capable of aligning climate imperatives with economic agents' decisions. Whatever form it takes, carbon pricing will have to be global – not just national or European – and socially equitable.

Lastly, there are growing expectations in terms of **coordination with fiscal policy**. The last few years have been marked by the resurgence of supply shocks. Many countries sharply increased their fiscal deficits, shielding people and businesses from overly significant impacts. This intervention was fully warranted for Covid, and partially warranted to counter the energy shock stemming from the Russian war in Ukraine.

What may first have looked like one-off events now appears to be a structural trend: economic fragmentation along geopolitical lines, and climate change may translate into more frequent supply shocks – either positive or negative. And related public expenditures – due to defence, transition investments, "insurer of first resort" – could increase by as much as 7% of GDP according to the IMF.[9] This change in paradigm raises challenges for fiscal policy, monetary policy and the resulting policy mix. Last September, Olivier Blanchard and myself had a friendly debate at the Paris School of Economics during a tribute to Daniel Cohen, another brilliant French economist who left us too early. Olivier asserted that fiscal policy is more powerful than monetary policy; although I see the point behind his arguments, I draw a somewhat different conclusion; let me explain why.

The first nuance refers to an experimental limitation of fiscal rules – however desirable they are. Discretionary fiscal tools may in theory be both efficient and well-targeted. But in real life, beyond a potential oversizing such as the one which has been observed in the United States, in the end it is often difficult to reverse support measures, even when the economic cycle improves. Fiscal policy stance tends to be subject to political dominance, and not only in the US or in France. Public opinion in many countries demand rising expenditures and tax cuts at once. Under this political pressure, many governments have failed to reduce deficits quickly enough when conditions improved. As a whole, advanced economies have therefore accumulated large fiscal deficits over the last forty years, leading to a staggered and continuous debt rise. The low rate environment that prevailed until 2021 – and allowed for an easing of the public interest burden – was the exception, not the rule, and should never be taken for granted.

The second nuance is in praise of monetary policy: even at the effective lower bound, it remained very powerful, thanks to unconventional tools. Whether accommodative or restrictive, it has a clear quantitative target (a 2% inflation), and several channels at its disposal to influence demand and balance it with supply. We could see it in the unprecedented sequence of deflationary and then inflationary shocks in the last four years. Whatever the circumstances, it has found the right tools to achieve its medium-term objective: not more – monetary policy is not omnipotent –, but not less, and this is not a small promise. Let us never forget that price stability is a necessary condition for growth, and the best way to fund investments at moderate long-term interest rates on the long run. Hence we need both fiscal and monetary policies, acting with clear objectives and full independence; but we also need the right policy mix. It's sometimes easier, rising tandem as during Covid and the accommodative policies. At present, the recovery cycle, which is set to accelerate over 2025-26, together with the gradual easing of monetary policy, create a favourable context for structural fiscal consolidation: this window of opportunity must not be missed.

**

Let me conclude with Michel de Montaigne and his famous *Essays*: "It is doubtless a fine harmony when doing and saying go together" ("*C'est sans doute une belle harmonie quand le faire et le dire vont ensemble*"). The central banks of tomorrow must say what they can do, but also what they cannot do. They must also say how they are going to do this: this is accountability, in particular with regard to our commitment to bring inflation down to 2%. Under these conditions, I believe that they have a bright future to write: because by combining saying and doing, they contribute to the rarest but most necessary commodity of this century, trust. Thank you for your attention.

---

[1] Eurostat, flash estimate, 31 May 2024

[2] Villeroy de Galhau (F.), Anatomy of a fall in inflation: from a successful first phase to the conditions for a controlled landing, speech, 28 March 2024

[3] Villeroy de Galhau (F.), Interview with Börsen Zeitung, 27 May 2024

[4] Standard Eurobarometer 101 - Spring 2024, published in May 2024

[5] European Central Bank, Climate change and the ECB

[6] Green Central Banking Scorecard, November 2022

[7] Bilal (A.) and Känzig (D.), The Macroeconomic Impact of Climate Change: Global vs. Local Temperature, NBER Working Paper, May 2024

[8] Kotz (M.), Leermann (A.) and Wenz (L.), The economic commitment of climate change, Nature, 17 April 2024

[9] IMF, Fiscal policy in the great election year, Chapter 1, April 2024