François Villeroy de Galhau: Developments in Europe against the background of global uncertainties

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Paris Europlace International Financial Forum, New York City, 18 April 2016.

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In 2016, the world in general, and Europe in particular, is experiencing a period of uncertainty: uncertainties relating to our security, with the threat of terrorist attacks; political uncertainties, with the risk of a "Brexit" and the refugee crisis; as well as economic uncertainties, with lower economic growth in emerging economies, including China, and high market volatility at the beginning of the year. Nevertheless, recovery is underway in Europe.

As you may know, a meeting of the ECB Governing Council will be held in two days, so I have to respect a silent period on monetary policy matters. But I can emphasize that, in response to weak inflation and heightened uncertainties, the Eurosystem, of which the Banque de France is a member, has been acting decisively. And European countries have been implementing structural reforms since the onset of the crisis.

Those national efforts are crucial, but we need to go further with more coordination: coordination to direct savings towards projects and countries that need them; coordination of the reforms themselves at the European level.

1/ Changes in economic conditions

[Slide 2] Economic growth in Europe recovered markedly in 2015 and is expected to get firmer in 2016 and 2017, notably thanks to the dynamism of the German and Spanish economies and, to a lesser extent, to France and Italy.

Labour market conditions are improving and unemployment is receding. In the euro area, the unemployment rate is at its lowest level for four years. However, it is still too high.

In France, growth remains moderate. It reached 1.2% in 2015, up from 0.2% in 2014, and should stay at least at this level in 2016 and 2017. Nonetheless, the business climate indicator[1] improved throughout the year, and in January 2016 reached its highest level for four years.

2/ Inflation developments

[Slide 3] In 2015, inflation was nil in the euro area, well below the Eurosystem objective of an inflation rate below, but close to, 2% over the medium term. Inflation has even dipped temporarily into negative territory, with prices falling 0.1% year-on-year in March. However, this decline is mostly related to energy prices: core inflation was 1% in the same month. Oil prices seem to have bottomed out and this should help inflation return to positive territory over the course of 2016, thereby lowering real interest rates and making monetary policy more effective.

[Slide 4] The new comprehensive package of measures adopted on 10 March 2016 made euro area monetary policy more accommodative. One of its distinctive features is that it targets the financing of the real economy. The new series of targeted refinancing operations (dubbed "TLTRO 2") should improve medium-term funding conditions for banks and foster bank lending to companies and households.

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[1] INSEE: *Indicateur de climat des affaires et de retournement conjoncturel.*

3/ Structural policies

Moreover, monetary policy is not the only game in town. It is supported by structural reforms that increase potential growth, particularly in countries with a high unemployment rate.

History has shown that ambitious reforms can contribute durably to growth. Sweden in the 1990s and Germany a decade later have demonstrated that structural reforms enhance employment rates, potential growth and resilience. They also reduce labour market duality, and provide more opportunities to new entrants in the labour market, particularly young people. In the wake of a severe crisis, Sweden and Germany rebuilt their economic models and, as a result, have been better able to weather the latest downturn.

Indeed, a number of European countries are conducting major reforms to bring high and sustainable growth back. Those reforms are particularly challenging when it comes to the labour market, but they are needed. We need to improve labour flexibility and reduce the duality in the labour market between permanent and temporary contracts, which generates both high structural unemployment and inequality.

The most emblematic example is Spanish reforms. Their results are impressive, especially when we consider the very difficult economic situation in the country during their implementation. Since the beginning of 2013, Spain has experienced a decrease in its unemployment rate of some 6 percentage points and Spanish growth is nowadays one of the main drivers of the European recovery.

Contrary to preconceptions, France has also demonstrated in the past its capacity to meet the challenge of economic and social reform. In the 1990s, to prepare for the introduction of the euro, France pursued a competitive disinflation policy that proved highly effective. Remember that in the late 1990s, France experienced the highest GDP growth and the weakest inflation rate among European countries, along with a significant fall in its unemployment rate.

Today, French reforms are heading in the right direction, *[Slide 5]* in particular the tax credit for competitiveness and investment (CICE) and the Responsibility and Solidarity Pact (RSP) that enhance the competitive strength of the French economy. A policy of administrative simplification, the so-called ‘simplification shock’, and a new law to sustain economic growth and entrepreneurship (‘loi Macron’), are also being conducted in order to rebuild business confidence. However, we are not there yet and a number of reforms need to be complemented. In particular, in the labour market: hopefully renewed progress will be made with the draft law under discussion in Parliament.

Finally, in the euro area, fiscal policy is now more balanced since significant adjustment has already been achieved. Structural efforts and a growth recovery have led to a reduction in deficits and to a stabilisation in the ratio of debt to GDP.

This more balanced policy mix is an opportunity to engage in new ways of thinking and to strengthen the recovery via stronger economic coordination in Europe. The room for manoeuvre in economic policy is highly heterogeneous across European countries, and each country should use its capacity to improve the overall situation *[Slide 6]*. European countries have done quite a lot on their own, but now we can and must do more to coordinate demand-side policies and structural reforms at the European level. To do so, I would like to make two proposals.

4/ Strengthen Investment

First, we need to improve investment financing *[Slide 7]*. Our efforts should be put 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.

Second, we need to focus on removing obstacles to investment, providing visibility and technical assistance to investment projects and making smarter use of new and existing financial resources. The European Fund for Strategic Investments (EFSI) drives the Investment Plan for Europe. It supports strategic investments in key areas such as infrastructure, education, research, innovation, as well as risk finance for small businesses. Through the use of limited public guarantees, it aims to foster private investments totalling EUR 315 billion in three years. For the first year, the Plan managed to trigger around EUR 76 billion of investment in Europe.

The action plan on the “Capital Markets Union project”, launched in September 2015, aims at diversifying the way the European Union economy is financed. The objective is to achieve a better balance between bank credit and market-based financing. France is a euro area frontrunner in this field, with markets providing 40% of the financing for its economy. Various initiatives are already well underway, like the framework for simple, transparent and comparable securitisation instruments, or the revision of capital requirements for investment in infrastructure by insurance companies.

The Juncker Plan and the Capital Markets Union should complement each other and the Banking Union, which is already in place, to fully deliver their results in terms of growth and investment. Therefore, I prefer the concept of a “Financing and Investment Union” rather than a “Capital Markets Union”, as it better reflects the ultimate objective which is growth, thanks to a better mix of financing instruments including, but not limited to, capital markets *[Slide 8]*.

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. Innovative schemes need to be developed at European level, such as European venture capital funds, in order to support the creation and growth of new businesses. The composition of investments is equally important, as too little money is devoted to R&D and long-term investments. We also need to encourage equity financing rather than debt funding.

5/ Improve European economic governance

The second idea I would like to share with you relates to economic governance in Europe. I believe we need to make progress towards a more economically integrated euro area. This is essential, regardless of whether or not the United Kingdom remains in the European Union. Naturally, I would like it to stay in. My point is not purely institutional. It is not about “more Brussels”, it is about more growth and employment. Indeed, economists estimate that the current lack of coordination between national economic policies has cost Europeans between two and five percentage points of GDP growth since 2011. Contrary to the case of monetary policy, the aim is not to fully integrate all of our economic policies at the European level, but to achieve a “full coordination” of fiscal and structural policies. For this, we need to have shared economic goals, and a true “collective strategy” for the euro area, in which each country has a role to play to improve everyone’s situation.

This requires trust based on a clear pact: national reforms *and*, not or, European coordination. This full coordination also rests on the setting up of a strong and legitimate European institution: a euro area Finance Minister backed by a European Treasury system and subject to greater democratic accountability. This Finance Minister would be in charge of defining the collective strategy, supervising its decentralised implementation by Member States and handling crisis management tools. Going forward, he/she could also be in charge of a common budget.