François Villeroy de Galhau: Recent European economic challenges

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Paris Europlace International Financial Forum, Tokyo, 5 December 2016.

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Accompanying slides.

Thank you for your invitation. I am very pleased to be here in Tokyo for the first time as a Governor. France and Japan have a lot in common. Both our countries have a long history and culture, a long-term vision and a strong private-public partnership. And Bank of Japan and Banque de France have developed a rich and fruitful relationship. Let me thank Governor Kuroda for his enlightening comments on digital innovation and FinTechs, which Banque de France clearly supports. I will focus for my part on European economic challenges.

In 2016, the world in general, and Europe in particular, has experienced a period of high uncertainty: uncertainties relating to our security, with the threat of terrorist attacks; political uncertainties, with “Brexit” and, more recently, Mr Trump’s victory in the United States; as well as economic uncertainties, including oil prices or Chinese growth, and high market volatility at the beginning of the year. The referendum in Italy yesterday may be deemed as another source of uncertainty. However it cannot be compared to the British referendum: Italian people have been called to the polls to vote on an internal constitutional matter, and not about Italy’s long-standing EU membership. We will nevertheless look closely at its consequences.

If we look beyond uncertainties, we have also received positive news; in particular, recovery is underway in Europe. As you may know, a meeting of the ECB Governing Council will be held in three days, so I have to respect a silent period and I will not speak 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 acted decisively. In addition, several European countries have implemented structural reforms since the onset of the crisis and, at the same time, the EU and the euro area have taken significant steps to enhance economic and financial integration and stability. All these efforts have strengthened the euro area’s resilience as shown by limited reactions to Brexit or the US elections or by the unaffected, steady recovery in the euro area.

1/ Changes in economic conditions

- [Slide 2] In Europe, economic recovery is underway. Europe is continuing to recover, at 1.7% in 2016, and is expected to carry on recovering in 2017. Euro area growth is robust since it is supported by domestic demand, i.e. household consumption and corporate investment. New more detailed euro area growth and inflation projections will be published on 8 December.
- It is particularly important to note that labour market conditions are improving and unemployment is receding. In the euro area, on the past 4 years, the unemployment rate has dropped from 13% to 9.8% last October and is at its lowest level in four years. It is still too high but is going in the right direction.
- For France, after 1.2% of GDP growth in 2015, we are likely to see a growth rate above that range for 2016 and 2017. In the short term, we expect growth at 0.4% in the last quarter of 2016. The Banque de France will publish its new growth and inflation projections for France on 9 December.

Inflation developments

- [Slide 3] Inflation, which was nil in the euro area in 2015, rose steadily in 2016: it should reach 0.6% in November. Monetary policy has helped and will continue to support a move toward the Eurosystem objective of an inflation rate below, but close to, 2% over the medium term. In addition, oil prices have bottomed out since the beginning of this year and this should directly help inflation to increase beyond 1% in the first months of 2017.
- [Slide 4] The 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 second series of targeted refinancing operations (dubbed “TLTRO 2”), for an amount of EUR 444.6 bn allotted so far, should continue to improve medium-term funding conditions for banks and foster bank lending to companies and households.

2/ Structural policies

Progress has also been made regarding structural reforms. Several European countries, including Germany and Spain, are showing the way forward to Europe. They have succeeded in carrying out wide-reaching reforms that are compatible with our common European social model, which combines high standards of public service and relatively low levels of inequality – much lower than in the American society. Progress has been made in all four key areas: Enterprise, Employment, Education and Expenditure reduction. And these reforms are delivering results today: in recent years, GDP and employment have grown much faster in those countries.

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) which are designed to foster an improvement in the competitiveness of the French economy. We should obviously persevere with more reforms. But progress has also been made with the recent labour law (‘Loi El Khomri’) which, among other things, clarifies the conditions under which firms can carry out dismissals for economic reasons.

Besides, France has strengths in the financial sector that we should not forget: robust banks and insurance companies – they went through the crisis without public money except in one very specific case (Dexia) –, a dynamic asset management industry, strong financial market infrastructures, and a highly skilled labour force. And the French authorities, including the Banque de France, attach the utmost importance to ensuring that Paris is one of Europe’s strongest and most attractive financial centres, still more after Brexit. You spoke about Brexit this morning. It is too early to tell what will be the precise choice of the British government, but one principle is obvious: if they want to keep full access to the European single market, they will have to apply all its rules. There can be no free riding, and no cherry picking. And if Britain were to choose a “hard Brexit", this would in particular mean the end of the European passport for the City of London. Be sure that the Euro area will then be one of the most integrated financial zones worldwide: we have a solid common currency, we have high savings resources, we already have a Banking Union, and we have a couple of significant financial centers, starting with Paris. Brexit was clearly not our wish, but we are now ready to welcome Japanese financial institutions; my predecessor Christian Noyer has been assigned to this mission by the French government and already came twice to Tokyo in the last months to convey this very concrete message.

3/ How can we give further impetus to Europe?

Getting back to the European level, I would like to point out that many improvements have also been made in the field of crisis prevention and management. Prevention is based on much more efficient financial regulation and on a European governance framework that is better organised now with well-designed monitoring mechanisms on fiscal performance as well as on macro-economic imbalances and structural reforms. Banking Union contributes to strengthening financial stability in the euro area and the EU as a whole and to ensuring that the banking sector is safe and reliable. The global European picture is of substantially enhanced resilience since the crisis. The Common Equity Tier 1 ratios of significant banking groups in the euro area have risen from 7% in 2008 to 14% today. Crisis management – including for Greece – has also evolved considerably with the creation of the ESM. So you can be fully confident about the resilience of the euro and of the euro area. It is not only an economic asset, it is also a political one, supported by each of the 19 governments and – which is still more important – by 68% of euro area citizens (and even by 70% of French citizens and 73% of German citizens).

Moreover, monetary policy played its full part to maintain euro area cohesion. Europe has clearly succeeded with monetary union, but monetary policy should not remain the only game in town. We must continue to make progress towards economic union in order to achieve more and to further join forces in the new international context. To do so, Europe should seize the opportunity to move forward on three concrete steps towards Economic Union:

- The first step, as of today, is to build a "Financing and Investment Union" (FIU) to steer abundant savings into productive investment. Resources are not lacking: in the euro area, the current account surplus, which is a measure of the excess of savings over investment, stands at more than 3% of GDP. This trend is often described as a "saving glut" but I believe it is more fitting to talk of an "investment crunch" [slide 6], since we lack productive investment. The FIU would merge together the initiatives already in place: the Capital Markets Union of course, but also the Juncker Investment Plan – which aims, through the use of limited public guarantees, to foster private investments totalling EUR 630 billion in six years –, and the Banking Union. We need to put the pieces of the puzzle together in order to magnify their impact through synergies. There are two objectives: [slide 7] increased diversification of firms' financing – with more equity financing –, and higher resilience of the euro area thanks to private risk-sharing across domestic borders.
- [slide 8] The second step, after the FIU, would be a collective economic strategy for the euro area. Growth and employment will be stronger in Europe if we combine more reforms where they are needed, such as in France and Italy, and more fiscal support in those countries with room for manoeuvre, such as Germany. In practice, for such a collective economic strategy to exist, the euro area needs an institution that fosters confidence: it could consist of a euro area "Finance Minister".
- The third step, in the longer term, would be a European fiscal capacity. It comes at the end as it requires more convergence and more confidence. A genuine euro budget would be a stabilisation tool and could include, for example, a euro area-wide unemployment insurance scheme. It could also be used to finance certain "European public goods" such as digital technology, the energy transition or the integration of refugees. And in the long term, it could directly issue common debt and even raise taxes.

Let me sum up. Since the beginning of the crisis, Europe has been able to strengthen itself and to build a set of instruments and mechanisms that have significantly increased its resilience (Banking Union, the ESM, the enhanced SGP, etc.). It is now a matter of continuing this progress and not seeing Brexit as a shock to the euro area but rather as an opportunity to pursue, in a structured way, the setting-up of a better Economic Union. And at the core of Europe, France has made progress, which needs to be accelerated. But in an uncertain world, France appears as a rather stable country, seen from the resilience of its economy, the strength of its financial sector, as well as the solidity of its political institutions.