François Villeroy de Galhau: Innovation and change

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Annual Exchange Conference "Innovation and change", Paris, 19 January 2016.

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Ladies and gentlemen,

It gives me great pleasure to respond to Stephane Boujnah's invitation and take part in this annual conference, the subject of which is key to the French economy today. Our economy, which is at the frontier of technology, must be able to innovate continuously – and thus change – in order to improve its growth prospects. As a result, business investment, which is one of the keys to innovation, must be able to find new financing. This does not mean that traditional financing through bank loans is no longer necessary, far from it. It means that funding must become more diverse in order to meet companies' financing needs, regardless of their size, age or sector. And of course, in this area, Euronext and the entire financial community have a vital role to play. But before addressing in more detail the financial levers of business investment, I would first like to talk about the economic levers that precede the need for financing.

I. In economic terms, how are France and the euro area currently faring, and how can we move things up a gear?

2016 has already got off to a volatile start: weakness in financial and commodity markets, originating in China and the Middle East; political uncertainty in Europe, in southern Europe, in Eastern Europe, in north-western Europe with the British referendum, and even in central Europe with the refugee crisis. It is our duty to be vigilant, but we have two other imperatives: on the one hand, to separate the reality from the hype, the real challenges – and there is no shortage of them – from the sensationalist and sometimes excessive statements made early this year; on the other, to stick to our medium-term objectives in the face of the current volatility. This evening, I will not speak of monetary policy, since we are in the silent period before the Governing Council meeting on Thursday. But this long-term strategy must apply to economic policy as a whole, including the need for reform.

a) Today a confirmed recovery is underway, with growth of over 1% in France in 2015 and 1.5% in the euro area. In 2016, despite the uncertainties, all indicators point to higher growth. Despite the weakening of large emerging countries, the French and European economies should continue to benefit from an exceptional combination of three trends: (i) the significant drop in oil and commodity prices (–45% and–31% respectively, in dollar terms, between 1 January 2015 and 14 January 2016); (ii) the downward trend in the exchange rate of the euro against the dollar (–10% over the same period); (iii) and very low interest rates (–80 basis points in bank lending rates since June 2014).

The non-standard monetary policy that we have conducted in Europe since June 2014 has done a lot for our economy. We now have reliable and concurrent estimates of its effectiveness: it has boosted growth prospects in the euro area by about 1% for the period 2015 to 2017, and those of inflation by 0.5 percentage point in 2016 and 0.3 percentage point in 2017. All this is a lot... and in this respect our growth performance remains insufficient, lower than what should be achieved thanks to these exceptional economic stimuli, and lower than the European average.

b) We must now turn our too moderate economic recovery into strong, sustainable and job-creating growth. This shall notably be achieved by boosting business investment. The problem does not lie with the amount of French investment, since the investment rate of non-financial corporations, which stood at 22.9% in 2015, is slightly above its long-term average, i.e. 21.4% since 1980. The problem lies with its quality and productivity, which is insufficient to

support growth: a large amount of construction, not enough machinery and equipment nor research and development.

Boosting productive investment is not something that can be decided from above: it depends on the decisions of thousands of entrepreneurs. But all are above all sensitive to three levers. First, growth prospects, since order books, i.e. expected demand or GDP, are the main drivers of investment. To raise medium-term growth in France, structural reforms are essential. Today we know France's handicaps: a highly indebted public sector, declining competitiveness, unwieldy procedures. We also know the solutions: they have worked in other European countries, Sweden in the 1990s, Germany in the 2000s, Spain in the 2010s. The second lever is confidence. Uncertainty is the enemy of investment. To reduce uncertainty, rules should be simplified, stabilised and made more visible. Finally, the third lever is profitability. This factor has a more direct effect for many SMEs which are sensitive to the volume of their self-financing.

II. However, while firms' investment decisions are mainly influenced by economic levers, financial levers also have an important role to play.

a) ***Today, companies need more appropriate financing: our challenge concerns equity financing more than debt financing.*** In order to steer investments increasingly towards innovation, making them de facto more and more risky, financing has to evolve. Innovative investments call for new modes of financing. European companies therefore need loans that are less secured, but also, for business start-ups and growing businesses, more equity capital. Indeed, equity capital has two advantages: it gives the entrepreneur access to long-term funds while also offering investors strong upside potential to reward the risk incurred. A catching-up economy – like Europe until the 1980s, and many emerging countries today – can finance its growth through debt. An economy at the technological frontier, which carries greater risk, must rely more on equity financing. However, in the euro area, companies' financing structure remains predominantly based on debt rather than equity. By comparison, the net equity of non-financial corporations represents 123% of GDP in the United States, against 52% in the euro area. This transatlantic divide, which is hardly ever mentioned, is even larger than the gap in rates of debt disintermediation: the well-known figure of 20% of capital market financing in Europe compared with 75% in the United States.

b) ***With regard to debt, France's situation currently appears on the whole satisfactory.*** Bank financing remains easily accessible. Indeed, in terms of volume, outstanding bank loans to businesses are rising at a faster pace in France than anywhere else in Europe, posting growth of 4.5% year-on-year at end-November 2015, compared with +2.1% in the United Kingdom, +1.0% in Germany, 0.0% in Italy and an average of +0.9% for the euro area. Interest rates in France are also among the lowest in Europe: the average nominal rate on new bank loans is currently less than 2% compared with 5% in 2007. Lastly, SMEs generally have little difficulty obtaining investment loans: according to the Banque de France's survey, in the third quarter of 2015, 92% of loan applications were accepted (i.e. at least 75% of the amount requested was granted), although there is still room for improvement in the case of VSEs.

At the same time, bond financing is increasing. The trend towards the diversification of debt financing appears to be more marked in France than in neighbouring European countries, with companies increasingly turning to capital markets to meet their funding needs. The disintermediation rate, that is the share of bond financing in overall corporate debt, has risen from 24.2% in 2008 to 38.6% in 2015, compared with respective rates of 14.1% and 13.5% for Germany and Italy. Nonetheless, in France, market financing is mainly the preserve of large corporations, accounting for some 70% of their total financial debt, compared with 25% for mid-caps and less than 5% for SMEs. Yet forcing them to switch to disintermediated financing would make little sense: this diversification of funding has to remain optional, driven by demand from companies themselves, rather than being imposed according to a set timetable and pre-defined objectives.

c) *The priority of increasing equity funding can be achieved via several channels*. With regard to “internal” equity, that is self-financing, the outlook is improving. For SMEs in particular, self-financing is crucial as it is still the method of choice for financing investment, even when companies have access to debt. The decline in French corporate profit margins since 2008 is a source of concern in this respect. However, the issue has been clearly identified and steps have been taken to tackle it, with the Tax Credit for Competitiveness and Employment or CICE, and the Responsibility and Solidarity Pact. These reforms are expected to boost the average corporate profit share from 29.5% in 2014 to over 32% in 2017.

In terms of “external” equity, of course, here at ***Euronext*** you’re at the heart of the action. As the leading pan-European stock exchange, you have a central role to play in enabling firms to access capital market financing, in the form of debt, of course, but above all in the form of equity. In this respect, I’d like to acknowledge Euronext’s efforts – under the supervision of the AMF with which the Banque de France has an excellent working relationship – to draw investors back to the bourse, and to encourage firms of all sizes and all sectors to tap capital markets. In the first three quarters of 2015, Euronext helped 38 companies carry out an initial public offering, raising a total of EUR 82.9 billion of equity and debt capital in both primary and secondary markets. Its subsidiary EnterNext, which is dedicated to the financing and promotion of small and mid-caps, in turn enabled 26 companies to carry out IPOs, raising EUR 6 billion over the period. You are thus helping to bring about two important reconciliations: between the worlds of business and finance, and between France and its appetite for risk. What’s more you are achieving this with a European dimension. I can’t stress this enough: having a strong position in market infrastructure is vital for the French economy.

I would like to look beyond Euronext now, and focus on two more general avenues for promoting equity financing.

First, ***the French public needs to adapt its savings behaviour*** to the current low interest rate environment. This is a chance to encourage a “riskier” and more long-term approach to investment, in the interest both of savers and our economy. Today, only 31% of households’ financial investments are made up of risky assets, compared with 45% in the euro area. This means taking action in two areas: first, the decrease in interest rates should be gradually passed on to risk-free investment returns – which is why I proposed lowering the rate on the PEL, the French housing savings plan, and why we must continue to lower the returns on life insurance savings invested in euro funds; second, we need to develop new products: less liquid, and with or without a long-term capital guarantee, and which allow savers to benefit from the higher returns offered by equities over the long term. A crucial point is to avoid any tax distortions that might mean these products are penalised more than liquid and risk-free investments. This level playing field in terms of taxation should also apply to the companies that are financed: in other words we need to avoid making debt financing more attractive than equity financing… and we know we have a long way to go on this.

The second avenue for fostering equity financing is to ***boost cross-border capital flows within the euro area***. One of the great paradoxes of the single currency bloc is that investment is too low while savings are generally in plentiful supply: the region has a high current account surplus, of more than EUR 300 billion per year, or over 3% of GDP for the 12 months up to end-September 2015. The problem is that these savings cannot circulate freely between member states due to financial fragmentation. This situation has serious consequences. It generates a growth lag, as excess savings in core countries are unable to satisfy the demand for investment in the periphery. It also makes the euro area more fragile, as national shocks cannot be smoothed by fiscal transfers – due to the lack of a fiscal union – or by stable, long-term private sector capital flows. By way of comparison, in the United States, 39% of shocks

are absorbed by capital flows between federal states and only 13% by government transfers.[1] These are flows of equity, not of credit: the former are much more effective at absorbing shocks as they are a genuine means of cross-border risk sharing.

A large part of the solution lies at European level, with the European Commission's plan for a Capital Markets Union (CMU). However, the goals and ambition of this project need to be more clearly defined if it is to be a success. I prefer to talk instead about a ***Financing and Investment Union***, for two reasons: first, because capital markets are merely a tool – the main objective is the sound financing of investment; second, because our channels of funding need to remain diverse – capital markets must coexist alongside bank lending, as well as private equity funding from insurers and asset managers. This Financing and Investment Union should be a consolidation and synthesis of the CMU, the Banking Union and the Juncker Plan. It would allow us to foster even greater cross-border capital flows, and share the burden of risk through innovative mechanisms, such as European venture capital schemes.

Let me conclude with a more general remark. It's tempting sometimes to be fatalistic: to say our growth depends on China, and that innovation can only come from the United States. Admittedly, the international environment does play an important role; but our economic destiny depends primarily on us, on our ability to innovate and to reform. Financing is merely a part of our current transformation, one that lends support to the economy and to our businesses. But it is a vital part of that transformation, and I am pleased that this conference is giving it the consideration it deserves.

Thank you for your attention.

[1] P. Asdrubali, B. E. Sorensen and O. Yosha, "Channels of interstate risk sharing: United States 1963–1990", *Quarterly Journal of Economics*, vol. 111, 1996, Oxford University Press.