François Villeroy de Galhau: France – economic developments and reforms, where are we heading?

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at The Economic Club of New York, New York City, 18 April 2018.

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Accompanying slides of this speech.

Ladies and Gentlemen,

I am very pleased and honoured to give this speech to the Economic Club of New York.

The theme of my speech is “economic developments and reforms in France”. One year ago, you would probably not have suggested it. This shift tells something: France is currently going through exciting times and deserves a close scrutiny. [slide 1].

Before addressing the subtitle of my speech “where are we heading?” I would like to ask “Where are we starting from?” As about everywhere among the advanced economies, France experienced a decline in its potential growth from 2% in the 1990s to about 1.3% currently. Potential growth could be higher, as in several other advanced countries.

An increase would indeed be necessary to face the headwinds of high public debt, ageing and environmental transition, while safeguarding the European social model. If funded, this European social model is a long term economic asset, while bringing more education and more cohesion [slide 2].

There are two other more specific challenges for France. The first one is a persistently high unemployment, which never fell below 7% since 1983. The second one is high public expenditures, the highest among EU countries in 2016 (as a share of GDP).

Yet, France also enjoys major assets. First, a high investment rate, which has returned to its 2008 peak for private non-residential investment – close to the US level, indeed – and remains above the euro area average for public investment. It also has a wealth of fast-growing innovative firms according to Deloitte. [slide 3]

Second, a high level of hourly productivity, on a par with Germany and the United States, but with a more dynamic working-age population than in the rest of Europe, which will support potential growth in the medium term. [slide 4]

That’s where we are starting from. I would like to underline that we are enjoying a favourable momentum, which offers a window of opportunity for reform. This opportunity is indeed being seized to implement ambitious and consistent reforms, so yes, France is heading in the right direction and at a fast pace. [slide 5]

1. A favourable momentum: a robust upturn creates an appropriate timing for reforms

Business climate and consumer confidence increased sharply in 2017. Surveys in all sectors reached levels that had not been observed for several years. After the uncertainties surrounding the presidential campaign, the French institutional framework now seems solid to international observers. Allow me a one-second excursion from economic to political science. In the troubled democratic times we live through, France has the strong advantage of a clear two-round majority voting system, and 5-year terms for the President as well as for Parliament.

The latest business surveys and economic data point towards some moderation of late, which is not specific to France but also seen in other euro area economies. GDP growth in the first quarter could thus prove somewhat softer than previously anticipated. However, the underlying momentum remains solid and broad-based, and we interpret recent data as reflecting a temporary pull-back from the very strong and above-trend pace recorded in the second half of last year. It does not alter the inflation outlook over the medium term horizon that is relevant for our monetary policy. [slide 6]

Against this backdrop, we forecast GDP growth in France to remain robust in 2018, at 1.9%, after 2.0% in 2017, and to stabilize at around 1.6%-1.7% per year in 2019–20, which would remain above potential. Thanks to this performance, the output gap is expected to close in 2019. The engines of growth should be more balanced. Household consumption is expected to accelerate somewhat, with significant gains in the purchasing power of households of + 1.5% to 2% per annum. In particular, the tax measures set out in the budget laws should help to boost household income from the end of 2018. Total investment should lose some momentum but remain a significant contributor to output growth. And as exports pick up, the contribution of external trade should turn neutral. [slide 7]

The performance on the labour market has been very encouraging as well.

The unemployment rate decreased from 10.0% at end 2016 to 8.9% at end 2017 on the back of job creations of around 250K in the private sector, which exceeded expectations. In this context, the unemployment rate is expected to further decline and hit at end-2020 (7.9% in 2020 Q4) its lowest level since end-2008. [slide 8]

This economic recovery and higher inflation in France as well as in the euro area as a whole (1.7% and 1.3% respectively for year-on-year harmonised inflation rates in March) have been decisively supported by our non-standard monetary policy measures. We are now following our central course of gradual normalization. And there is at present a high convergence in our views within the Governing council: whether our net asset purchases stop in September or December is not a deep existential question. Along with this clear sequencing of gradual normalisation, we also agree that our monetary policy will remain accommodative for an extended period of time. In particular, keeping a sizeable stock of assets is key for easing financial conditions over a long horizon by compressing term premia.

So we are predictable, but we are not precommited. What could slow down this course of gradual normalisation? Certainly not fiscal dominance: let me be crystal clear, nobody should expect us to delay a warranted monetary normalisation in order to accommodate the debt problems of any Member state. Instead, we should pay close attention to a possible cumulative risks scenario, the likelihood of which has increased recently: an adverse loop of protectionist threats, unfavourable exchange rate movements, and abrupt financial markets corrections. Such a negative loop would tighten financial conditions, and deteriorate the growth outlook in the Eurozone. Our monetary policy stance would then have to be adapted, depending on the ultimate impact on inflation prospects.

In any case, this cyclical expansion provides an appropriate timing for reforms, especially for those that may be costly in a downturn, such as reduction in public expenditures and labour market reforms. The growth and employment performances of other European countries [slide 9] in recent years show that implementing deep reforms can have large payoffs. In Spain, for instance, significant reforms were implemented between 2010 and 2012 to reduce the duality of the labour market, to increase labour flexibility for firms and to strengthen active labour market policies. There have been some short-term employment costs, but France would not have to face these costs in the current upturn thanks to the supportive medium prospects, and could enjoy major benefits from structural reforms.

2. This momentum is being harnessed to implement ambitious and consistent reforms.
[slide 10]

However, to take advantage from these benefits, there is a need for consistent structural reforms. The success of the reforms will indeed hinge on perseverance – as no reform has a one-year pay-back – and on their overall consistency, as all reforms are in a close interaction. Let me start first with the interaction between the public debt, efficient public spending and the tax system.

Although some progress has already been achieved, structural public finance reforms are still needed. Thanks to the strong economic growth in 2017, the headline deficit fell below the 3% threshold, reaching 2.6% of GDP, and finally complies with the Stability and Growth Pact deficit rule. A tax reform was voted last Fall, lowering the tax burden on companies and on capital: the corporate tax rate will gradually fall from 33% to 25% in 2022 and personal capital income will be taxed by a flat rate from 2018. And last week, the French government published its revised medium-term targets: the public deficit is projected to turn into a slight surplus by 2022, while the public debt-to-GDP ratio – which reached 97.0% of GDP in 2017 – would decline by almost 8 percentage points at the same 5-year horizon. This ambition is very welcome but the better-than-expected results of 2017 should not make us complacent about the remaining challenges. Even with favourable cyclical conditions and persistently above-trend GDP growth forecasts, the success of the consolidation strategy will depend on capping public spending growth. The government projects public spending to increase in real terms by around 0.25% per annum (on average) between 2019 and 2022, compared to +1.1% in 2017–2018. Achieving this significant change is necessary and will require additional efforts, which are not yet specified. Public expenditure needs to be made more efficient, in particular on social protection spending, which include pensions and unemployment benefits and which constitute the bulk of the difference between French and German public spending ratio, as can be seen on the graph. [slide 11]

Second, I would like to emphasise the interaction between labour market and education reforms.

Ambitious labour market reforms have been implemented, aiming at increasing employment flexibility. The negotiation space given to social partners for decision-making, especially at firm level, has been widened. This could reconcile efficiency and worker protection, as we see it in Northern Europe. Staff-representation obligations have been simplified by the creation of a single representative body instead of three, which enlarges the negotiation field and hence eases compromise. Finally, the uncertainties of labour disputes have been eased with a cap on severance pay in case of abusive lay-off and a new type of collective layoff by mutual consent. [slide 12]

To yield its benefits, increased flexibility on the labour market requires greater adaptability of skills through a better-functioning lifelong training and apprenticeship system. Without adaptability of skills, the higher layoff rate due to increased flexibility could push up structural unemployment, as unemployed workers deprived from appropriate skills may not find a new job. On the contrary, combining flexibility and skill adaptability will lead to a higher job turnover, but also to a better allocation of labour and a lower structural unemployment. Currently, the French lifelong training system is unable to provide the appropriate skills, as shown by the disconnection between job vacancies and the unemployment rate, here on an inverted scale. Unfilled vacancies represented more than 200 000 lost jobs in 2017. Apprenticeship is insufficiently developed, resulting in a high youth unemployment rate. Lifelong training and the apprenticeship system are currently being reformed, with ambitious and accurate proposals by the government. The lifelong training reform will strengthen training rights, especially for the least qualified and the unemployed. It will simplify arrangements for businesses and streamline the governance and financing of the system, while 14bn € will be dedicated to it in the 5-year investment plan. Add the announced bold plan for primary and secondary education, as well as for the access to University, and you can really expect that the French labour market and skills will dramatically improve. [slide 13]

My final illustration is the interaction between labour and product market reforms. Labour and product market reform both imply an alleviation of red tape and ease business activity.

There has been significant progress in the past, as reflected by the decrease in OECD's Product Market Regulation or network industries regulations indicators. The impetus for these reforms was either European, for example in network industries, or national, for example in retail trade or in regulated professions with the 2015 Macron law. It led in both cases to a significant decrease in prices, purchasing power gains for households and a cut in intermediate consumption costs for firms. One spectacular example is the arrival of a new competitor in the mobile services market, leading to an 11.4% telecommunication price reduction in 2012. A significant reform is underway with the ongoing railway reform preparing for increased opening to competition. [slide 14]. This is not yet done and you see again images of French strikes. But they shouldn't have significant economic effects, and strikes are sometimes, at least in France, the road to reform.

Finally, the European environment can support the French momentum. A strengthened Economic Union in the Eurozone can indeed be an accelerator for national reforms. There should be, according to me, four dimensions to this accelerator role: macroeconomic, microeconomic, fiscal and institutional. The macro accelerator is a collective economic strategy in the euro area. It is premised on one simple fact: economic growth and employment will be stronger in the euro area as we will combine more reforms in countries where they are needed, like France, with more stimulus in countries with leeway for it, like Germany or the Netherlands. The micro accelerator would rely on a Financing Union for Investment and Innovation. The aim is to mobilise the EUR 390 billion savings surplus of the euro area last year, notably to shore up equity which is the key to an innovation economy, and also to foster synergies, thanks to an integrated steering mechanism, between the Juncker investment Plan, the Capital Markets Union and Banking Union. The fiscal accelerator could be a euro area investment budget used to finance, for the benefit of all countries, certain "European common goods" such as digital technology, energy transition, security, and migration controls. If there is such progress on substance, in terms of institutions, we would need a euro area Finance Minister, President of the Eurogroup and member of the Commission, backed by a European Treasury; but also a euro area Parliament group, in order to ensure the democratic legitimacy of the institutions and decisions. [slide 15]

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France is heading in the right direction and at a fast pace, with a strong government commitment to reforms. I stress it as fully independent Central Banker. France is changing for the best.

But France is not alone obviously. The European and international environments need to remain supportive. In terms of economic upturn first, but also in institutional terms. A country cannot implement the appropriate structural reforms, improve its flexibility and attractiveness and then face a major disruption in international trade, reducing the pay-offs of such a political effort. If we want to preserve the present global expansion, if we want to encourage reforms and hence increase potential growth, we need to maintain an open international environment, a rule-based multilateral order. [slide 16]

I stress it here in the United States, as a dedicated European speaking to close historical allies: we have many common challenges, politically and economically.

To avoid disaster, we should resolutely build common solutions. Believe me: France is taking its part of the task, today more than ever.