François Villeroy de Galhau: France and Europe - economic developments, reforms and attractiveness

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 2018.

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Accompanying slides of this speech.

Ladies and gentlemen,

Let me welcome this traditional gathering – Paris Europlace in New York – with a less traditional timing: one year after the French elections. And indeed much happened in these 12 months. In my remarks today, I would like to elaborate on what I call "the French momentum" and more generally the "euro area momentum". We have a unique opportunity to implement crucial reforms both in France and in Europe that we must definitely seize.

So I would like to share with you some thoughts on (i) our cyclical favourable environment (ii) hence, our structural acceleration, and (iii) Paris' attractiveness, including in the post-Brexit world we must prepare.

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1.Our cyclical opportunity and the present expansion phase

[Slide 2] The euro area economy is experiencing a strong and broad-based expansion:

we have now seen 19 consecutive quarters of positive growth. In 2017, real GDP growth peaked at 2.5% and short-term economic indicators all point to a continued economic upswing. According to the latest ECB projections, real GDP is expected to expand at 2.4% in 2018, above potential. The breadth of this steady economic growth is noteworthy: dispersion across countries and sectors is at its lowest level for two decades.

Growth has been supported by buoyant domestic demand and a pick-up in net exports. Financing conditions for firms have been very favourable, supporting investment, while private consumption has benefited from low levels of inflation.

[Slide 3] This steady economic growth has translated to the labour market bringing close to 8 million workers [7.8m] back to employment since 2013, more than offsetting the losses experienced during the crisis. Annual growth in employment has reached its highest level since 2008 and the unemployment rate fell to 8.7% in the fourth quarter of 2017, the lowest rate for nine years. Looking ahead, unemployment is expected to further decrease to reach 7.2% in 2020, in spite of an increase in the participation rate.

[Slide 4] In France, GDP growth is robust, averaging 2.0% in 2017. Expansion is expected to continue at a sustained pace in 2018, supported by strong domestic demand and a notable increase in exports. Investment should remain robust thanks to favourable financing conditions and the positive business outlook. Net exports are expected to pick up in 2018 and be supportive of growth. The upswing is expected to continue in 2019–2020 with a GDP growth rate which should remain above-potential growth, despite a slight slackening in global demand.

[Slide 5] In France too, the ongoing recovery has led to a strong decline in the unemployment rate which fell to 8.9% in the fourth quarter of 2017. Since 2015, job creation has been boosted by measures to reduce labour costs (CICE, PRS, SME hiring scheme) [I will come back to French structural reforms in more detail later]. Although the unemployment rate is still too high, notably among young people, our latest projections forecast a steady decline until 2020. Net job creations are expected to remain strong as the economy improves.

Following improvement in the labour market, wage growth is expected to build up, supporting households' disposable income and underpinning solid private consumption dynamics.

[Slide 6] Deflationary risks have disappeared in the **euro area**. Headline inflation printed at 1.3% in March while core inflation is stable at 1.0%. We are now out of the deflationary risk zone although inflationary developments still remain subdued. Yet, the ongoing economic upturn and the labour market improvements are expected to pave the way to increasing inflationary pressures, preparing for a return of inflation to a rate below, but close to, 2% over the medium term. Our forecast is 1.7% for 2020.

[Slide 7] This gradual rise in inflation in the euro area and improvement in the outlook for inflation is due in large part to the accommodative monetary policy of the ECB. We are now increasingly confident that inflation will soon be on a sustained path of adjustment back towards our inflation aim, and so justify our course of gradual normalisation. And we won't give in to fiscal dominance: nobody should expect us to delay a warranted monetary normalisation in order to accommodate the debt problems of any Member state.

2. Our structural acceleration: France is catching up

[Slide 8] Monetary policy plays its full role but cannot be the only game in town, as it may have only a limited impact on national economic adjustments within the euro area. Since the financial crisis, several European countries, including Spain, have successfully launched major reforms and reached higher and sustainable growth while preserving their social model.

[Slide 9] However, efforts should be pursued to spur economic growth in the medium term. Structural unemployment remains high and potential growth remains significantly below its 1990s or 2000s average. Structural reforms are needed to unleash the full economic potential of European countries.

The case of France, today, is particularly interesting in that regard. France faces important structural challenges but as already said, the economic environment for reform has never been more favourable since the financial crisis. So it is our imperative to "fix the roof", now. And the good news is that reforms are on a firm upward path. I stress it as a fully independent Central Banker: the new government has indeed displayed a strong commitment to reforms and already implemented major structural reforms to boost employment, productivity and resilience.

[Slide 10] The recent labour market reforms have widened the negotiation space given to social partners for decision-making and reduced the uncertainties of labour disputes.

This should give more flexibility to firms and contribute to supporting employment.

The ongoing apprenticeship reform aims at making this status more attractive for both workers and firms, in order to tackle youth unemployment. In a context where the number of job vacancies remains too high, the ongoing reform of lifelong vocational training, which is currently too costly and inefficient, should help to better match the skills of workers to the needs of firms. Add very significant reforms of primary and secondary education and university, and you can expect a steady improvement in French labour's skills in the coming years.

The unemployment benefits reform will also be an essential building block in improving the functioning of the labour market. More control over the job-search effort should increase labour force participation and also contribute to tackling structural unemployment, while improving the efficiency of the welfare state.

[Slide 11] Finally, consistent tax reforms have aimed at rebalancing the tax burden from production factors towards broad-based taxes. Labour costs were lowered, with in particular a tax credit on payroll, implemented in 2013 and reinforced by social contribution cuts this year. Regarding capital, important measures have also been taken to alleviate taxation on productive capital and savings: the scrapping of the household wealth tax on everything except property assets, the introduction of a 30% flat tax on household capital gains, dividends or interests and a decrease in corporate tax from 33% to 25% in 2022 to ensure convergence towards the EU average. These measures should contribute to supporting the positive trend in private domestic and foreign investment in France.

[Slide 12] All these reforms should be enhanced by further progresses made by the French government to improve the sustainability of public finances; I would also hope for an acceleration in this respect. Nevertheless, the present package is already impressive, and reinforces the attractiveness of France. As you know, France has many assets: it has many fast-growing tech-firms. It offers high-quality infrastructures and a high-standard quality of life. But more importantly, its capital, Paris, besides being one of the most attractive cities in Europe, is in a strong position to become the main euro area centre for market activities, especially in the Brexit context.

3. Paris' attractiveness as an integrated financial centre in a post-Brexit world

Brexit was and remains bad news mostly for the United Kingdom but also for Europe.

As for now, there is one principle which in our view is the corner stone of the future agreement between the European Union and the United Kingdom – preserving the integrity of our common good, the EU single market. In practice, it means that we cannot separate access and rules and that UKIbased entities cannot get a European passport and access the EU single market if they do not fully comply with the single market's rules and do not recognise the authority of the European Court of Justice. The City of London will of course remain a major global financial centre but will no longer be in the position to serve as the European financial hub. Against that backdrop, further integration of capital markets in the EU is all the more needed. Succeeding in that endeavour requires an integrated approach combining and coordinating the Juncker Investment Plan, the Banking Union and the Capital Markets Union to achieve a true "Financing Union for Investment and Innovation".

This Financing Union will be built on the EUR 390 billion in annual surplus savings in the euro area.

Another consequence of Brexit is that a number of financial activities will be relocated within the EU 27. The competitive landscape between financial centres will therefore change even though we do not expect the emergence of a continental "City of London" but a more multipolar and specialised competitive structure. It is our collective responsibility to foster a competitive and fair ecosystem for international players; as we have a single rule book, this competition will exclude any regulatory or supervisory "race to the bottom".

Against this backdrop, the Paris financial centre has many assets. Paris hosts one of the most developed capital markets in continental Europe, the first asset management industry, a leading bond market, the largest commercial paper market with NEU-CP and the largest private equity investor in continental Europe. Moreover, Paris offers an attractive pool of highly skilled staff in financial services. The French government and the French financial authorities, including the Banque de France, are also working together to facilitating the dissemination of sound and safe financial innovations and fostering the scaling up of sustainable finance. These investments are protected by a very resilient banking system, accompanied by consistent regulation. Let me remind you that Paris is already home to the European Securities and Markets Authority and will soon host the European Banking Authority. In addition, the Paris Court of Appeal was granted an international chamber last February, with international commercial affairs falling within its remit. That will duly complete the Paris court organisation, which already includes an international chamber in its commercial court. Last but not least, let me stress that the French authorities are making sure that the Paris financial centre and its participants benefit from a streamlined and business-friendly regulatory framework, for instance in areas such as bond issuance and securitisation. Meanwhile, significant efforts have been made by the French government to alleviate the tax regime and social contributions of “impatriates.” Starting in 2016 under the previous government, they have been amplified by the new one, including on the eve of the business summit last January.

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France is changing, for the better. But it is still dependent on its economic environment, obviously. Let me conclude with two wishes. First: that Europe is courageous enough to strengthen itself through this cyclical upswing. Combining more reforms in France and more fiscal stimulus in Germany, as will happen, is welcome but not sufficient: we need a stronger Economic Union in the euro area to avoid overburdening monetary policy by the next recession. And second, that the United States and the G20 are clear-sighted enough to address their economic challenges through multilateral answers, and not unilateral ones: here too, France is a reliable partner.