Jean-Claude Trichet: The economic situation in France and the euro area

Speech by Mr Jean-Claude Trichet, Governor of the Banque de France, at the press conference of the Monetary Policy Council of the Banque de France on 20 December 2000.

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Ladies and Gentlemen,

Allow me to welcome you on behalf of the Monetary Policy Council of the Banque de France. As the euro stands on the threshold of its third year, I shall discuss in the name of our MPC the economic situation in France and the euro area, before commenting upon the latest monetary policy decisions made by the Eurosystem.

Activity advanced at a sustained pace in the euro area

The upturn experienced by the euro-area economies in the first half of 1999 continued and strengthened throughout 2000. Foreign trade contributed significantly to the rebound. In addition, the euro area benefited from a marked improvement in domestic demand, with household consumption increasing at a fast clip before stabilising at a high level in the third quarter. At the same time, good borrowing conditions and the prospect of robust demand, coupled with a substantial increase in the use of production capacity and improved corporate profitability, gave investment a strong boost. According to the most recent estimates, the conjunction of these auspicious developments should translate into 3.4% growth in euro-area GDP in 2000.

Given the prevailing wage moderation, this acceleration in activity has been particularly propitious for job creation: the euro-area unemployment rate has declined by one percentage point since October 1999 and stood at 8.9% in October 2000.

Surging oil prices and the depreciation in the euro's effective exchange rate have fuelled a marked rise in inflationary pressure since the autumn of 1999. Inflation as measured by the Harmonised Index of Consumer Prices (HICP) thus rose above the 2% threshold in the twelve months to February 2000. In November 2000, the year-on-year increase amounted to 2.9%.

There have also been increasing signs of pressure on the productive system, with the appearance of production bottlenecks and rising capacity utilisation rates throughout the euro area. The latter work out to 84.7% for the fourth quarter of 2000, i.e. almost three points above their long-term average of 81.8%.

In addition, the value of imports rose substantially under the combined impact of buoyant economic activity, an almost two-fold increase in oil prices and the euro's depreciation. As a result, the current account, which had shown a surplus, shrank to a slight deficit.

Robust growth for the French economy

Following the trend initiated in 1999, the French economy enjoyed robust growth. Although the growth rate levelled off somewhat in the third quarter, it should remain sustained given the renewed confidence expressed by households and the business prospects of the industrial sector, where our surveys indicate that order books are well-filled. Under these conditions, GDP is expected to grow by 3.2% in 2000, and perhaps by roughly 3% in 2001.

All components of GDP were favourably oriented, in particular corporate investment, which grew by about 6%. Household consumption also made a significant contribution to growth despite the strong rise in retail prices during the year, which were impacted in particular by raw material and oil prices. Foreign trade made strong headway and generated a current account surplus that was still substantial despite the oil shock, reflecting in particular the continued buoyancy of service trade. The current account surplus for the first nine months of 2000 amounted to EUR 23.6 billion.

The labour market benefited from the continued growth. According to INSEE (France's national institute of statistics and economic studies), some 485,000 net salaried positions were created in the market sector during the year. The unemployment rate according to the ILO definition stood at 9.4% of the labour force in October, down by 1.6 point year-on-year.

The sharp increase in the prices of imported goods, due chiefly to oil price developments and the depreciation of the euro, translated into a sharp acceleration in the consumer price index, with a year-on-year increase of 2.2% in November. These developments call for vigilance, particularly since the underlying index, excluding energy and food prices, also quickened steadily throughout the year to reach a year-on-year increase of 1.4% in November, compared with 0.7% in December 1999.

At the same time, the pressures on the productive system appeared to be particularly strong in France. The Banque de France's surveys indicate that the production capacity utilisation rate of over 87% is almost three points higher than its long-run average. Recruitment has become increasingly difficult: according to the INSEE surveys, 53% of industrial companies reported difficulty in hiring new staff in October 2000, against 39% in January 2000 and 32% in October 1999. This was the information available to me on 20 December 1999 when I commented on monetary policy developments in 1999. It is the highest level ever recorded in these statistics. These pressures on the productive system have been corroborated by the sharp increase in imported capital goods and manufactured products.

Price stability: the monetary policy decisions of the Eurosystem

The recent decisions should be assessed against the price stability objective assigned to the Eurosystem by the Treaty on European Union. In its pursuit of transparency and accountability, the Governing Council of the European Central Bank decided in October 1998 to give a precise definition of price stability as being a year-on-year increase in the euro-area HICP of below 2%. Its success in meeting this objective, which is the same as that adopted by the Monetary Policy Council for French monetary policy when the Banque de France became independent, should be assessed in the medium term.

In order to meet its primary objective of price stability, the Governing Council has based its monetary strategy on two pillars, which were already part of the strategy of the Banque de France. It has pursued this strategy steadfastly.

The first pillar assigns a prominent role to money, signalled by the announcement of a quantitative reference value for M3 growth, the euro area's broad monetary aggregate.

At its meeting on 14 December 2000, the Governing Council reviewed its reference value for monetary growth. It decided to reconfirm this value, namely an annual growth rate of 4.5% for the broad M3 aggregate.

The monetary authorities also wanted to be able to base their decisions on all of the information available. Hence the second pillar, which makes it possible to assess present and future price developments using a broad range of non-monetary indicators.

These indicators stem from a wide range of sources: macroeconomic data, financial market indicators, exchange rates, survey findings and projections, etc.

After a co-ordinated reduction in the key rates of the future euro area in December 1998 and a further cut in April 1999, which reduced the rate of the Eurosystem's main refinancing operation to 2.5%, the Governing Council has raised the Eurosystem's key rates in several stages since November 1999 for a total increase of 2.25 points. These moves were made in response to signals from the two monetary strategy pillars, which pointed to deteriorating risks to price stability.

With regard to the first pillar, i.e. monetary developments, the euro area has consistently enjoyed ample liquidity conditions. Measured in terms of the moving three-month average, the M3 aggregate, which started the year with a growth trend of above 6%, began to show signs of slowing in the second quarter of 2000, due in particular to the hikes in the key rates. It worked out to 5.5% for the August to October 2000 period, that is, one point above the 4.5% reference value. Although M1 growth (banknotes and coins, overnight deposits) has slowed considerably, it was still very sustained with a year-on-year increase of 5.8% in October. Overnight deposits alone rose by 6.6%. This dynamism reflects the need for high cash balances in a brisk economic environment, despite the increase in the opportunity cost of holding such balances.

In October, the annual growth rate of credit granted by monetary financial institutions to the private sector was 10.8% and that of loans 9.7%, while financing extended in the form of securities purchases grew by 21.2% year-on-year. This strong growth in credit to the private sector underlies the marked expansion of M3. The dynamic trend in the credit to euro-area residents counterpart to M3, which reflects the good performance of the economy, can also be explained by the increasing borrowing requirements of telecommunications operators, surging property prices in certain euro-area countries, and the spread of mergers and acquisitions.

However, external transactions have had a restrictive impact on M3 growth, albeit to a lesser extent than in 1999.

In France, credit to the private sector continued to advance at a sustained pace, posting a year-on-year increase of 9.3% in October. The annual growth rate of total domestic debt was 5.7% in October.

In the course of the year, the various components of the second pillar signalled upside risks to price stability. This was true for the indicators for supply and labour markets, the continuing rise in oil prices and the protracted depreciation in the euro's exchange rate, which have exerted or continue to exert upward pressure on import, production and consumer prices.

As regards the exchange rate of the euro, which is an important monetary policy indicator, both the Monetary Policy Council and the ECB Governing Council are convinced that the external value of the euro does not reflect the euro area's favourable situation and future prospects.

This sentiment is shared by the Eurogroup, which agreed with the European Central Bank in Versailles that "**a strong euro is in the interests of Europe**". This phrase is the most concise and clear statement of Europe's position with respect to the external value of the euro.

Moreover, the G7 also concurs with the Eurosystem's analysis. On 23 September, following the concerted intervention on foreign exchange markets on 22 September, the G7 expressed "the shared concern of the Finance Ministers and the Governors about the potential implications of recent movements in the euro for the world economy".

Financial stability

In Europe, price stability is the statutory responsibility of the central banks, that is, the Eurosystem. Not just because that is how one safeguards the purchasing power of our fellow citizens, in particular of the most vulnerable amongst them, who have the least protection against price increases. But also because price stability allows us to create the conditions for sustainable growth and dynamic job creation, and to combat unemployment effectively.

In today's world, however, financial stability, for which price stability is a prerequisite, is of great value. We must unremittingly endeavour to create conditions for the international economy that minimise misalignments in asset prices, excessive volatility, purely speculative phenomena and dangerous herd behaviour. This is the underlying message in central banks' repeated calls for prudence and caution. Nothing is more conducive to economic euphoria than ample monetary liquidity, but the after-effects can be very painful, with the formation of speculative bubbles, sharp swings in asset prices, and the herd behaviour of huge capital flows. A monetary policy based on stability is the indispensable complement to the remarkable efforts undertaken these past years to improve the international financial architecture.

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The economy of the euro area has the favourable monetary, financial and competitive conditions necessary to contribute to the pursuit of growth that is sustainable because non-inflationary. But as the Monetary Policy Council has indicated these past years, monetary policy needs to be relayed by the other main components of economic policy. Four conditions would appear necessary to preserve and reinforce the complete success of the single currency.

Firstly, national fiscal policies should contribute to maintaining the framework of stability

The single monetary policy cannot, by itself, ensure price stability in the best possible conditions. Fiscal policies must respect the letter and the spirit of the Stability and Growth Pact.

In the absence of a significant Community budget, the close co-ordination of national fiscal policies and careful peer surveillance within the Council of the Eurogroup and the Ecofin Council—consisting of the Finance Ministers of the 15 member countries—are indispensable for there to be an appropriate policy mix for the euro area as a whole.

This surveillance is all the more necessary as Monetary Union introduces a degree of interdependence in fiscal matters. While the short-term macro-economic effects of an excessively expansionary national fiscal policy remain fairly restricted to the domestic economy involved, the costs in terms of risk premia on interest and exchange rates are borne by all members of Monetary Union. Under these circumstances, the Pact allows well-managed economies to avoid unwarranted risk premia by organising a system for sanctioning excessive deficits, thus helping to prevent such deficits.

Furthermore, the purpose of the Pact is to allow national automatic stabilisers to come into play where necessary. Its medium-term objective, which stipulates that public finances must be close to balance or in surplus, encourages the Union's Member States to re-establish as fast as possible the leeway allowing them to cope with cyclical swings or any asymmetrical shocks affecting one of them without exceeding the 3% deficit ceiling.

Consequently, more than ever, the Member States should take advantage of the improved economic conditions in the euro area to step up their consolidation efforts.

Concerning France in particular, the Monetary Policy Council notes that, as in previous years, public spending as a percentage of GDP is too high. According to the European Commission, it stood at 53.9% in France in 1999, compared with an average of 49.1% for the euro area as a whole and less than 40% for the G7 countries. An initial decrease in this ratio to less than 50% of GDP is necessary to maintain the low medium and long-term market interest rates that are propitious for growth and the fight against unemployment, and to create the conditions for a gradual and lasting reduction of compulsory levies.

Secondly, implementing adequate structural reforms

The effectiveness of economic policies is not merely the result of a good mix of fiscal and monetary policies. Structural policies also have a major role to play. This is particularly true in France and all the large economies of the euro area in which, according to all international organisations, unemployment stems largely from structural factors, i.e. it is unfortunately maintained by our own regulations and approaches.

The importance of structural reforms in the effective fight against unemployment was explicitly recognised by the European Council meeting in Nice after those of Luxembourg and Cardiff.

It is not the Banque de France's role to take the place of the relevant authorities by issuing a list of recommendations for reforms in the fields of education and training, the functioning of the labour market or social welfare. However, as far as methods are concerned, the Monetary Policy Council believes that a benchmarking principle for structural issues could be adopted in the euro area, namely convergence towards best practices, as we did in monetary and fiscal matters with the Maastricht criteria. Why not reverse the burden of proof in the field of structural reform by asking euro area countries why they do not introduce, in their own countries, reforms that have been successfully implemented in another euro area country? The choice of such reforms should depend on three criteria: first that they have been decided on the basis of a political consensus, second, that they have been implemented on the basis of a social consensus and third, that they have been successful in combating unemployment. A large number of reforms pursued within the euro area meet these criteria.

Thirdly, maintaining economic competitiveness: making France an attractive business location in an equally attractive euro area

In the new environment created by Monetary Union and the single currency, cost and price competitiveness is, more than ever a key indicator of the conduct of national economic policies. European policies must place the emphasis upon this aspect of competitiveness. Before the euro, national economic policies were based on the close monitoring of several indicators such as the trade balance, the balance of payments, the exchange and interest rates. Policymakers thus constantly received information on the markets' main reactions to shifts in economic policy and were strongly encouraged to take them into account where relevant.

With the introduction of the euro, some of these indicators have either disappeared at the domestic level or their impact has been severely limited. Of course, the indicators continue to exist for the euro area as a whole, hence the importance of the Treaty's provisions on the co-ordination of fiscal and economic policies.

Nevertheless, the rules of the market economy continue to apply to each Member State of Monetary Union as well as to the Union as a whole. At the national level therefore, economic policymakers need to be even more vigilant than before regarding the indicators of competitiveness. These data, which focus on trends in unit labour costs, the quality of the regulatory and tax framework and, more generally, an economic, legal and tax environment conducive to the creation and dynamism of companies, represent the main indicators shaping monetary domestic policies in the Monetary Union.

The level of unit production costs is of primary importance. It would be a serious mistake to forget this in the context of a buoyant economy. It is mainly because the French economy has preserved and strengthened its competitiveness over a long period that we have, in the past four years, enjoyed growth that is robust and more rapid than that of the other large European countries, while also maintaining a large current account surplus. The multipartisan strategy of low inflation and competitiveness, conducted consistently and tenaciously over a long period, must be steadfastly pursued in the single currency context.

Fourthly, the gradual change in the mindset governing our perception of economic phenomena

The objective of durable, sustained and non-inflationary growth, which could force unemployment down to its low tidemark, could be more easily achieved if Europe and France gradually adopted an open attitude towards the important "factors of production", namely labour, capital and technical progress. For a long time, persistent mass unemployment, the structural causes of which were poorly understood, led to the adoption of certain neo-Malthusian attitudes: efforts to reduce the available workforce in order to curtail unemployment, spurning productivity-enhancing investment thought to contribute to higher unemployment and, finally, wariness towards technical progress, which was seen as a potential destroyer of jobs.

Little wonder that after seeking to limit the available workforce, capital stock and technical progress, Europe and France saw that their non-inflationary growth potential was still not as high as they would have wished, despite the significant advances made in recent years. Fortunately, a profound change in perspective is underway in Europe and France, and we are discarding neo-Malthusian attitudes. This change has been prompted notably by the new information and communication technologies and by the realisation that the spread in Europe of pre-inflationary bottlenecks is, in itself, an obstacle to growth that is robust and sustainable because it is non-inflationary. To entrench this change in attitude, our strategy should move in three directions to:

- **ease the constraints on labour.** Some 53% of companies currently report that they are facing serious recruitment difficulties, notwithstanding the 9.4% unemployment rate. It is therefore necessary to step up the education, training and integration of people hitherto excluded from the workforce. Companies in particular must increase their efforts. As the Monetary Policy Council has been recommending for the past three years, a more extensive use of overtime should be accepted, especially in sectors where there is a labour shortage. More generally, the increase in Europe's employment rate from the current 61% to 70% in ten years' time, an objective which was confirmed by the European Council meeting in Nice and which aims at expanding the available workforce, is particularly timely and reveals a profound change in attitude;
- **invest massively and loosen the constraints on capital.** Investment is essential in our economy in which the capacity utilisation rate is currently at a historic high, and where an increasing proportion of companies—41% today, as opposed to 30% at the end of 1999—are experiencing production bottlenecks. The latest Banque de France survey shows that the capacity utilisation rate has reached a record high. This state of affairs makes the recommendation issued by the Council over the past four years more appropriate than ever: "Now is the time to invest".
- **lastly, actively seek improvements in productivity, which lie at the very heart of economic growth** by embracing technical progress, the digital revolution, the new information and communication technologies, biotechnology and material sciences and by promoting a high level of research and development in the productive sector in France as well as Europe. This openness to technical progress and rapid productivity enhancement is one of the keys to maintaining low inflation and a long-lasting growth, which is vibrant, sustainable and creates jobs.

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This, Ladies and Gentlemen, is what I wished to say about monetary policy and the French and European economies as we stand on the verge of the year 2001. May I draw your attention to the press kit that will be handed out to you. It contains documents that should prove very useful to a sound understanding of the economic and monetary situation, in particular the charts on production bottlenecks and recruitment difficulties. I would also like to point out the one hundred questions-and-answers on the changeover to the euro. These should provide individuals, professionals and the specialised press with clear and accurate information on any questions that may arise regarding the challenging events that await us in the years 2001 and 2002. This document will be available by tomorrow on the Bank's web site at www.banque-France.fr, and it will be constantly updated.

Thank you for your attention.