Jean-Claude Trichet: Report on the operations of the Banque de France

Introductory letter for the Annual Report of the Banque de France, by Mr Jean-Claude Trichet, Governor of the Banque de France, submitted to the President of the French Republic, the President of the Senate and the President of the National Assembly.

* * *

I am honoured to present you with the report on the operations of the Banque de France, monetary policy and the prospects for it, as required by law. As is the custom, I also submit herewith the Monetary Policy Council's comments on the past year, which was marked by the introduction of the euro and the implementation of the single monetary policy.

After a brief slowdown at the end of 1998 and the start of 1999, French economic growth became firmer from the second quarter of 1999 onwards. The expansion became more broad-based, which points to robust growth in 2000, as do forecasts and business surveys. Foreign trade, which had an adverse effect on activity in 1998, sustained GDP growth in 1999 thanks to the recovery in exports that started in the spring. Furthermore, domestic demand remained strong. The particularly high level of household confidence, the surge in job creation and the purchasing power generated by continuing subdued inflation fostered firm consumption growth, which rose by 2.2% on average in 1999, while corporate investment recorded sustained 7.6% growth. Overall, GDP increased by an average of 2.9%. I would like to emphasise that the performance of the French economy was above the averages for the euro area as a whole, where 2.4% growth was recorded, and the large countries of the European Union.

In parallel to this strong recovery in activity, the current account surplus remained high, with France having the second largest in the world. In 1999, as in 1998, the good competitiveness of the productive sector thus remained one of the main pillars supporting French economic growth.

The acceleration in economic growth during 1999 enabled the creation of 375,000 dependent jobs in market services. The number of jobseekers fell by 11.4% and the unemployment rate decreased from 11.5% of the labour force in December 1998 to 10.6% at the end of 1999, the lowest level recorded since 1992.

Inflation quickened somewhat, especially at the year-end, whilst remaining within limits compatible with the objective of stability (namely less than 2%) assigned to monetary policy. According to the Harmonised Index of Consumer Prices (HICP), which is the measure of inflation adopted for the countries of the European Union, the rise in prices in France reached a twelve-month rate of 1.4% in December 1999, as against 0.3% a year earlier. This increase can mainly be explained by the sharp 20.6% annual rise in oil product prices. Underlying inflation, which measures the rise in prices, excluding products with highly-variable prices (notably energy and fresh produce) and also public utility charges, after stripping out the impact of tax measures, rose at a slower twelve-month rate of 0.7%. France was thus the best performer of the euro area in this field, along with Germany, with twelve-month HICP growth of 1.7% in December 1999.

Since the start of 1999, the Eurosystem - comprising the European Central Bank (ECB) and the eleven national central banks of the countries having adopted the euro as their currency - has been responsible for defining and implementing monetary policy.

In accordance with the Maastricht Treaty, the primary objective of the single monetary policy is price stability. This is defined as a year-on-year increase in the HICP for the euro area of below 2%. The definition of this medium-term objective is the same as that adopted by the Monetary Policy Council for French monetary policy when the Banque de France was granted independent status a little more than six years ago.

In order to achieve its main goal of price stability, the Governing Council of the ECB decided, as you know, to refer to two groups of indicators, or “pillars”, for European monetary policy:

– the first pillar is a prominent role for money, reflected by the choice of a quantitative reference value for growth in M3, the broad monetary aggregate for the euro area. This reference value has been set at 4.5%.

  This concept of a reference value implies close monitoring of monetary developments, without implying a commitment to mechanistically correct the deviations that may appear in the short term. At its 2 December 1999 meeting, the Governing Council decided to keep the same 4.5% reference value for 2000;

– concerning the second pillar, the ECB Governing Council monitors developments in a broad range of economic and financial indicators giving advanced warning of inflationary pressure. This group of indicators mainly covers different price and cost indices, wages, the exchange rate, various measures of real economic activity and surveys of business leaders and consumers.

  After observing monetary developments and changes in economic and financial indicators, the Governing Council, which had cut the euro area’s main refinancing rate from 3% to 2.5% on 8 April, put it back up to 3% on 4 November 1999. Monetary conditions thus changed in connection with the assessment of inflationary risks.

The indications given by the two pillars became consistent with each other in the second half of the year, pointing towards a steady rise in the risks to future price stability.

For the first pillar, the twelve-month rate of M3 growth for the period from October to December averaged 6.1%, which was 1.6 percentage points above the 4.5% reference value.

An analysis of the factors behind this rapid expansion of M3, which especially concerned its most liquid components, reveals strong growth in credit to the private sector. From the start of 1999, lending to the private sector grew at an annual trend rate of about 10% in connection with the pick-up in activity, but probably also the significant rise in the prices of property and financial assets, which were very responsive in certain sectors and economies of the area, as well as the rising number of mergers and acquisitions, many of which reflected direct investment outside the euro area. In France, twelve-month growth in total domestic debt stood at 8.1% in December 1999, compared with 4.5% in 1998.

Among the elements forming the second pillar, the exchange rate of the euro is an important monetary policy indicator.

The depreciation of the euro seen in 1999 is a matter of concern because it causes production costs and the general price level to rise. In addition, this depreciation of the European currency simultaneously reflected and boosted the negative financial flows, in the form of both direct and portfolio investment, that affected the entire euro area in 1999.

The French economy, like the euro area’s, is enjoying favourable monetary and financial conditions and high competitiveness. These factors are facilitating a durable, non-inflationary upturn in activity. However, while a sound monetary policy is a necessary condition for economic success, it is not sufficient in itself to guarantee growth and job creation.

Since its establishment more than six years ago, the French Monetary Policy Council has reiterated, notably in the Banque de France’s Annual Report, the three other main prerequisites for growth and durable job creation: a sound fiscal policy aimed at controlling public spending and reducing deficits lastingly; ambitious structural reforms in the areas of education and training, the labour market and welfare and, lastly; the continuation and strengthening of a policy aimed at containing unit production costs in the economy and improving corporate competitiveness.

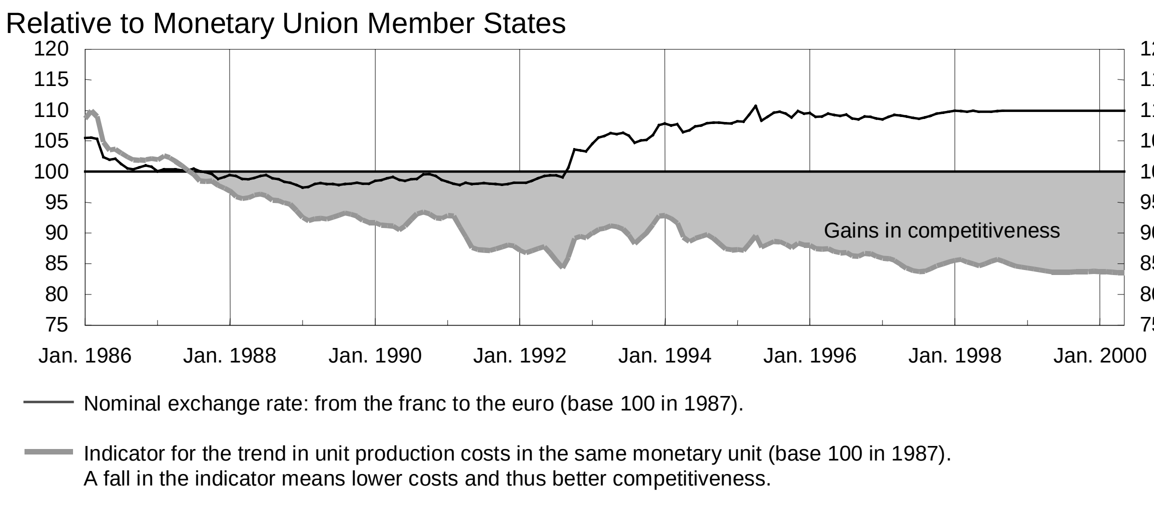
These guidelines are equally valid for the entire euro area economy as for the French economy.

With regard to the first two conditions, and without forgetting the major achievements in the fight against unemployment in recent years, the Banque de France is convinced that we could have even lower unemployment - as low as in the best-performing economies in Europe and the world - if the level of public spending (which can be likened to the overheads of our economies) was lower and if the labour market functioned in a way even more conducive to job creation. It should be recalled that our Monetary Policy Council recommends, as an essential first step, that our public spending be reduced to below 50% of GDP as quickly as possible (it came to 52.4% in 1999). Note also that the Stability and Growth Pact recommends that public finances be "close to balance or in surplus" in the current period. This is not yet the case in France. At the end of 2000, it probably will be in at least four euro area member countries and in a total of at least seven European Union Member States.

Turning to the third condition, it is important to remember that the considerable improvement in the cost competitiveness of the French economy in the 1980s and 1990s played a very large part in the recent success of our economy, a fact that we perhaps tend to neglect a little today. If the French economy has grown more quickly than the other main European economies between 1997 and 2000, whilst recording the largest external surplus in Europe and the second largest in the world over the last three years, it is to a large extent because, thanks to our low inflation, average unit wage costs in the manufacturing sector have, since the start of 1987, increased significantly less in France than in the euro area as a whole (some 16% less), as can be seen from the following graph:

Competitiveness of the French economy

Unit production costs in the manufacturing sector (unit wage costs)



This remarkable trend in our production costs - made possible by long-run low inflation - is a major achievement of the cross-party economic and monetary strategy pursued by the French government and central bank over a long period. It is important for France and the euro area to maintain and consolidate this strong cost-competitiveness position. *Since the introduction of the single currency, it is more important than ever that we very closely monitor the indicator for unit production costs as it determines the competitiveness of the goods manufactured in our economy and therefore the current level of employment. This indicator also determines future employment because it dictates the attractiveness of an investment in our economy compared to elsewhere, particularly outside the euro area.*

Allow me to lastly make a general remark about our strategic approach to growth.

Under the notable influence of new information and communication technologies, a change is underway in the overall attitude of Europeans in general and French people in particular concerning the motors of economic growth and job creation. Persistent mass unemployment, the structural causes of which were poorly understood, had for a long time led to the adoption of certain Malthusian attitudes: wariness towards technical progress as it could potentially destroy jobs, the avoidance of productivity-enhancing investments thought to contribute to higher unemployment and, lastly, efforts to reduce the available work force with a view to sharing the same number of jobs between a smaller number of people.

Having thus sought to limit technical progress, the available work force and the capital stock, it is not surprising that, despite the considerable progress in recent years, Europe and France have seen that their non-inflationary growth potential was still not as high as would have been desirable. In Europe and in France, we are seeing a profound change in perspective and are moving away from Malthusian attitudes. The Banque de France and the entire Eurosystem can be counted upon to support this change.

This is why the Monetary Policy Council continues to make the following recommendations: in the interest of currency and price stability and therefore of robust growth, sustainable because it is non-inflationary and effective in combating unemployment, it is now more than ever the time to:

– *invest and ease the constraints on capital*. Investment is essential in our economy, in which the capacity utilisation rate currently stands at about 87% and 31% of firms are experiencing production bottlenecks. An increase in the capital stock is necessary to achieve faster growth today and to eliminate inflationary pressure;

– *reduce the constraints on labour*. In an economy, in which 42% of businesses are at present indicating that they are encountering serious recruitment difficulties, especially for skilled labour, it is necessary to not only step up training and education efforts, but also to accept the extensive use of overtime in all sectors where there is a labour shortage. Moreover, the increase in Europe's employment ratio from 61% today to 70% in ten years time, decided upon at the European Council meeting in Lisbon in order to expand the labour force, is particularly opportune and reveals a profound change in attitude;

– *actively seek productivity improvements, which lie at the very heart of economic growth*. Now is the time to embrace technical progress, the digital revolution, new information and communication technologies, biotechnology and material sciences. In a French and a European economy characterised up to now by lower productivity growth than in the United States since 1995, this openness to technical progress and rapid productivity enhancement is a crucial factor if we are to achieve our ambitions of faster growth today, durably low inflation and robust, sustainable growth.