Christian Noyer: Monetary policy, the French economy and its outlook

Introductory letter by Mr Christian Noyer, Governor of the Bank of France, to the Bank of France's Annual Report 2006, submitted to the President of the French Republic, the President of the Senate, and the President of the National Assembly, 1 August 2007.

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I have the honour of submitting to you, as required by law, the report on the operations of the Banque de France, monetary policy and its outlook.

The year 2006 was marked by robust and more balanced growth in global economic activity across virtually all regions. Thanks to this favourable international environment, the French economy saw a return to dynamic growth conducive to employment and the reduction of government deficits. This cyclical upturn should not, however, mask the structural difficulties facing the French economy, which is performing less well in all these areas than its main trading partners and which, moreover, is witnessing a further widening of its external deficit.

Against this backdrop, I should like to outline a number of analyses of the growth environment, monetary policy, the state of the French economy and the main challenges that it needs to rise to in order to take advantage of globalisation and make structural improvements to growth and employment.

In 2006, the European economy entered a period of sustained and balanced growth

Growth in the euro area is sustained: after 2.9% in 2006, it could stand at 2.6% in 2007. Such a performance – growth above 2% for two consecutive years – has not been observed since 1999-2000. In 2006 alone, over two million jobs were created in the euro area, which brings to 13 million the total number of jobs created since the introduction of the single currency; this figure is slightly higher than that for the United States over the same period. After a catch-up phase in which growth was significantly above its long-term trend, the euro area's GDP is currently increasing at a rate close to the economy's potential.

This growth is balanced since all of the components of demand are contributing to it in a harmonious fashion. In the first phases of recovery, the contribution of external demand was decisive. But productive investment and, almost everywhere, household consumption are now supporting the business cycle. This has enabled and led, in most countries, to a welcome consolidation of public finances, with no adverse impact on the economy.

Concerning the future, the outlook for Europe is dominated by three questions, varied in nature.

The first naturally concerns the international environment. Forecasts for world growth remain good. At this juncture, the US economy appears to be absorbing the economic and financial impact of the slowdown in the property market. Emerging market economies displayed encouraging resilience in the face of the two episodes of financial volatility that affected international equity markets in May 2006 and March 2007. Nevertheless, several risks should be highlighted: that of a sudden drop in US consumption in the wake of the problems in the property market; that of a sharp increase in commodity prices; that of a return to volatility on financial markets, after several exceptionally calm years; and, linked to the latter, that of a disorderly adjustment of exchange rates triggered by the build-up of international imbalances.

The second concern relates to the extremely rapid growth of monetary and credit aggregates in the euro area. The annual growth rate of M3, which was below 6% in 2004, gradually accelerated and currently exceeds 10%. Loans to the private sector also continue to expand by more than 10%. Structural changes in money and credit demand – linked to financial innovation – may partly account for this acceleration. However, these developments must be closely monitored in view of their implications for monetary stability and that of financial systems. During 2004 and 2005, household borrowing was the primary source of credit growth; in 2006, this was replaced by lending to enterprises, in line with the economic recovery and the rise in – often highly leveraged – company buyouts. The strong profits and financial soundness of firms facilitate and sometimes encourage increased borrowing, which is then presented as "optimising" their liability structure. But balance sheets are weakening and difficulties could appear in the event of a turnaround in the business cycle.

The third question concerns the acceleration of productivity observed in the euro area since mid-2005: is it purely cyclical or does it reflect a more permanent and structural improvement? Over such a short period, caution would favour the first answer. Nonetheless, the conjunction of strong employment growth and a rapid rise in productivity is highly unusual. It constitutes a reversal of the previous trend in Europe since, for over a decade, periods in which there has been an improvement in employment have also seen a slowdown in productivity. In general, workers that have just entered the job market are initially less productive than more experienced employees. This effect now appears to be offset by other more favourable and fundamental factors. The structural reforms implemented in the last few years may account for this development.

The answers to these questions will make it possible to assess the magnitude of risks to inflation and the capacity of the European economy to continue growing at close to its potential rate.

Inflation and monetary policy

After several years in which globalisation fostered moderate inflation, inflationary pressures have appeared in the international environment. Commodity prices, stimulated by strong growth in emerging markets, now appear on an upward trend. Most of the world's economies – including emerging market economies – are currently close to full utilisation of their production capacity. Lastly, global liquidity, irrespective of the indicator used to measure it, is expanding strongly.

Against this backdrop, monetary policy has become more restrictive across all countries. Since December 2004, key interest rates have risen from 2.25% to 5.25% in the United States, from 4.75% to 5.75% in the United Kingdom and from 2.00% to 4.00% in the euro area. As regards the latter, the seven increases in interest rates implemented since December 2005 have, as mentioned above, been accompanied by strong GDP growth, and during this period monetary policy has ensured price stability at the same time as more than two million jobs were created.

The ECB's monetary policy stance has aimed, in accordance with the Treaty, to maintain price stability over the long term. In sync with the consolidation of growth in the euro area, it has gradually been adjusted upwards, with the Governing Council striving consistently to calibrate interest rates as precisely as possible to allow growth to firm, while ensuring it is not jeopardised by mounting inflationary pressures.

Price stability is foremost among the objectives assigned to central banks in all countries. This is not a random choice. It is the fruit of experience. Many countries have attempted, over recent decades – and particularly after the oil shocks at the end of the last century – to stimulate growth via expansive monetary policies. All of these attempts failed. Inflation rose, sometimes to very high levels, without there being any improvement in employment.

Two lessons have been learned from this period, which still inform the conduct of monetary policy today.

First, over the medium and long term, growth is determined by productivity, investment and the quantity of labour mobilised in the economy. At this time horizon, there is no trade-off between inflation and growth, and monetary policy is neutral with respect to output and employment.

Second, inflation itself is strongly influenced by the expectations of economic agents, both households and enterprises. These agents are increasingly well informed. They quickly perceive developments that threaten their purchasing power or the value of their savings. If monetary policy is likely to encourage inflation, they adjust their behaviour very rapidly, for example by asking for higher wages, thereby triggering a wage-price spiral; or by demanding greater remuneration of their savings, resulting in higher long-term interest rates and slower growth.

How, in the ECB Governing Council's view, can monetary policy make an effective contribution to economic growth? First and foremost, by anchoring inflation expectations. If monetary policy is credible, confidence prevails and economic agents make their decisions in a more reliable environment. Economic signals are less blurred by concerns about inflation. Shocks are more easily absorbed, or at least are less amplified by economic agents' attempts to shelter against the risk of inflationary pressures. Overall, the economy is less volatile, business cycles less pronounced and economic growth steadier.

More fundamentally still, maintaining the internal value of money means preserving consumers' purchasing power. French citizens, who are clearly committed to price stability, know this. Conversely, inflation is a form of confiscation, which primarily affects the least privileged households. In a modern economy, the social contract is based on the confidence that citizens have in their currency. With the euro, French citizens now possess one of the world's two foremost currencies, whose legitimacy is based on the stability that it bestows on their savings and purchasing power.

The French economy

In spring 2007, the picture of the French economy is mixed.

At first glance, France's performance is strong. Growth is above 2%, inflation is under control, investment is dynamic and 256,000 jobs have been created over the past year (of which 155,000 in the market economy). In 2006, the fiscal deficit decreased sharply and government debt was cut by 2 GDP percentage points.

This assessment is, however, significantly tempered by the two following observations. First, and for the first time for a long time, growth in France is below the euro area average. France is following and benefiting from a European movement that it is not contributing to fuel. This is illustrated in particular by the (negative) growth differential with Germany, which is without precedent over the past 20 years.

Second, France records a substantial current account deficit, which deserves particular attention. Thanks to the euro, the French economy is shielded from financial turbulence which would, in the past under such circumstances, have jeopardised the stability of its currency. Although the external balance is no longer a constraint on growth, it nevertheless remains a significant and telling signal of the threats to its sustainability.

What is the cause of the deficit? French domestic demand, boosted by higher household consumption than the European average, may have been one explanatory factor in the past, but the main explanation lies elsewhere.

France's declining export performance is frequently attributed to the inadequate degree of sectoral specialisation. This is of course insufficient to explain the movement recorded over the past three years. Specialisation tends to evolve slowly over time, whereas the decline in the trade balance has been sudden and dramatic; and had not been anticipated by any of the analysts who continuously study its structure and developments.

It is clear that the price-competitiveness of French industries has deteriorated significantly in recent years. Has the euro's appreciation played a role in this? On the one hand, it undoubtedly penalises export sectors whose competitors are located in other monetary areas. But, on the other hand, it benefits those sectors which are large consumers of imported commodities. At this stage, the overall effect on France's growth and external balance is not clearly apparent. Furthermore, two observations must be made: first, it is mainly intra-euro area trade that is worsening; second, many of France's European partners faced with the same constraints are performing better.

French competitiveness has in particular been impacted by wage increases and catch-ups associated with the reduction in the working week, while Germany has experienced several consecutive years of real wage cuts. From this point of view, it is likely to be positively affected by a strict application of the revaluation rules for the minimum wage.

In addition, industrial output has virtually stagnated over the past six years, in spite of efforts aimed at making the French economy more attractive. France is not the only European country in this situation. Industrial output in Italy is also fl at, while that of the United Kingdom has dropped by 5% despite its buoyant economic growth. At the same time, however, industrial activity in Germany and Spain has grown by 15% and 10% respectively. It is as if the French economy had been hit by a "shock" hindering its ability to react to an increase in domestic and, especially, world demand. We need to take a look at the origins of this shock.

Corporate investment hardly seems to account for this shock, given that it has risen by the same proportion in France and Germany in recent years (12% in 4 years). Other gridlocks, that are less clearly definable, are therefore hindering the industrial sector's reaction capacity. Although it is currently impossible to clearly identify them, labour market rigidities have probably played a major role, especially on the supply side. Thus, despite the significant improvement in the employment situation, the total number of hours worked in France each year hardly increased between 2000 and 2006.

Higher costs and sluggish supply: overall, the French economy is still absorbing the effects of the reduction in the working week and the wage catch-ups which it has given rise to over the past ten years. And these effects have a delayed yet strong impact on the external performance of the French economy.

Reforms

In order to reinforce the growth dynamics beyond the current cycle, it seems necessary to considerably increase the quantity of labour. The European countries whose per capita income is expanding most rapidly have enlarged and activated their workforce via increases in participation and employment rates.

This assessment is encouraging for France, which has, thanks to its demography, large growth reserves. If these could be "activated" by appropriate policies, France should, in a few years, be able to substantially raise per capita income and catch up with, or even overtake, the best European performers.

This catching-up is feasible and the current economic recovery provides a particularly favourable context in which to implement ambitious reforms. It requires a radical change in habits and policies. In addition to reducing the social contributions weighing on overtime, it is also necessary to take measures to raise the participation rate. Some would be simple and not too costly: for example, allowing pensioners, without any restrictions, to draw a pension and a wage concurrently. Others require profound changes and a widespread consultation, such as the development of part-time work or the reform of employment contracts. To convince companies to invest and recruit, it seems essential to reassure them of their ability to adjust their staff levels to the changes in their order books without undue delays or costs. While the solidarity that underpins social cohesion must guarantee financial support and help to temporarily unemployed workers seeking to re-enter the labour market, it must not expose firms to excessive risks if it is not to deter them from developing their productive capacity and job opportunities in France.

Reforms should not only be conducted on the labour market but also on the goods market. The countries that have succeeded are those that have developed a virtuous circle of activity, productivity and employment. If one link is missing, the reforms implemented elsewhere will not have their expected effects.

We know that France has vast labour pools in market services. We also know that by their very nature, most of these jobs cannot be moved abroad. However, many obstacles still lie in the way of their development. It is too often difficult, even prohibited, in France to produce or sell services.

There are a number of causes for these obstacles. First, there is a desire to protect existing activities and to ensure that the professional quality of service provided is upheld. Second, regulations aim to prevent excessively harsh working conditions. All of these reasons are legitimate in themselves. But, taken together, they considerably restrict supply even though – as foreign examples have shown – demand is potentially sizeable. These restrictions also encourage the substitution of labour by capital and therefore result in growth that is both constrained and has an insufficient employment content. They are sometimes based on a notion of working rhythms that is out of step with the functioning of a modern society and technological progress. They are very costly for the economy. And, lastly, they do a disservice to those they set out to protect. The main victims are those for whom access to employment requires flexibility, adaptation, and freedom to choose working hours, i.e. primarily young people and women.

A complete overhaul of all the legal and regulatory conditions governing a wide range of commercial and services activities therefore appears to be an urgent priority.

Lastly, in order to increase France's productivity, a shift towards technology- and science-based activities is essential. To do so, research and development (R&D) efforts must be encouraged. In this respect, while the share of public R&D expenditure is comparable or even greater than that of the country's main trading partners, private sector R&D investment remains well below that in Germany, the United States or Japan. The creation of poles of competitiveness in 2005 and the Industrial Innovation Agency in 2006 contribute to achieving this strategic objective. These recent initiatives should be pursued in order to expand the poles of competitiveness, attract researchers and companies, and integrate SMEs and start-ups that do not benefit from the resources available under these innovation drives.

In the main, these reforms are currently underway or being examined in our country. It is thus becoming possible to create lasting conditions for stronger and more employment-rich growth.

Public finances

Despite the partial consolidation seen over the past two years, public finances remain weak and call for great vigilance.

Following the reform of the Stability and Growth Pact, France made a number of commitments. These commitments have been made for a reason and the credibility of the efforts undertaken elsewhere on the European stage depends on their respect. France, which is the euro area's second largest economy in terms of size, naturally aims to play a key role in this area in order to enhance and develop "economic governance".

Come what may, it is in the interest of France's economy and citizens to consolidate public finances. The role traditionally attributed to public spending and welfare is to contribute to a better allocation of resources in the economy, foster the desired redistribution of income and, if the conditions are in place, help stabilise economic cycles. These three functions are more difficult to realise in a globalised economy that reduces leeway and creates, in practice, latent and permanent competition between tax systems and public policies. A number of major imperatives thus emerge.

- First, introduce a great degree of selectivity in terms of public spending. Since France is the country in the euro area with by far, as a percentage of GDP, the highest level of public spending, it should give priority to forward-looking spending that supports reforms. From this point of view, a review is necessary in particular of the "defensive" cuts in social contributions that offset the constraints, obstacles and costs facing our companies. These cuts now exceed the equivalent of France's spending on higher education. More generally, the effectiveness of subsidised contracts in the long term is questionable: they are useful, or even essential, when they allow those deprived of equal opportunities to integrate into the labour force; they are more dubious when, conversely, they financially compensate the effects of rigidities in hiring decisions and the functioning of the labour market. It would be extremely useful to conduct a thorough review of these measures on the basis of this simple distinction.
- Second, reduce structural expenditure. France has a high quality civil service, which is a crucial asset. Current demographic trends and the needs of a modern economy require adjustments to be made. France must have a great civil service in terms of quality but a less bloated one in terms of quantity. The reforms implemented over the past decades are not necessarily consistent with this imperative: of all developed countries, France has recorded the greatest growth in public sector jobs. The State, in particular, has not reduced staff numbers in proportion to the posts transferred to decentralised authorities, whereas the latter have recruited on a large scale to fill these positions. Demographic developments provide an opportunity to turn this trend around and create more flexibility. Recent announcements stating that half the posts left vacant following retirements are not to be filled show that this opportunity will be seized.
- Lastly, maintain cyclical flexibility. France, as we mentioned, is currently at a favourable point of the business cycle that automatically increases government revenue and, all other things being equal, reduces the deficit. This gives an impression of affluence that may be misleading and dangerous. What counts here is the general government structural balance. In our country, it is high (above 2% of GDP), which means that our public finances are particularly vulnerable to an economic slowdown or a turnaround in the business cycle. In such a case – unless we are prepared to enter an endless downward spiral – even the forward-looking spending would have to be sacrificed.

One imperative must ultimately dominate the management of public finances: the well-being of future generations. It is they who will have to sustain, service and finance the public debt that is building up today. It may be understandable and justifiable if this debt were used to establish an economic capital that would benefit these generations. But this debt would be economically inefficient and morally unjust if future generations had to finance current generations' welfare spending. Such a transfer would be especially paradoxical since sustainable development has become a key priority and the quality of the environment passed on to future generations has never before to such an extent inspired and guided public action.

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The French economy must now be allowed to fulfil its potential. While globalisation offers opportunities, it also creates numerous insecurities. The accumulation of such sentiment may result in slowing down or preventing the necessary reforms. But because the world economy is changing rapidly, the refusal to adapt would lead, inevitably, to weaker growth for France and greater insecurity for all French citizens, especially those that are least protected.

This dilemma is not peculiar to France. All the other European countries are experiencing this friction between the natural desire for greater security and the unavoidable need to adapt. It is important for each country, according to its traditions and culture, to find the means of taking up this challenge.

However, France boasts numerous and decisive advantages: Europe's most dynamic demography; a high level of energy independence, which is an inestimable advantage in these times of economic and geopolitical uncertainty with regard to supplies; active and dynamic companies, which have been able to take ample advantage of the opportunities afforded by globalisation; and lastly a highly-skilled workforce which, to some extent, accounts for France's high hourly productivity levels. These advantages must therefore enable France to achieve strong growth that creates jobs in a stable monetary environment. This opportunity must be seized.