Christian Noyer: The outlook for the economies of the euro area and France

Speech by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, at the Paris Europlace International Financial Forum, New York, 14 April 2014.

* * *

Ladies and gentlemen,

I am very pleased to be here with you today for this Paris Europlace International Financial Forum. I would like to extend my sincere thanks to the whole Paris Europlace team for their great work on this specific event and, more generally, for their commitment to the French financial sector.

I would like to provide you with a quick overview of the outlook for the economies of the euro area and for France.

1. The economic and financial situation in the euro area

I shall start by updating you on the current situation in the euro area.

As you know, the second quarter of 2013 marked a turning point in that it put an end to six consecutive quarters of recession. The euro area economy finally saw a return to positive growth, with a 0.3% expansion, and this was confirmed in the third quarter with 0.1% growth, and again in the fourth quarter with 0.3% growth.

The recovery in 2013 was modest and unequal across countries. However, it still reflects a sharp improvement in the overall trend, which is continuing and gradually getting stronger.

The ECB staff macroeconomic projections foresee annual real GDP increasing by 1.2% in 2014 and 1.5% in 2015.

In addition, the majority of soft indicators are improving, and have been above their long-term average for a number of months now, confirming a rebound in economic activity.

Although the strength of the rebound varies across countries, it is important to highlight the return to positive growth in those countries most affected by the crisis and which are of major importance to the euro area: I'm thinking above all of Spain and Italy, where exports have rebounded sharply and are currently driving economic activity.

On a financial level, we are also seeing a significant return to normal in the euro area:

- bond markets in periphery countries are continuing to stabilise and interest rates have come back down to sustainable levels, with several periphery countries or programme countries recently managing to obtain market financing at perfectly satisfactory rates;
- fragmentation within the euro area is decreasing – as shown for example by the fall in liquidity surpluses or Target2 balances;
- credit dynamics are still subdued on the whole, due to continuing weak demand and ongoing bank deleveraging. But we are confident that the asset quality review which we are undertaking and the upcoming stress tests will revive confidence and thus boost credit. Besides, we are working on revitalising market-based financing in the euro area, notably through the revival of a transparent, robust and efficient securitization market; this has the potential to provide a useful complement to credit, the ultimate objective being, of course, the healthy financing of the euro area recovery.

In this context, of course, the key question at the heart of current debates is: how can we amplify this recovery?

I believe that, fundamentally, what Europe needs in order to strengthen its pace of growth is to improve its competitiveness in today's globalised world. Obviously, the euro area is not without its strengths, and the region is well-equipped to face the challenges of the 21st century. With 370 million consumers and a high level of purchasing power, it is still the largest market in the world. It is also the world's most economically integrated zone, with a highly qualified labour force and extremely good infrastructure.

Besides, we have achieved considerable improvements in our economic governance and are continuing to make progress in this area with the implementation this year of the single supervisory mechanism, which will be followed by a single resolution mechanism, as announced by the European Council of Ministers in March. This banking union is absolutely key to the strengthening of the euro area. It will make the transmission of the single monetary policy more efficient, it will break the vicious circle between banks and sovereign risk, and it will bring more confidence, more stability and, ultimately, more growth.

However, the problem we face today is that many countries in the euro area are too often unable to take full advantage of these benefits, due to rigidities that have built up gradually during periods of easy growth. The only solution is to carry out structural reforms.

In this field as well, the euro area has made considerable progress these last few years, especially in those countries with the biggest competitive lag relative to the rest of the region, and which had thus been plunged deeper into crisis than their neighbours. Cost competitiveness has improved substantially. There has also been a strong correction in current account balances, with several countries managing to turn significant trade deficits into surpluses.

This progress can be attributed to major reforms in some of the most decisive areas for competitiveness, that is goods and labour markets, social security systems and pension schemes. Of course, the effects of these changes will mainly be felt over the medium to long-term.

We still have a lot of work to do, however, particularly in liberalising goods and services markets, making labour markets more flexible, and increasing profit margins to enable companies to start investing in innovative technology again. This is without doubt the most important lever for guaranteeing a strong and sustainable recovery in the euro area, and one that will create jobs.

2. The outlook for inflation in the Euro area

Of course, no summary of the euro area situation would be complete without talking about the current low level of inflation, which poses a major challenge for the Eurosystem, and for the euro area economy as a whole.

The sources of and reasons for such a low level of inflation are complex and multiple. Temporary and global factors may be at play in the euro area, with import prices falling. I also think there are more permanent and deeper forces pushing inflation down both at the euro area and global level.

Let me make a few points regarding this challenge to European monetary policy today.

First, and you all know this perfectly well, low inflation is not deflation. Deflation is a permanent and cumulative process of decline in the overall price index, fuelled by negative expectations. Having this in mind, there is no deflation today in the euro area. Prices are still increasing and, most importantly, so are nominal wages. And, something even more crucial: inflation expectations remain firmly anchored in positive territory, even in the short run.

Second, low inflation provides economic stimulus by boosting real income. In most parts of the euro area, nominal wages are downward rigid. Every time inflation "surprises" on the downside, it creates an unexpected increase in real wages and purchasing power. I believe this mechanism is playing some role by improving economic sentiment and supporting consumption as we have seen in the euro area over the past months.

That said, when inflation is too low, it carries very significant dangers and risks:

- First, it makes real adjustment more complicated.
- Second, low inflation makes it difficult to attain low, or negative, real interest rates, which are necessary in all advanced economies at the current juncture.
- Finally, low inflation increases the risk that the economy could fall into outright deflation if and when it is hit by a negative shock. The 2% target is meant to act as a cushion against that risk.

To sum up, the situation today calls for a very careful assessment of the balance of risks. Precisely because deflation is hard to reverse, even small probabilities cannot be neglected and must be fully factored into policy-making. I think the ECB Governing Council has made this point very clear over its last meetings. We currently anticipate a progressive return of inflation to our objective of below but close to 2%. Our monetary policy remains very accommodative and we continue to expect the key ECB interest rates to remain at present or lower levels for an extended period of time. Should we note a deviation from this path, we will use every instrument within our mandate, including unconventional ones, in order to cope effectively with risks of a too prolonged period of low inflation.

3. Outlook for the French economy

I would like to end my speech by taking a closer look at the situation in France.

Our growth is expected to be close to the euro area average in 2014, at around 1%.

France has some major strengths for competing in a global economy: dynamic demographics, a well-trained labour force, expertise in strategic or high-tech sectors such as mathematics, aeronautics and nuclear engineering, and excellent infrastructure. We also have the advantage of an efficient financial system which has always managed to play its role in financing the economy. French banks have made the necessary efforts to meet the Basel 3 solvency requirements, and are also improving their liquidity levels in a highly favourable monetary policy environment.

But our economy has two main handicaps: first, taxes and social security contributions are too much of a burden, particularly for companies, because of our excessively high level of public spending; and second, our labour market and goods and services markets are overregulated and excessively rigid.

As far as I can see, France's main priority today is to ensure that it can take full advantage of its strengths by implementing structural reforms that reduce the burden of taxation and simplify administrative formalities. The government has made it clear that it shares this view of the causes behind our current problems and of the solutions that we need to implement as soon as possible.

It has indeed begun implementing major structural reforms, and is committed to going further, notably on firms' cost competitiveness and on the reduction of the public deficit through greater cost efficiency in public administration.

Thank you for your attention and I am looking forward to your questions.