Introductory letter to the Banque de France's Annual Report

submitted to
the President of the French Republic,
the President of the Senate, and
the President of the National Assembly

by
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2013

BANQUE DE FRANCE

EUROSYSTÈME

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.

For France, the coming period is both one of reckoning and of opportunities. A time of reckoning, because the country can no longer put off consolidating its public finances and improving its competitiveness. And a time of opportunities, because the recovery, albeit gradual, of the world economy and the euro area and the major changes in economic strategy could restore France to a path of sound, sustainable and job-creating growth, after two years of quasi-stagnation. Economic policy faces two challenges: at the European level, consolidating the stabilisation and recovery process; at the national level, continuing in a consistent manner to shore up public finances and improve external accounts.

The euro area

After more than three years of serious difficulties, the euro area has now stabilised and can return to a path of growth. Its recovery, which is already perceptible, is based on three interrelated successes.

First, the success of adjustment efforts in many countries. In the euro area as a whole, deficit-to-GDP ratios have fallen by over a quarter in the past two years. Furthermore, economic competitiveness, measured by unit labour costs, has improved over the same period, by 20% in Ireland, 15% in Greece and Spain and almost 10% in Portugal. The fact that these countries have now returned to a path of sound and sustainable growth, underpinned by investors, is the proof that the recovery plan implemented was the right response to the crisis.

Second, the success in establishing the banking union. Few observers realise the scale and speed of the changes that have taken place, which are unprecedented in the history of European integration. The principles of banking union were adopted in June 2012 by the Summit of Heads of State or Government. Less than two years later, the main pillar, the Single Supervisory Mechanism (SSM) is being set up and will be operational by the end of the year, under the aegis of the European Central Bank (ECB), and political agreement from the EU Council and the European Parliament has just been obtained for the second pillar, the Single Resolution Mechanism. In the coming months, the bank asset quality review together with stress tests will make it possible to ensure that European banks are sound and resilient and, where necessary, to impose corrective actions. Based on these solid foundations, bank lending should once again be able to play its role in the financing of economic growth in Europe. More generally, the banking union will without doubt be a powerful driving force for the coherence and strengthening of the euro area and a major asset for our economy in terms of international competition.

Lastly, and this results from the two previous successes and the effectiveness of monetary policy: the reduction of internal financial volatility and financial market segmentation. Just two years ago, the survival and integrity of the euro area were being openly called into question. Government bond yields and financing conditions in peripheral countries reached almost unsustainable levels. Domestic money and financial markets were segmented, or had even seized up. The risk of certain countries exiting the euro area was at times openly evoked.

While it is too early to declare that the crisis is over, there has been a spectacular turnaround in the situation. Sovereign bond spreads have converged to levels that better reflect national economic and fiscal fundamentals. Market segmentation, which persists, has nevertheless declined substantially. Financing conditions differ less across countries for the same borrower categories.

Despite these clear successes, the euro area still needs to address three major challenges in the short term.

First, the possible persistence of a rate of inflation that is too low. In all advanced countries, inflation has fallen over the past eighteen months. This trend is especially remarkable given that it coincides, almost everywhere, with a recovery in growth. It is also particularly marked in the euro area: the annual inflation rate fell from 2.7% at end-2011 to 0.5% in March 2014. Temporary and global factors are at play, with import prices declining, notably in the case of raw materials and energy. There are also deeper and more permanent forces at work: spare capacity remains high and powerful deflationary pressures are emerging from the deleveraging of the private and public sectors and the restoration of competitiveness through wage and price cuts in the countries worst affected by the crisis.

The euro area may therefore face an extended period of low inflation or, at any rate, significantly below our definition of price stability. How should we interpret this and what conclusions should we draw?

Firstly, low inflation does not mean deflation. Deflation is a permanent and cumulative process of decrease in the overall price index, driven by negative expectations. Deflation is a vicious circle: since consumers expect prices to carry on falling, they tend to delay purchases, thereby further fuelling the deflation process. Moreover, deflation increases the real burden of debt and creates an incentive to defer investment.

Empirical evidence shows that, currently, there is no deflation in the euro area as a whole. In most countries, prices and, most importantly, nominal wages are still increasing. Asset prices are far from experiencing widespread declines, and indeed stock prices have risen sharply. Inflation expectations remain firmly anchored in positive territory.

Furthermore, low inflation has positive effects. It provides economic stimulus by boosting real income, i.e. purchasing power. This mechanism has certainly contributed to improving economic and consumer sentiment, as we have seen in the euro area over the past months.

Nonetheless, when inflation is too low, it carries very significant dangers and risks.

On the one hand, it makes economic adjustment more complicated. There is less scope for downward adjustment in relative prices and real wages. These adjustments are vital in the euro area in order for some countries, including France, to regain competitiveness.

On the other, it makes it difficult to attain low, or negative, real interest rates, which are generally needed in advanced economies at the current juncture.

Lastly, too low inflation increases the risk of an economy falling into outright deflation in the event of an unexpected negative shock. By maintaining its price stability objective, i.e. inflation below but close to 2% over the medium-term, the Eurosystem seeks to protect the economy from this risk by providing room to absorb shocks, and has signalled that it is symmetrically addressing the risk of inflation drifting from its target on the upside, or on the downside.

On the basis of the Eurosystem staff macroeconomic projections, the benchmark scenario points to a slow but steady rise in inflation towards our price stability target over the coming two years, as the economic recovery gradually gathers strength. The Governing Council of the ECB made it clear that particular vigilance was required when faced with an extended period of low inflation. It reduced the key ECB interest rates in May and then in November, bringing the rate on the main refinancing operations to 0.25%. It firmly reiterated its forward guidance, i.e. that it continued to expect the key ECB interest rate to remain at present or lower levels for an extended period of time, and also committed to keeping in place its fixed-rate tender procedures with full allotment for a prolonged period. Lastly, it confirmed that if inflation did not return to its target as expected, it stood ready to use other non-standard instruments to achieve this. It is therefore fully committed to maintaining price stability in the euro area in a symmetric manner.

A second challenge for the euro area relates to the recent euro appreciation. Given the weight of imports in the euro area's GDP, such an exchange rate development is a powerful deflationary factor. For monetary policy, the exchange rate can neither be a target, nor an objective. But it is naturally an important parameter that affects overall monetary and financial conditions. An increase in the exchange rate is equivalent to an unintended and unwanted tightening of monetary policy.

However, the link with monetary policy is not as direct and evident as many analysts suggest. Developments and figures show that monetary policy in the euro area has now become more accommodative than that of the United States, which is entirely warranted by their respective economic conditions. Admittedly, the ECB's balance sheet is smaller than that of the US Federal Reserve because the policy tools used are different, but the objective, i.e. low interest rates across the entire yield curve, has been achieved.

Yields on the least risky European bonds, such as those of French and German sovereign issuers, are lower than those on comparable US bonds. Markets have factored in the Eurosystem's commitment to keeping interest rates close to zero for a much longer time than in the United States.

The euro's appreciation must therefore be attributed to factors other than the monetary policy stance. Over the recent period, large capital flows were observed from emerging countries to euro area markets, in particular those of the peripheral countries. This reflects renewed confidence in these countries thanks to the success of the adjustment policies that they are carrying out. This is a welcome development, even though the ensuing exchange rate appreciation creates certain challenges for monetary policy.

Lastly, the euro area faces the risks stemming from global financial volatility. While growth seems to be back on track in the United States and other advanced economies, there is still a great deal of uncertainty surrounding emerging countries. For the past three years, they have been confronted with a rapid succession of strong capital inflows and outflows that have significantly disrupted growth and the conduct of economic policy. These external shocks have also highlighted or compounded the structural difficulties of many countries, including the largest ones. Even though instability has been dispelled, risks persist. The implications for Europe are obvious: in the same way as emerging countries were badly affected by the European crisis of 2010-2011, the euro area could, going forward, be impacted by a sudden slowdown in growth in the rest of the world, or by large and volatile capital flows.

These successes and challenges in the euro area are helpful for France; but they also mean that our country has to succeed in the adjustment process it has undertaken, both for its own benefit and for the stability of the euro area.

The French economy

There have been two major changes to France's economic strategy over the past two years: first restoring the country's competitiveness has been made the central priority of economic policy; and second, more recently, a decision has been made to move towards expenditure-based fiscal consolidation, and thus reduce the tax burden on businesses. The government has set itself a target of achieving EUR 50 billion in savings over the next three fiscal years, which represents a major effort, even though many of our partners have already managed to achieve equivalent or even greater savings.

Provided these two objectives complement and reinforce each other, and are successfully transposed into economic and financial policy, then France can expect to see a return to dynamic and sustainable growth, which will in turn lead to a substantial improvement in employment.

Timing is absolutely crucial: if there is a lag between the reduction in taxes and the reduction in spending, the resulting increase in the budget deficit could jeopardise the country's fiscal trajectory and undermine the credibility of its entire economic programme.

Competitiveness policy

This policy is based primarily on reducing the payroll charges paid by employers, a strategy which raises a number of issues.

First, the specific calibration of this measure. The traditional strategy of concentrating the bulk of the reductions on the very lowest wages tends to boost job-creation only in low-qualified, protected sectors. By contrast, including medium-sized wages helps to stimulate sectors exposed to global competition, an important objective in the current context given France's large trade deficit. The decision to reduce payroll charges on wages up to 3.5 times the minimum wage thus appears to be a sound one in this regard, although, to be truly effective in the long-term, it will need to be accompanied by structural reforms to the labour market.

It is important to recognise, however, that while reducing payroll charges is a prerequisite, it is not sufficient on its own to restore competitiveness. Reducing charges gives firms the financial means to invest, but it does not in itself create profitable opportunities for investment. For that, firms need to be able to anticipate that they will be in a position to take advantage of opportunities to grow, innovate and use their production capacity. The ultimate goal is to encourage firms to start investing again and to create jobs. Restoring their profit margins is a precondition for this, but it is not the only factor driving the investment process; businesses, notably small and medium-sized enterprises (SMEs), also need a favourable environment.

In this regard, the regulation and functioning of French markets – the product and labour markets – still make it difficult for firms to take full advantage of investment and innovation opportunities.

The dominant issue here is flexibility. For many of our fellow citizens, this carries negative connotations, as it is associated with a loss of job security. However, in a changing global environment, it is in fact rigidity which creates job insecurity. It gives those who benefit from protection the unfortunately temporary illusion that they do not need to adapt, which only serves to amplify the sense of disillusionment and incomprehension when the adjustment finally becomes inevitable.

The reform carried out in 2013 following the agreement on job security was a step in the right direction, but the labour market is still too rigid and there are insufficient incentives for firms to take risks and create jobs. Aspects of working conditions that in other countries are decided between industry unions and employers are, in France, enshrined in the national Labour Code. It would be beneficial to give French unions and employers more scope to negotiate compromises at a local level as these can be more economically efficient and provide greater protection for workers. Moreover, the complete lack of dialogue over working hours in both the private and public sectors means we are failing to take advantage of an important lever for improving the competitiveness of our economy. Businesses should be able to negotiate directly with trade unions over this key aspect of their competitive positioning. In accordance with international labour laws, including those applicable in the European Union, unions could thus be authorised to sign collective agreements opting out of national provisions on working hours. Government departments should also be able to organise themselves better while keeping their headcount under control.

Similarly, the time has come to tackle France's tax and social thresholds. The difficulties encountered by SMEs in achieving growth have long been singled out as one of the principal weaknesses of the French economy, particularly with regard to international competition. The country's tax and social thresholds are among the main obstacles to business growth; according to some studies, the threshold of 50 employees generates significant costs for the French economy. Why not start by suspending some of the obligations associated with these thresholds for a three-year period, as an economic and social experiment, and then assessing the results of this exercise?

France's minimum wage regime is also particularly detrimental to employment; numerous studies have shown that the apparent protection afforded by the high level of the minimum wage in relation to average pay in fact leaves its beneficiaries, notably young people entering the job market, more exposed to the threat of unemployment and does very little to lift low-paid workers out of poverty. Measures to minimise the negative effects of a high minimum wage for low-skilled workers mobilise substantial resources each year (more than 1% of GDP), in the form of reductions in social security contributions. The rules governing the revaluation of the minimum wage are also very strict, and have no equivalent in other industrialised countries applying a minimum wage. A complete overhaul of this system is required.

Regarding goods markets and growth for businesses, it is clear that we can still make significant progress in a number of areas. By taking an open and pragmatic approach, we can modernise the way we operate and open up opportunities for growth and job creation. Relaxing some of the rules on working on Sundays, keeping certain streamlined administrative procedures such as the *auto-entrepreneur* status, allowing consumers to benefit from technological advances that promote competition, such as online retailing, opening up regulated professions to competition, or encouraging new personal public transport systems – these are all promising avenues of reform, some of which the government has already begun implementing.

Excess regulation and standards are highly detrimental to growth and jobs. One typical and far from isolated example of this is housing. Despite spending more public money than any other developed country on housing, and despite historically low interest rates, France still does not build enough to meet potential demand, principally due to a lack of constructible land, complex planning regulations and the slowness of administrative procedures. More generally, according to the OECD, administrative red tape costs businesses between EUR 60 billion and EUR 80 billion per year. The continuation and acceleration of the "simplification shock" is thus a vital ingredient of competitiveness and growth.

Reducing public spending

Going forward, everything hinges on our ability to maintain and increase the quality and efficiency of public expenditure, while at the same time reducing the actual amount. This is the key to restoring our competitiveness and credibility, as well as our economic, financial and social stability. Of course, we should not sacrifice expenditure on our future – investment and research for example – nor the social policies which have proved their efficiency and have a highly positive impact on the economy – notably our high quality public health system and our family policy. In the latter case, it is true that we need to find a different way of financing this policy; but, it is also important to remember that France's demographics constitute a major competitive advantage and that, for decades, its family policy has made a significant contribution to consumption, growth and employment.

Optimising public expenditure calls for a profound change of approach and of method. It is not about slashing all items of expenditure equally and indiscriminately. There are two points in particular that I would like to highlight.

Efforts to cut spending should focus not just on the State budget but on all public institutions and policies.

For the past decade, public authorities have focused their efforts on controlling levels of social security spending. This is completely justified as continuing to run a huge social security deficit makes no economic sense and is unfair on future generations. A number of reforms have been implemented, for example changes to the pension system, and these deserve credit. But they are still far from sufficient, and more needs to be done.

The national inter-professional agreement of 11 January 2013 led to a number of positive changes which have helped to secure career paths and increase job mobility (the introduction of a system allowing workers to accumulate unemployment benefit entitlements or *droits rechargeables*, training credits that can be carried over from one job to another throughout the beneficiary's career, the obligation for all employers to provide subsidised supplementary health cover).

However, a number of important questions remain concerning the economic and social efficiency of our social policies, and their impact on the budget deficit.

With regard to unemployment benefits, for example, the measures introduced under the agreement of 22 March 2014 will cover approximately 10% of the forecast unemployment insurance deficit, whereas the system has already accumulated debts of EUR 18 billion. While it makes sense to maintain lax eligibility criteria for unemployment benefits during times of economic difficulty, we could still have done more to tighten certain parameters, such as the replacement rate or certain features of specific benefit regimes.

Like other sectors, the healthcare system is also coming under increased financial strain. In light of this, it is perhaps not appropriate to make the widespread application of the *tiers-payant* system a priority, given the risk to the budget deficit and the fact that the cover already provided is generous.

There is another budget item, however, that is proving just as robust as social spending, and equally likely to undermine the country's deficit reduction efforts: local authority spending and taxation.

The figures speak for themselves. Spending by local administrations increased by 13.9% between 2007 and 2012, outstripping the rise in State spending over the same period (11.2%). The wage bill in particular proved very dynamic.

French towns, *départements* and regions generally only account for a small portion of the rise in the public deficit and usually run more or less balanced budgets. However, until recently, this was achieved at the expense of a sharp rise in State contributions and, above all, in local taxes – particularly those levied on businesses. If this trend were to continue, and the efforts to reduce charges at national level were offset by rising local taxes, it would throw the country's entire economic strategy into jeopardy. In addition, local administration was the only budget category to see a rise in its deficit in 2013 (from EUR 5.4 billion to EUR 9.2 billion), making it even more important to cut spending.

What is needed today, as the *Cour des comptes* (French Court of Auditors) recently pointed out, is a global system of governance for local finances. This could be based on two main pillars: providing an accurate and aggregated view of the health of local finances, which is currently made difficult by the limited reliability of the data collected by local authorities; and the establishment of a legal framework governing local authority financing, which has the same objectives and normative weight as the law on the financing of the social security regime.

We also urgently need to simplify the country's complex, multi-layer system of local government (the so-called administrative "millefeuille"), by reducing the number of layers and eliminating overlaps in responsibilities, both to generate savings and make public services more efficient. Clear measures to concentrate greater responsibilities at the regional level, such as those announced recently by the Prime Minister, are a step in the right direction. It is also vital to bring payroll costs under control throughout local government.

This goal of controlling payroll costs applies to all levels of public administration. In 2013, despite the freeze on the index points in the pay grid, the overall wage bill in the public sector rose by nearly EUR 5 billion, which is equivalent to the savings generated on the cost of public debt due to the low level of interest rates. The *Cour des comptes* has rightly highlighted a number of ways of keeping costs down: maintaining the freeze on the public sector pay grid, reducing automatic pay rises applicable to specific categories of public sector employees, and limiting pay rises linked to seniority by temporarily slowing down automatic promotions. But while these measures are indeed necessary in the short term, they are not a medium- or long-term solution. Protracted reductions in real wages would only lead to the pauperisation of public sector workers, without tackling the underlying problems of overstaffing and the declining quality of public services. Therefore, to really be effective, the best way to control the wage bill is to reduce overall staff levels, a move that can easily be offset by improving overall efficiency.

There needs to be a greater focus on assessing efficiency in public spending.

One way of genuinely making progress in this area would be to systematically evaluate public services and to test them out in advance, using techniques that have already been applied for many years in other countries, notably "Anglo-Saxon" ones. This would help to optimise expenditure in priority areas of public service (housing, subsidised jobs – which are too often concentrated in the non-competitive sector – job training, etc.). It would also help to make reforms more socially acceptable, in that, if the spending cuts ultimately lead to better public services, then there is no reason to oppose them.

Public policies should be judged according to their efficiency and productivity. For this, the State can rely on the excellent audits carried out by the *Cour des comptes*, which have demonstrated that the increases in spending and headcount over recent years have often resulted in a loss of productivity which outweighs the positive effects of the rises, or in a deterioration in the standard of service. This is particularly evident in the case of education, which is vital for France's future: despite benefiting from increased resources, the French education system is continuing to slide down the international rankings. A similar phenomenon can be seen in the French overseas territories: the high wages paid to public sector workers, including local staff, are weighing heavily on public finances, while at the same time pushing up both prices and private-sector pay, damaging the competitiveness of the local economy and causing high structural unemployment.

Financing growth

Improving competitiveness and reducing public spending will help France to boost its growth potential. Yet to reap the full benefits of this policy, economic agents need to find the right financing to fund their investments and sustain a healthier pace of growth. In the current context of low credit demand, French banks, including the Banque Publique d'Investissement, have managed to meet most of the business sector's financing needs, so that in France, lending to non-financial corporations has actually continued to grow slightly in contrast with the other major euro area countries where it has contracted. However, due to the new regulatory requirements, there is no guarantee that our banks will be able to continue meeting this demand if the credit market picks up. It is absolutely vital, therefore, that we find additional means of financing to complement bank lending - hence the recent reform of life insurance. This means encouraging market financing, increasing private placements with a broad range of institutional investors, successfully introducing crowdfunding and reviving simple and transparent securitisation mechanisms that are cheap, safe, and match the needs of banks and investors. These are important challenges for France and, in 2014, the Banque de France is committed to backing those projects already underway.

The period ahead calls for a determined and wholehearted implementation of the general economic policy that has been decided. This is the only way that France can see a return to solid economic growth, achieve a sustained reduction in unemployment and balance its public finances and its external accounts.

Paris, 24 April 2014

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