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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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.

The French economy is facing some exceptional challenges. Growth in 2013 will probably be close to zero for the second consecutive year, well below the level needed to maintain employment. The international environment remains uncertain, despite the highly accommodative monetary policies conducted by developed countries for a number of years now. Public debt is at its highest level since the Second World War. Lastly, the imbalances and uncertainties in the euro area have not yet been fully reabsorbed.

For some observers, Europe appears to be imposing excessive constraints. However, this vision is incorrect. If certain disciplinary rules exist within Europe, it is because they are necessary to ensure cohesion and balance in the euro area. Despite the turmoil of the last three years, it is still the second largest monetary area and largest market in the world, and the region with the highest concentration of purchasing power.

The constraints stem primarily from the transformation of the global economy and the resulting need to boost competitiveness. Billions of human beings now aspire to the level of riches enjoyed by the most developed countries, and this legitimate desire, combined with technological advances, has led to profound shifts in the world's economic geography and in the conditions of production. France has a number of strengths that can help it to grow and prosper in this environment: the most dynamic demographics in Europe, expertise in a number of advanced technologies and high quality public infrastructure. But its competitiveness is waning and, for the past decade, it has no longer been able to take full advantage of the opportunities offered by globalisation while at the same time being exposed to the corresponding risks and shocks.

In France's case, the constraints also stem from the high level of public debt, which is the result of decades of imbalances in public finances. More than 60% of public debt is now held by non-residents, reflecting the attractiveness of French debt relative to the rest of the euro area, but also the country's financial dependence. The current exceptionally favourable financing conditions, along with France's membership of the euro area, offer a unique opportunity for us to consolidate and improve our public finances.

This strategy of fiscal consolidation occasionally comes under criticism, with calls for a more activist fiscal policy designed to support growth by stimulating demand. The debate has now become sufficiently heated to merit closer examination.

The short-term effectiveness of fiscal policies – or, in technical terms, "multipliers" – depends on the particular circumstances. In a severe economic depression or deflationary environment, it is vital to boost demand, and intervention may even be necessary to support means of production that are viable but temporarily under threat. But these policies have to be temporary. Although they help counter the effects of an acute crisis (global GDP shrank 5% in the first quarter of 2009), they can, if kept in place too long, end up hindering the economic recovery. This is particularly true if, as in France's case, the country was already in a difficult financial position before adopting the policies.

Of course, the pace of fiscal consolidation should be calibrated to ensure that its short-term mechanical effect on economic activity does not stifle the recovery. Given the weak growth environment, choosing a path of ongoing structural consolidation makes sense. This choice meets the need for efficiency, but also has a moral rationale: to avoid leaving future generations with an unsustainable debt burden that is crippling to long-term growth.

For the past ten years, France has had one of the highest levels of public spending in the world. Over a certain threshold, which our country has probably crossed, any increase in public spending and debt has extremely negative effects on confidence. Households perceive the imbalance in public finances, anticipate a future increase in taxes and thus start to reduce their spending straight away. Businesses do the same with their investments and, together, these reactions largely offset the temporary boost to growth provided by an increase in fiscal spending. In contrast, credible fiscal consolidation, sustained over the medium term, has highly positive effects on confidence, consumption, investment and, ultimately, growth. This is the current line of French fiscal policy, in keeping with the underlying thinking behind euro area economic governance.

The trajectory set by the government aims at eliminating the structural deficit over the next four years. Overall, a structural adjustment equivalent to 4% of GDP will have been made in the 2010-2013 period and, beyond that, the effort will essentially come in the form of spending cuts. These measures should result in a stabilisation of public debt levels at a little over 90% of GDP.

The underlying objective is growth. Not just a temporary spurt, sustained artificially by public spending, but strong and lasting growth that creates jobs and is based on the development of modern and competitive production capacity. This kind of growth cannot just be summoned up. It requires a profound change in public policy. There is a true coherence and continuity in seeking to combat unemployment, balance public finances and restore competitiveness.

The fight against unemployment and reform of the labour market

France is one of the biggest spenders on employment policies in the developed world, but it still has one of the highest levels of unemployment, particularly among the younger population. This contradiction raises two questions.

The first question regards the actual effectiveness of its system of benefits and subsidies. The *Cour des Comptes* (National Audit Office) has recalled the various shortcomings in these mechanisms, relating to their sheer number and complexity, difficulties in managing them and, in some cases, their intrinsic design. An appraisal of the subsidised contracts system, for example, notably in the market services sector, shows it has been fairly ineffective considering the amount of resources invested. The poor coordination between different types of income support – the employment allowance tax credit and active solidarity benefit (RSA) – has made them difficult to understand and considerably less efficient. The huge resources France devotes to professional training are of little benefit to the unemployed and, more broadly, to the least qualified members of the workforce who most need it. In this respect, the reforms in professional training, which will be discussed at the labour conference on 20 and 21 June, are absolutely vital.

The second, more fundamental, question raised relates to the actual role of labour policies, notably with respect to the functioning of the labour market. Do these subsidies not serve to offset market rigidities that could in fact be addressed directly at a lower cost and with more effective results? France and Germany both saw similar drops in economic activity during the crisis, but whereas in France the downturn was primarily absorbed through job losses, in Germany the economy adjusted through a reduction in working hours and through a sharp, but temporary rise in partial unemployment. Overall, despite the fact that German GDP contracted almost twice as much as in France in 2009, German unemployment remained stable while around 500,000 jobs were destroyed in France. It is easier to bounce back from partial unemployment and a temporary reduction in working hours when the economy improves, than from job cuts which are often irreversible. France has partially made up for its lag in introducing effective benefit systems for compensating partial unemployment. But our economy and workers have paid a steep price for the choices made in the past, to the detriment of labour market flexibility.

These implicit choices explain why, despite the amount of money spent on employment, inequalities still exist in terms of risk exposure and job security. It is perfectly legitimate to want to maintain stable and permanent jobs, but doing so is often detrimental to the jobless.

Recent reforms have been aimed directly at improving the operation of the labour market. The law on job security, which transposes the inter-professional agreement reached on 11 January 2013, reduces the legal uncertainties associated with redundancy plans and thus promotes hiring and job creation. The introduction of a system allowing workers to accumulate unemployment benefit entitlements (*droits rechargeables*) is a step forward both on a social level – it reinforces workers' rights – and on an economic level: it means the unemployed face less risk and have a greater incentive to go back to work before their benefit entitlements have expired.

These reforms must be continued as there is still room for improvement in many areas: labour market duality, professional training, labour disputes, etc.

The unemployment insurance deficit is increasing rapidly. Achieving a balance depends on three main parameters: conditions of access (associated with the length of employment required), the duration of benefit payments and the replacement rate. For each of these parameters, the French system is one of the most generous in the world. In an uncertain economic environment, it makes sense to keep relaxing access conditions, as has been done with the introduction of accumulative unemployment benefit entitlements. A reduction in the duration of benefit payments could be considered once the economic environment improves significantly. As for the replacement rate, which is particularly generous in France (between 57.4% and 75% depending on a worker's last earnings), there are steps that can be taken immediately, notably for higher earners. Reducing benefits and making them more degressive over time would encourage people to go back to work more quickly. In addition, the overall unemployment insurance deficit is made considerably worse by the various specific benefit schemes, and these would benefit from being revised.

Many of the provisions of current labour laws provide for collective negotiations between employers and unions. This is an extremely positive step as it means the specific characteristics of each sector or company can be taken into account when adapting to changes in activity, thus ensuring better job protection.

More importantly, what the French economy needs is a less defensive and more offensive approach to employment. Public policies are often overly concerned with preserving the jobs of the past, at times to the detriment of future job creations. This is also one of the reasons policies have proved relatively ineffective, despite the amount of resources invested. Today's jobs are not the same as those of yesterday and, likewise, those of tomorrow will be different from the jobs that exist today. In order to create jobs for the future, we need to find ways to adapt our production capacity, redeploy our productive resources and allow the free movement of both workers and investments, domestic and foreign alike.

The need to reduce public spending

The Government has committed itself to following a fiscal path aimed at eliminating the structural deficit by 2016. Meeting this commitment will determine both the country's financing conditions and the level of confidence – at home and abroad – in its economic policies. The stakes are high.

Initially, efforts were focused on increasing taxes and social contributions in order to generate rapid results. However, the government now needs to concentrate on public spending to meet its target, as the tax burden has reached a very high level and any further increases in employer contributions would lead to a new deterioration in both activity and employment.

One of the key factors behind rising public spending is the size of the public sector wage bill. As in all other sectors of the economy, the government needs to look constantly for ways of making productivity gains, and this should apply equally to local government, central government and welfare departments. The strategic long-term objective should thus be a trend decline in the number of public sector workers, which is high in France in relation to other comparable countries. In the short term, given that the government has chosen to keep overall public sector staffing levels stable and to freeze the index points in the pay grid, another metric can be used – slowing down the rise in the age and job skill coefficient (GVT). This would be consistent with the lengthening of working life.

The large number of public policies generates high coordination costs. Decentralisation has led to responsibilities being split between a large number of players, often through contractual agreements specifying the distribution of powers and financial costs. A great deal of effort is devoted at different levels of government to managing the interaction between these agents.

A radical simplification of this build-up of administrative structures would generate major savings and make government action more efficient. The "simplification shock" announced by the government is more vital than ever, and should be based on the principle of giving each public sector player exclusive responsibility for one particular area.

More generally, there needs to be a complete review of public policies notably regarding transfers, and, in the case of households, there could be grounds for temporarily breaking the link between benefits and inflation. The specific characteristics of the wages and pensions paid to France's overseas territories are helping to keep living and wage costs high, hampering competitiveness in these regions. An in-depth review should therefore be carried out.

Welfare spending accounts for around 30% of GDP and the country's social deficit path is unsustainable as it stands. Giving in to the temptation to keep raising social contributions leads to an increase in labour costs, which ultimately weighs on activity and jobs: the best way to deal with the problem is by tackling spending.

Extensive measures are needed to balance the French welfare system. Regarding our pension system, it now seems inevitable that we will have to increase the number of years workers pay into the pension system or raise the minimum retirement age. But using these methods alone will place the entire burden on the working population and in particular on younger generations. If we are to share the effort equally between those in jobs and those in retirement, it seems important to stop indexing our various pension schemes to inflation – as was the case for the general supplementary retirement benefit plan.

Restoring the competitiveness of companies

For ten years now, the current account balance has been continually deteriorating and, worse still, French firms' export market share has been contracting. This represents a marked contrast with Germany, while it is more recent and less pronounced with respect to the other main euro area countries. This trend is often associated, in analyses and commentaries, with the deindustrialisation of the French economy, measured by the shrinking share of industry in GDP and employment.

To counter this trend, France introduced a National Pact for Competitiveness, including a tax credit for competitiveness and employment that came into force in January 2013. By offering companies a tax credit calculated on the basis of the gross wage bill, two objectives are sought: restoring wage and price competitiveness, and encouraging the self-financing of investments, which themselves foster productivity and competitive advantages. This tax credit is an essential first step.

Given France's poor competitiveness and the reforms undertaken by our euro area partners, this effort must be pursued.

First, the competitive advantage given to wages must be preserved. Going forward, it is important that any discretionary increases in the minimum wage do not undermine this advantage, especially since the recent reform in its calculation method guarantees a regular rise in its real purchasing power. Any future increases in employer's social contributions should be avoided, as this would erode the cost competitiveness, which is already insufficient.

Naturally, the question of competitiveness cannot be seen solely in terms of costs and wages. Compared to the euro area average, the cost competitiveness of the French economy was preserved until the 2008 crisis. Despite this, France's market share has worsened significantly since the start of the 2000s, including vis-à-vis European countries other than Germany. This decline is evenly spread across all export areas, pointing to a general weakness in productive supply rather than a lack of geographical or sectoral specialisation. There are therefore fundamental underlying reasons for France's poor performance. One such reason relates to firms' low profit margins. Faced with foreign competition, in France and on export markets, companies have sought to offset high labour costs by cutting back their margins. By doing so, they have lessened their capacity to invest and fund R&D, gradually trimming the innovation content of their products, and thus weakening their non-cost competitiveness.

More generally, a more comprehensive approach to competitiveness is required in order to reduce all the obstacles and rigidities that curb the capacity of the French economy to adapt to a rapidly changing world. The focus therefore cannot be on industry alone. Industry is naturally crucial for development and economic growth since the bulk of R&D and exports are still concentrated in the sector. It generates positive externalities for all other activities. Nevertheless, in all advanced countries, the share of industry is falling in GDP and even more so in employment. Services are becoming increasingly a source of technology and value added.

The competitiveness of services, even when they are not exported, is therefore essential to that of the economy as a whole. There is considerable scope for further progress here. It is in the service sector that the wage differentials with our competitors have grown the fastest. For industry, services act as suppliers and subcontractors that contribute indirectly to competitiveness, even though they do not enter into direct contact with foreign markets. Yet, it is precisely in services and closed professions that the greatest number of obstacles to activity and restrictions on competition remain. Lastly, the largest labour pools are found in the service sector and many of them by nature cannot be moved abroad.

Studies carried out by the Banque de France show a strong potential for boosting growth through product market reforms, for example regulated professions, especially if they are implemented at the same time as labour market reforms.

In parallel, it appears necessary to conduct a general review of the complexity and abundance of rules and administrative procedures. The initiative announced in this area addresses a real need. The great number and the instability of tax and labour regulations, amongst others, are a major obstacle to the creation and development of companies and more generally economic activities.

Transformation in the financing of the economy

In order to produce value, create employment and generate growth, our economy needs to be financed effectively. And yet, our banking and financial ecosystem is undergoing a major transformation. Over the past years, credit institutions have undertaken far-reaching reforms to comply with the new international solvency and liquidity rules, against the backdrop in France of large-scale shifts from bank deposits to regulated savings. Insurance companies are preparing to apply the new French and European standards, in a difficult environment of ongoing low interest rates. All players have recently had to face much greater fiscal constraints.

Our surveys do not show any particular funding pressures for large and medium-sized enterprises, which can seek market financing if necessary. As regards SMEs, which we monitor closely and which rely more heavily on bank funding, access to cash loans has become more difficult over the past months, but applications for investment loans continue to be largely met and interest rates are generally very low.

In order to support the economic recovery, our financial system must be able to develop in a stable and regulated environment that aims, in the same way as the draft law on the separation and regulation of banking activities, to ensure that finance works for the real economy. This environment must also take account of the international context in which our financial players operate. In this respect, it will be essential to define the base, interest rates and scope of a possible financial transaction tax in order to prevent the risk of destroying entire segments of our financial industry or the offshoring of jobs as well as the highly counterproductive effects on government borrowing and the financing of the economy. It is important to strike the right balance between ensuring financial stability, consumer protection and legal certainty – notably concerning the construction of insurance contracts – and promoting economic dynamism. Achieving this balance is one of the prerequisites for a return to sustained growth in France.

Housing supply policy

Housing is an indirect but essential determinant of economic competitiveness. It is the largest item of household expenditure and its share is constantly increasing. Barriers to housing market access are a major cause of inequality and a primary source of economic insecurity, especially for workers without permanent contracts. Lastly, difficulties in finding accommodation reduce geographical mobility and result in long-term unemployment. Resolving the housing problem in France would therefore simultaneously enhance competitiveness, defend purchasing power, promote labour mobility and reduce inequalities.

As is the case with other public policies, the results have proved disappointing given the substantial resources (almost EUR 47 billion) allocated by the government to support housing: between 3 and 4 million French citizens are currently considered to be poorly housed. There are few doubts and little discussion about the causes of this failing. For the past two decades, housing policy has focused on providing financial help to individuals, i.e. on supporting and funding demand. Many instruments and procedures have been implemented with this aim, either in the form of direct subsidies, or loans with advantageous interest rates.

At the same time, however, regulatory constraints have increased on construction and housing supply. Naturally, the aims of regulations are highly legitimate: improving housing standards, respecting social diversity, and ensuring the harmonious development of urban areas. But the accumulation of rules and standards increases formalities, pushes back deadlines, and imposes increasingly crippling constraints on construction. It is becoming necessary to better define the priorities.

The measures recently announced set out to reduce the length of administrative procedures for the largest projects and accelerate the processing of litigation in the area of town planning. Legislation that is currently being drafted should allow rules and regulations to be further simplified and enable responsibility for town planning to be conferred to larger local authorities. These two developments are both positive and important.

Stability of the euro area, growth and monetary policy

For the past three years, efforts have been mainly directed in Europe at containing the impact of the financial crisis and limiting its magnitude. Even today, uncertainties persist and vulnerabilities are still present. But, for the past ten months, a new phase has been underway that should allow economic policy-making to return to a long-term horizon.

The threat of serious events that could jeopardise the integrity of monetary union has subsided. Yield spreads on the sovereign debt of different countries have returned to levels close to those justified by their national economic and fiscal fundamentals. Corporate financing conditions have come closer in Member States. Financial market segmentation in the euro area has declined markedly. Redenomination risk has disappeared.

The recent crisis in Cyprus was symptomatic of this turnaround. This episode was extremely difficult for both the Cypriots themselves and for their European partners. But, for the first time since 2010, the serious events that took place in one country in the area did not have adverse effects on the others. No contagion was observed between Cyprus and the other peripheral countries. Quite the contrary, throughout this crisis, yield spreads on all sovereign debt continued their downward trend that has been underway for several months. Against this backdrop, the euro area showed a new resilience and soundness.

This positive development owes much to the actions of the Eurosystem. Faced with the exceptional threats that were affecting the euro area, new means were used to ensure the provision of liquidity: very long-term refinancing operations, the extension of the list of eligible collateral accepted in refinancing operations and the announcement of the Outright Monetary Transactions (OMT) programme. In France, these measures facilitated the provision of credit and thus underpinned the real economy. Thanks notably to the Eurosystem's monetary policy, French interest rates are historically low.

These innovations have not undermined the primary objective of price stability. Indeed, at the start of 2013, inflation rates fell to a level of below 2%. Inflation expectations also remain firmly anchored. The flexibility of the operational framework has also enhanced the mobilisation of credit claims in France, which has facilitated the refinancing of French banks and in turn the financing of the economy.

Tangible progress has been made towards the creation of a banking union. The scale and, above all, the speed of the changes made have been unprecedented in the history of the European Union. The principle for the union was adopted in June 2012 by the Summit of Heads of State or Government. In December, an agreement was reached on the practical implementation of a single supervisory mechanism in the euro area, under the aegis of the ECB, paving the way for the banking union to become operational as of 2014. The Eurosystem and all national supervisors are working on it with vigour. Further progress also remains necessary to establish a European banking resolution authority and a single deposit guarantee system.

In a more stable financial environment, the euro area must continue to reform. France can better contribute to these reforms by pursuing its recovery, and first of all consolidating its public finances and shoring up its competitiveness. This recovery is not just an abstract legal or accounting exercise. It is a prerequisite for creating room for manoeuvre, stimulating growth, and enabling France to fully exercise its responsibilities in the euro area.

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