THE ROLE OF THE STATE IN ECONOMIC GROWTH

PARIS

Keynote Address by Michel Sapin

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Distinguished guests,

It is an honor for me to be here tonight to open this first conference held by Columbia University on "The Role of the State in Europe in Response to the Economic Crisis and the Quest for Growth."

I see three reasons for considering this a very good choice of topic. First, I am a firm believer in Europe. Second, I also believe that States, governing institutions, have a crucial part to play in getting us out of the current challenging situation. And third, the quest for growth is obviously a concern we all share. This was the theme discussed at the G20 Meeting in Cairns – with special emphasis on growth in the euro area. It will also be the common preoccupation of the IMF and World Bank Annual Meetings in Washington, which I will be attending at the end of the week.

The issue facing us today is how to adjust economic policy to a changed environment. It is no longer a matter of coming up with an immediate response to a financial crisis. What we now need to do is boost growth and employment quickly, so that we can keep from getting mired in a period of low growth and low inflation. Such a trend would be fraught with risk: the risk of deflation following any further large shocks, as well as the risk that structural unemployment will rise and stay high, and therefore that our growth potential will fall and stay low.

I would like to keep things simple in my talk by highlighting the policy levers available to our public institutions, whether they are national governments, European institutions, or central banks.

To start with, a few words of diagnosis, with a special focus on the euro area

The 2008 financial crisis affected every large economic region in the world. But those regions were not equally well-equipped to pull out of it, or equally successful in doing so.

The crises of the late 2000s, first the subprime lending crisis, then the eurozone crisis, grew out of a boom in debt, often private, sometimes public. That boom was facilitated by inadequate supervision and regulation at a time of prolonged expansionary monetary policy, and by increasing integration in the euro area, which made it easier to finance investments that led to a number of imbalances, some of them extreme.

If you look at total debt, the pre-crisis conditions in aggregate terms were fairly similar in the United States, the United Kingdom, Japan, and the euro area – but with great heterogeneity among eurozone countries.

Although the troubles that shook the world's financial institutions originated in the United States, the US economy experienced less of a slump – GDP contracted by "only" 2.8 percent – exited the recession as early as June 2009, and had recovered to its pre-crisis level by mid-2010.

The euro area, in contrast, was hit by two crises. The global financial crisis resulted in a crisis for several member countries that had mounting external imbalances, due to an excessive build-up of private or public sector debt. The first phase of the crisis was more severe, with eurozone GDP shedding close to 6 percentage points, and starting in 2011, the euro area was confronted with another crisis – a crisis of confidence in the sustainability of sovereign debt that triggered a second dip in economic activity.

Where do we stand now?

The euro area has yet to return to its level of wealth prior to the crisis. It should emerge from recession in 2014, of course. But the European environment is worse today than was expected just a few months ago.

After output fell well short of forecasts during the first half of the year, and with the business climate looking morose for most of our trading partners, the euro area growth outlook has been revised downward. It is highly likely for euro area growth to be below potential again – for the third year in a row – and for the output gap to widen. The European Commission estimates it will be close to 3 percentage points of GDP.

More importantly, inflation is extremely low, something that was not anticipated. In September, it was 0.3 percent – its lowest level since mid-2009 – despite the steps taken by the ECB, whose key rates have reached a floor.

This makes conducting economic policy a very complicated affair. Closing competitiveness gaps between countries become harder, and deleveraging by economic agents is hampered. Nor is it easy to reduce deficits, because weak inflation means lower tax revenue.

The state of the economy has extremely negative social consequences and involves any number of risks. The jobless rate has hit record highs in several euro area countries. In 2014, it is likely to be close to 12 percent in the currency bloc as a whole, and can be expected to exceed 25 percent in Spain and Greece. In seven eurozone countries, unemployment is higher today than it ever has been. And youth unemployment is much higher still, although many targeted programs have been launched at the European and member-state level.

The current jobless rate, as the IMF has recently stressed, reflects a low level of economic activity. It will not recede until growth bounces back significantly. As we all know, and as Mario Draghi quite rightly emphasized in a recent speech, persistently slow growth, coupled with abnormally low inflation, entails risks – including the risk of rising structural unemployment and reduced growth potential for euro area economies.

Under the circumstances, what should we do to pull the euro area out of the low-growth trap, and what should we be doing for France?

We need to re-examine our policy mix. If we fail to do so, the euro area could well lapse into a third crisis. It may not be a recession, but rather a period of anemic growth and low inflation with consequences that are every bit as serious.

We need coordinated action by all the relevant institutions, with all policy levers being used.

As Mr. Draghi said in his Jackson Hole speech in late August, the overriding concern of policy-makers should be to insure against downside risk. The risks of “doing too little” outweigh those of “doing too much” to promote growth.
Each euro area country has to do its own homework and respond to the specific shortcomings in its own economy. But Europe as a whole also has a collective responsibility.

Our governing institutions have four policy levers available to them:

- To address the danger of persistently low inflation, monetary policy must remain accommodative and provide further support to the economy.
- The pace of fiscal consolidation must be adjusted to reflect weak demand, which holds growth and inflation down, and therefore limits our ability to reduce deficits.

- Such a policy must be accompanied by structural reforms at all levels in order to raise the medium- and long-term growth potential of our economies.

- Last of all, we need to build a bridge between the short term and the long term, between supply and demand. That bridge is investment, both public and private.

I will be brief on the issue of monetary policy. To start with, I would like to acknowledge the measures adopted by the ECB in early June, and then in early September. Cutting interest rates to record lows, providing liquidity to support lending to the real economy through TLTROs, and asset-buying programs are policies that will obviously take time to become fully effective, so we need to wait until they are completely deployed, meaning until the end of the year at least. Even so, they have already produced a first, notable positive effect: the euro has fallen by nearly 10 percent against the dollar from its peak. This should work to the advantage of both growth and inflation in the euro area. A weaker euro is a countercyclical cushion – steady appreciation of the common currency is quite clearly one of the factors that have been driving euro-area inflation down.

The battle is far from over, however. Inflation expectations (in particular for the 5-year period beginning 5 years from now) have declined somewhat from their 2-percent level, and the inflation rate is not expected to move back into the vicinity of the target until 2017. This makes it important for the ECB to remain vigilant. Mr. Draghi has continually asserted that the central bank's Governing Council is prepared to resort to further unconventional monetary policies if need be.

National governments must also pitch in to ensure that monetary policy decisions by the central bank work effectively. In this regard, full implementation of banking union will be crucial. By agreeing to overhaul the arrangements for supervising euro-area banks, the Commission and the Member States have shouldered their responsibility for countering the financial fragmentation that puts businesses in Southern European countries at a disadvantage. That will be a big help to the ECB.

But we must also make it easier for banks to refinance their existing loans by means of safe, straightforward, transparent securitization.

To conclude my remarks on monetary policy, I urge everyone to reread Mr. Draghi's speech of late August in Jackson Hole. The ECB is doing and will continue to do everything it can, but in the current situation, monetary policy alone can't solve our problems. The Member States and the European Commission must also take action.

Along with monetary policy, fiscal policy is an essential instrument that calls for serious thought.

This is a multi-faceted issue. What should Member States with fiscal room for maneuver be doing? And what should countries that lack such room for maneuver do at a time of weak growth and low inflation, which worsen our headline deficits? Should we seek to offset their impact? In other words, in addition to the familiar automatic stabilizers that dampen fluctuations in GDP, should we bring stabilizers of inflation into play?

Let me say just a few words about inflation.

It is essential to realize not only that excessively low inflation adversely affects deleveraging by economic agents and existing imbalances inside the euro area, but also that it makes fiscal adjustment harder to achieve.
Government revenue is highly dependent on nominal GDP growth. At the same time, public spending reacts only sluggishly and belatedly to trends in inflation. For example, transfer payments, which are indexed to the anticipated inflation rate, are not adjusted until subsequent years. Other forms of public expenditure vary either little or not at all with inflation. This goes for State employees' base wages, which have been frozen for several years, and healthcare spending, which is largely governed by entirely different factors like technological change and the growing demand for treatment.

As a consequence, policies for putting public finances back on a sustainable path become less effective; a given amount of fiscal consolidation makes a smaller dent in the debt-to-GDP ratio than it would have in other circumstances.

Furthermore, in technical terms – if we confine ourselves to the usual EU concepts – the resulting increase in the budget deficit comes to be viewed as structural in nature. This means that unless this lower-than-expected inflation gets factored in, the amount of fiscal consolidation ultimately required ends up being greater than what was initially requested.
What is the conclusion to be drawn?

Just as the entire economics community recommends letting automatic stabilizers offset changes in government revenue and expenditure during a recession, when we are confronted with extremely low inflation – a “disinflationary shock” so to speak – the right choice is to make use of “automatic inflation stabilizers,” which means not trying to compensate for the lesser reduction in the deficit caused by such low inflation. If we attempt the opposite, we will accomplish little other than to depress demand a bit more and, in so doing, to push the rate of inflation even lower.

Whether the pace of deficit reduction should be adjusted, and how, is an issue that must be addressed at the euro-area level. For this reason, we have raised it with the heads of State and government, and we will continue to discuss it this fall.

In this connection, I want to stress just one point. We are not calling for a change in the EU’s budgetary rules. Those rules “anchor” the euro area’s renewed credibility, as economists put it. But it is no less important to demonstrate our ability to take advantage of all the flexibility offered by the Fiscal Compact.

How do we apply all that to France?

The measures adopted here since 2012 have already begun to work, although the results are partially concealed by low growth. Our structural deficit, a reflection of imbalances in our public accounts adjusted for the economic cycle, has virtually been halved between 2011 and 2014. This brings it to its lowest level since 2001. In just half a parliamentary term, we have eliminated the imbalances built up over the 10-year period from 2002 to 2012.

After a phase of higher taxes to finance deficit reduction, as of 2015, we will be entering a phase in which we will reduce the deficit by decreasing the ratio of public spending to GDP – to an extent unprecedented in France. This policy will have a more positive medium-term impact. In the period from 2015 through 2017, we will be saving a total of €50 billion across the entire public sector: €19 billion at the central government and its agencies, €11 billion at local governments, and the balance at the social security funds – a central government expenditure that will go down in 2015.

The effort involved is considerable. In 2015 alone, we will be saving €21 billion, equal to 1 percentage point of GDP. By saving 40 percent of a €50–billion total in the first of three years, we highlight our commitment and our credibility.

To put it differently, government spending in real terms will recede to barely above the rate of inflation (0.2 percent in 2015), whereas it increased by more than 2 percent a year during the 2000s.

Our ambitious savings program hasn't changed since the spring, when we first announced it. What has changed is the macroeconomic environment and outlook. We have reduced by half our growth forecast and our inflation forecast for 2014, as have all the economic research firms.

In response, we have chosen to adjust the pace of our program to the state of the economy in France. In a period as difficult as the present one, it is important to strike a balance between deficit reduction and support for growth. Our ultimate goal, after all, is to achieve debt sustainability, which depends not only on the numerator of the ratio – that is, the national debt, and therefore the budget deficit – but also on the denominator – meaning GDP, and therefore growth.

So while we will stick to our economic policy, the deficit will be reduced more gradually than expected, due to macroeconomic circumstances. We will not be seeking to offset the effects of the lower-than-anticipated growth and inflation rates we now have.

The upshot is that our deficit won't fall below the 3-percent threshold until 2017, and that in accounting terms, the reduction in our structural deficit will be less significant than announced last spring. The current estimate for this adjustment is ¼ of a percentage point of GDP in 2015. This downward revision stems from a combination of accounting effects (a change in the European System of National Accounts, a downward revision of growth potential as part of the move to more conservative accounting). But it also reflects low inflation, which on its own warrants scaling back our structural deficit reduction target for 2015 by ¼ of a percentage point of GDP.

Such a strategy must be combined with far-reaching reforms that help raise the growth potential of our economies.

The first fundamental reform under way in France has to do with competitiveness. With the help of the CICE (the Competitiveness and Employment Tax Credit) and the income and payroll tax relief provided for in the Responsibility and Solidarity Pact launched in the spring, a total of €40 billion, equal to 2 percentage points of GDP, will be given back to companies by 2017. This is exactly the amount of profit margins they lost between 2008 and 2013. The first benefits can already be seen: France has stopped losing ground in competitiveness ratings.

The Pact is central to our economic policy, and there will be no departures from it. We intend to implement the Pact in full.

Along with these major changes in economic policy, there are other, equally important projects for reforming and updating our social and economic model. They are part of a long-term process initiated in 2012.

Allow me to touch briefly upon a few reforms undertaken in the past two years:

- In the labor market, three national multi-sector agreements have been signed to lay the foundations for secure career paths, reform vocational education, and revise our

- unemployment insurance system by introducing "renewable" unemployment benefit entitlements.

- Our pension system has been preserved, and mechanisms for ensuring long-term balance have been put in place.

- The Consumer Act passed early this year includes new provisions to increase competition in the service sector. A group action provision now makes it possible to seek redress for violations of consumer rights and competition law.

Our reform agenda will be taken further in the next few months:

- Before the end of the year, Emmanuel Macron will be submitting a bill to Parliament that includes various sector-specific provisions for improving the efficiency of the economy, most notably by increasing supply in markets for goods and services. The bill is designed to serve two purposes: to counter regulations that breed economic inefficiency, and to lower the prices paid by consumers and businesses by reducing barriers to entry and stimulating competition. It will also include provisions that clarify the existing rules and regulations on the opening of retail outlets on Sundays.

- There will be further labor market reform. For example, negotiations with union and company representatives are under way to encourage labor-management dialogue by reviewing size-related criteria to avoid threshold effects. These reforms, which follow those I carried out in my previous position, are transforming the quality of labor relations. The very fact that we are reforming France's labor market, unemployment insurance, and vocational education system represents progress for the economy; achieving it through national multi-sector agreements makes those reforms even more promising.

- Local government reform will streamline the structure of various local government layers and rearrange spheres of responsibility. A new map of France's regions will be adopted by the end of the year, the first integrated metropolitan areas will come into existence next year, and an additional law will clarify the areas of responsibility for all authorities. This amounts to a far-reaching modernization of the framework in which France's government authorities operate.

So the reform process is under way in France, but it should be recalled that other countries are also in need of reforms that will vary in each case according to the country's specific weaknesses.
An example that immediately comes to mind is the opening of retail outlets on Sundays in Germany!

And while I can't go into this right now, Europe itself is clearly in need of far-reaching reforms. We are moving ahead with integrated supervision as of this coming November 4th, but there is still a great deal of inefficiency in Europe, and we will have to overcome it if we want to arrive at an integrated economic environment – I am thinking here of the 28 national tax systems operating side by side that provide the basis for assessing taxes on companies.

Last of all, we need to build a bridge between the short term and the long term. That bridge is investment, both public and private.

Investment from both public and private sources has been one of the primary casualties of the crisis. In the European Union as a whole, it currently stands nearly 15 percent below its pre-crisis level.

In part, of course, investment will recover as the demand outlook brightens and businesses get access to financing on more affordable terms. French companies, which are gradually returning to their former competitive strength, should be in a position to benefit from economic recovery – provided that it is a reality in the euro area.

Jean-Claude Juncker has called for a €300 billion investment plan for the European Union, which he promises to present within the first three months of his mandate. We have started to work on it ourselves. I have made some initial suggestions on the financing component, together with Wolfgang Schäuble.

The rest of the world wonders, and rightly so, why growth and inflation are so low in the euro area. To tackle this problem, we need a consistent growth strategy for the euro area and for France, one that combines a clearheaded view of the situation (what I would call the truth) with an ability to stay the course so that we can render our policies intelligible. In other words, we need to show determination. As you have undoubtedly gathered, that is what my European counterparts and I are working to achieve.

Thank you for your attention.

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