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Canevas pour l'intervention du Gouverneur sur la situation économique internationale et européenne

I am honoured to appear here today to discuss my views on some of the important issues related to the world economic and financial situation. Where do we stand? My answer is threefold.

- GDP growth is still on a sustained path on the exports markets of the euro area, mainly in the United States and Asia, although its pace was slower in Q2 2004 than in the previous quarters.

- In the euro area, growth is picking up with some lag and at a lower pace than in other industrial countries, against the background of a solid external demand. Economic activity is more vigorous in France than it is elsewhere in the Euro area, due to a relatively strong domestic demand.

- Overall, undue pessimism is not warranted. But due attention should be paid to the risks attached to increased inflationary pressures and ballooning global imbalances, which call for appropriate policy actions.

Growth is solid in all major export markets of the euro area

United States

- In the US, the recovery is now well underway. Growth was strong in 2003, standing at 3.1% on average. It was supported by a sustained increase in domestic demand and from the second semester up, a pick up in exports following the dollar's depreciation. In Q1 2004, GDP recorded a q-o-q 1.0% increase as in the previous quarter, mainly driven by domestic demand. Yet, GDP growth decelerated somehow in Q2 2004, at 0.7% q-o-q, following a lower contribution of private consumption. Indeed, labour income has so far not relayed tax cuts in supporting domestic demand. While the current high pace of productivity can naturally be seen as an asset for the US economy, we must acknowledge that these gains have so far not resulted in a strong acceleration of real wages: indeed, average real weekly wages have only increased by 0.4% y-o-y in August 2004, after –0.3% in July 2004.

- Even after this slight slowing down, the US economy growth remains quite strong. It may even be considered as more solid, that is more sustainable in the long run, than before. Moreover, recent leading indicators of economic activity tend to show that growth would remain solid from Q3 2004 onwards. On the one hand, consumer spending will be hampered by a less stimulating policy than in 2001 and 2002. On the other hand, business investment would continue to be fuelled by improved corporate balance sheets and increased profits. Corporate profits to GDP ratios have now come back to the level they reached in 2000.

Japan

- In Japan, the initially export-led recovery has broadened its base, with a steady increase in business investment since Q2 2002 and consumer price deflationary pressures abating somewhat. Furthermore, private consumption has picked up over the last summer, following the rebound observed in personal disposable income and firmer GDP growth in the US would help in strengthening economic activity.

- The recovery may be blocked at some point by the persisting difficulties in the financial system's situation and growing imbalances in the general government sector. In August 2004, bank loans were still decreasing at y-o-y rates close to 3%.

United Kingdom

- In the UK, increased private consumption, government spending and a booming housing market have supported GDP growth. While business investment has accelerated in the recent past, the relatively high level of corporate indebtedness combined with a downward trend in share prices may trigger balance sheet restructuring and a lower growth rate for capital spending than in the previous cycle.

Emerging areas

- Non Japan-Asia (including China and India) continues to record stellar growth rates, reflecting both vigorous export flows and the persistence of a process of internal demand broadening in Asia. In Eastern Europe, growth is also and would remain very robust, against the background of continuing direct investment flows.

The situation is also improving in the Euro area, although to a lesser degree

Euro area

- National accounts figures relating to the first two quarters of 2004 have been more encouraging than in the previous quarters, although the recovery is still modest compared to other major economic areas. GDP grew only by 0.4% in 2003, but posted a y-o-y 2.0% growth in Q2 2004 after 1.3% in Q1 2004, this acceleration mainly reflecting stronger external demand and stock building. At the current juncture, PMI indices for both the manufacturing and services sectors have remained for more than one year above the level signalling an expansion of economic activity.

- Yet, the Euro area is still over-dependent on external demand: net exports explain the four fifths of the overall 0.5% GDP increase recorded in Q2 2004. On average, domestic demand shows no clear sign of recovery. In some respect, this delay reflects slower employment growth in Europe, with the unemployment rate at its peak since January 2004 (9%), which weighs on personal disposal income and therefore domestic demand. In Germany, namely, this could be linked to the efforts made by firms to offset past losses in competitiveness, which imply maintaining a downward pressure on employment and wages. Besides, the necessary structural reforms that are being implemented to contain health care expenditure and increase flexibility on the labour market may have short-term adverse consequences on consumption spending.

<u>France</u>

- In this context, France, where domestic demand has been transitorily boosted by public consumption and one-off measures in favour of consumption, remains an exception. GDP growth, fuelled by a relatively strong domestic demand, stood at 1.7% and 3.0% y-o-y in the two first quarters of 2004, with a carry-over for the whole of 2004 at 2.1%. The contribution of private consumption to y-o-y GDP growth went from 1 point in Q1 2004 to 1.5 point in Q2 2004. The conditions of public consumption reached 0.8 point in Q2 2004, after 0.6 point in the previous quarter.

- The business climate indicator calculated by the Banque de France posted 104 in July after 106 in June and 93 one year earlier. GDP is expected to grow by 0.6% in Q3 2004 after 0.8% in Q2 2004. That means that growth in France will reach at least 2.5% in 2004, maybe more.

Nevertheless, due attention should be paid to the risks attached to increased inflationary pressures and ballooning global imbalances

Inflationary pressures

- Increased inflationary pressures may arise from a situation where GDP growth would stand above potential in the United States and Japan in 2004 and to a lesser extent in 2005-2006, with output gaps closing by then, according to most international forecasters. In the euro area, the HICP has recently picked up above 2% following increased oil and commodity prices. Furthermore, perceived inflation remains relatively high, in the neighbourhood of 4%.

- In my view, the impact of the recent surge must not be overstated as in real terms today's price (USD 40 per barrel) is far below the levels reached in the early 80s (about USD 70 relatively to the US CPI). In addition, oil stands today for a lower share of energy consumption in OECD countries than it used to be (40% against more than 50% in the early 70s). And let me add, to take a French example, that the global cost of imported energy will approximately account for less than 1.7% of GDP in 2004 after 1.5% in 2003, which is far less than the 1981 ratio (5%).

- Nevertheless, anchoring price expectations is more than ever a key to any recovery and it must be clear for the general public that we pay due attention to possible second round effects which could arise from persistently high oil prices, in connection with the degree and the type of wage indexation.

Global imbalances

- The US economy is recording a ballooning current account deficit (5.7% of GDP in Q2 2004), meaning that growth in the US is significantly financed by the savings of the rest of the world, including emerging and transition countries whose catching-up process requires strong capital inflows.

- But, a reversal of capital flows to the US is now a distinct possibility because an increasing share of the external deficit is financed by non-resident purchases of US government securities (from 20% of total net capital inflows in 2002 to 33% in 2003), which are more easily transferable than foreign direct investments. Furthermore, the financing of the US current account deficit largely rests on Asian investors, particularly Asian central banks, which makes their investment strategy crucial to its sustainability. Finally, it is debatable whether the return on capital is structurally higher in the US than in the rest of the world and will remain so.

- A lowering of capital inflows to the US could trigger an excessive depreciation of the dollar and/or an abrupt rise in interest rates with spillover effects on other financial markets, should non-residents investors demand an increasing premium for holding dollar-denominated assets. In the light of these risks of disruption, a move towards re-balancing the US current account is clearly warranted.

Policy responses

- In theory, current account deficits can be reverted through adjustments in exchange rates and/or growth differentials. Past experience and econometric simulations illustrate that a reduction in growth differentials between the US and their trading partners would be much more efficient to curb the US current account deficit than a dollar exchange rate depreciation.

- In this regard, a less accommodative stance of the US policy mix, aiming at bringing public finances on a prudent medium run path and favouring a gradual revival of domestic savings, is clearly warranted for a sustained reduction of the current account deficit.

- Nevertheless, member states of the euro area, and perhaps more specifically France and Germany, have a lot to do to foster economic growth through an acceleration of structural reforms aimed at raising productivity, improving the efficiency of public services and reducing deficits.

- Euro area governments have made substantial progress over the past few years in implementing structural policy reforms in product and labour markets in order to raise the productive and job-creating potential of their economies, to increase their resilience to shocks and to underpin business and consumer confidence. They should, however, continue to implement in a determined way structural reforms, notably as regards products markets, trade liberalisation in services and a better functioning of labour markets.

- In particular, the areas in which further progress is needed are well identified, and a certain number of Member States are already tackling the reforms to be made in these areas. I can review some of them:

  – accelerating the liberalisation of the network industries;

  – further eliminating remaining barriers to trade entry; further improving the efficiency and mobility of the labour markets by making tax and benefit systems more employment-friendly for instance;

  – encouraging entrepreneurship by improving and simplifying the corporate tax system and regulatory environment and pressing forward the harmonisation of accounting standards and value added and business taxation among the different member economies;

  – and, finally, increasing the European Union's research and development spending.

Conclusion

- Notwithstanding the risks and imbalances mentioned above, I remain cautiously confident on both economic and financial prospects. The continuous decrease in unit labour costs registered in the US in the recent past (-0.3 % y-o-y at the end of Q2 2004) should contribute to restoring corporate profitability, business investment and therefore the net demand addressed by the US to the rest of the world.

- Meanwhile, Japan would continue to press forward with structural reforms to accelerate the removal of bad loans from balance sheets and restore profitability in both the banking and the corporate sectors.

- Finally, efforts in the Euro area to foster productivity gains should help reduce inflationary pressures. If inflation decelerates, the resulting increase in real wages would support private consumption and investment prospects.