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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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.

In 2008, the crisis loomed large. What started out as relative optimism about countries' capacities to contain the financial turmoil, culminated in a climate of deep global recession, marked in particular by the fallout from Lehman's failure.

In reality, these imbalances appeared well before financial tensions came to a head in the autumn. In an environment that was already highly uncertain, Q1 2008 was characterised by two equally problematic developments: first, there was a cyclical slowdown in growth in developed countries on the back of the property market collapse in the United States and some European countries; second, a strong surge was seen in inflation, fuelled by rising oil and food prices. This highly damaging combination gave rise to serious monetary policy dilemmas. Against this backdrop, the euro area policy rate was raised to 4.25% in July, with annual inflation reaching 4%. Moreover, all surveys highlighted the deep concern of Europe's citizens that price instability could reach a level that had not been observed for 15 years.

Conditions deteriorated sharply in the wake of Lehman's failure in September. The financial crisis intensified, with the money and financial markets very quickly seizing up. Risk premia rose, bond issuance came to a halt and the financing channels of the economy became blocked. Confidence evaporated and even the least risky types of investment, such as money market funds, were then subject to substantial withdrawals. In many countries, demand for banknotes surged, reflecting concerns about the soundness of banking institutions. Furthermore, what had so far mainly been a financial crisis now started affecting the real economy. Uncertain about the business outlook and faced with financing difficulties, firms cut back or halted investment. In most countries (although not in France) households, hit by the fall in their real estate and equity wealth, increased their savings and reduced their consumption.

In such a period, any hope of a "decoupling" of the global economy from US growth was dashed. Europe, Japan and the emerging economies were all, in turn, affected. Two transmission channels were at work simultaneously. The first was the trade channel: the economies most dependent on US demand, such as China, witnessed a sharp decline in their exports, which then affected their main suppliers in Asia and Europe. The second was the financial channel: faced with liquidity pressures, major banks reduced their international exposures to emerging economies, which triggered capital outflows and created considerable financing difficulties for local businesses, especially in terms of their exports. As a result, international trade contracted sharply and a dangerous spiral was activated in which falling demand and worsening financial tensions were mutually reinforcing at the global level. As a result, in Q4 2008 and Q1 2009, there was a massive and synchronised drop in GDP and in particular in industrial activity worldwide. The effects of this recession —the most severe for 60 years— will be felt well beyond the end of 2008. Across all countries, these negative dynamics continue to prevail in H1 2009, although, with the combination of the economic stimulus measures taken and the positive effects of disinflation on households' purchasing power, the economy may still stabilise towards the end of the year.

The economic policy response was exceptionally vigorous. In Europe, a turning point was marked on 12 October when, initiated by the French presidency, the Eurogroup adopted a coherent and ambitious plan to restore confidence in banks and the financial system. A number of different but complementary guarantees were offered to ensure that financial institutions had normal and regular access to the resources required for their lending. Banks were recapitalised. Last but not least, depositors received clear and unconditional assurance that the public authorities would neither accept nor tolerate the failure of any banking or financial institution.

The framework put in place by France has proved particularly effective. Whereas in other European countries bank borrowing is directly guaranteed by the State, in France the *Société de financement de l'économie française* (SFEF) was set up to borrow on the markets under State guarantee in order to on-lend the money raised to banks against collateral such as housing loans, and corporate and consumer credit. These issues have met with investor enthusiasm and have been priced at lower levels than government-backed issues in other European countries. This has enabled the banks concerned (representing over 80% of loans to the economy) to improve the medium-term refinancing of their corporate, housing, consumer and local government lending at a time when refinancing at this maturity has been very difficult or even impossible to obtain on financial markets. As a result, they were able to set a credit growth target of 3%-4% by end-2009.

The impact of these measures on confidence and financial sentiment was immediate. The return to normal market functioning is a more gradual process, but is being strongly underpinned by the actions of central banks, whose contribution during this period has been crucial.

First, a steep fall in inflation allowed monetary policy to be eased in full compliance with the primary objective of price stability. In the euro area, seven interest rate cuts were implemented in six months, including one —on 8 October— in coordination with the main central banks in the industrialised countries. All in all, the policy rate was lowered by 325 basis points, falling from 4.25% in September to 1% at the time of the writing of this letter. Against this backdrop, inflation expectations remained anchored at levels consistent with price stability over the medium term. These cuts have fed through to financing conditions in the economy. The three-month EURIBOR rate, to which a large number of bank loans are indexed, declined by 400 basis points, to stand at 1.25% in mid-May, against 5.30% in early October 2008. The easing in long-term rates was less pronounced, as risk premia on corporate bonds remain high.

To deal with the crisis, the Eurosystem also made very rapid and far-reaching changes to its operational framework. Since the creation of the single currency, euro area banks have been authorised to use a broader and more diverse range of assets as collateral for refinancing than in any other developed country. The list of eligible collateral has been further extended. Moreover, in October 2008 a fixed-rate tender procedure with full allotment was introduced, with maturities that have been progressively extended (up to one year currently). Not only do banks have full assurance as to the volume of liquidity available, they also have an absolute guarantee as to the cost of this liquidity.

With the combination of these three measures —large rate cuts, a broader range of eligible collateral and unlimited provision of liquidity at a fixed rate— the euro area has introduced a truly "unconventional" approach to monetary policy, well before the term appeared in public communication.

Internationally, a debate has emerged on the role of fiscal policy. It focuses on three areas: first, when interest rates reach very low levels or the zero lower bound, the impact of monetary policy is somewhat blunted and transmission mechanisms are less reliable. In a recession, this may warrant the use of discretionary fiscal measures to prop up activity. This is the approach taken in some countries, including the United States. Second, the magnitude of automatic stabilisers varies greatly across countries, although this aspect is often overlooked in international discussions: those stabilisers are much stronger in Europe than in the United States or other OECD countries. Third, it remains crucial in the current climate to ensure the long-term sustainability of public finances, without which confidence in public action would be undermined, thus compromising its effectiveness.

The measures adopted in France strike an appropriate balance between these three considerations. Tax cuts and new social spending provide rapid and targeted support for demand while contributing to national solidarity. Bringing forward certain investment spending decisions helps to both bolster activity and prepare for the future without worsening the long-term structural balance. Lastly, combined with rapid disinflation, the functioning and improvement of social safety nets —particularly unemployment benefits— maximise the stabilising effect of public finances. Moreover, France, like all countries, is supporting the automobile sector, which has been particularly badly hit by the accelerator effect of the slowdown in demand. The whole industrial base is irrigated by the activity of this sector that should be encouraged to adapt to meet the requirements of sustainable development.

The third cornerstone of public action is to ensure the smooth functioning of the financial sector. In all countries, governments have helped to recapitalise banks, and, via guarantees, maintain their funding. In many countries, substantial energy and resources are being devoted to dealing with "toxic assets", which can be defined as structured products directly or indirectly impacted by the failure of subprime lenders. This is not the case in France, whose banking system has specific features. True, French banks have experienced shocks and some have posted losses. In a number of instances, very serious deficiencies were detected in risk control and management systems. But, overall, our banking sector is weathering the crisis better than many others. Very significant amounts of public money have been committed although they are far lower than in most neighbouring countries. Furthermore, government stimulus must be considered in net terms: guarantees will not necessarily be called, capital provisions are temporary, etc. And, in all cases, these support measures bear a high rate of interest and involve no additional cost for the taxpayer.

The fact that French banks have remained profitable overall can be attributed to the success of the universal banking model that predominates in our country. This model guarantees banks a recurring flow of income and profit, ensures an appropriate distribution of risks among the different categories of activities and allows banks to better absorb shocks, however violent.

It is now broadly recognised that strong banking supervision in our country has offered protection from the excesses observed elsewhere. Here too, our model has proved its worth. Throughout the year, proximity between the supervisory authority and the central bank has produced many benefits, both in terms of information exchange and increased efficiency. This is one of the key lessons from the crisis which inspire all countries that are currently reforming their prudential supervision framework.

It is too early while the crisis is evolving, to draw definitive conclusions. Nevertheless, some clear lessons are emerging.

First, the crisis has shown the importance of sound regulation of financial activities across the board. Innovation —including through securitisation and derivatives— should not be discouraged. But excessive risk taking should not be encouraged. In particular, it is important to ensure that accounting standards do not amplify market volatility and to provision for risks earlier in the cycle, when profits are high, without waiting for risks to materialise. Since the consequences and cost of these excesses are ultimately borne by the taxpayer, tighter regulation is warranted. The initiatives called for by France in particular prompted the G20 to launch an ambitious reform programme. This will naturally be a long-term process, but it is vital to keep the momentum.

Second, the crisis has revealed a new world economic order in which the major emerging economies are playing an increasingly important role. The consequences of this for the international monetary and financial system will have to be taken into account. The stronger and highly positive role played by the G20 is a concrete reflection, at the institutional level, of these far-reaching changes.

Lastly, it is important to take a long-term view.

The crisis may, in some countries, lead to a review of export-led growth models, which have proved highly vulnerable. It should not however call into question the openness of our economies which has been the source of our prosperity for five decades. In all countries, governments have implemented measures to support the financial system as well as certain industries. Naturally enough, given their cost, these measures have initially benefited domestic institutions and producers. This "renationalisation" of economic policy is probably inevitable at this stage of the crisis. But there is a risk that it will distort fair competition, which is not in the interest of our country. If sustained, it would create a breeding ground for a return to protectionism, which would be detrimental to our economy.

One of the paradoxes of crises is that in the short term they require measures that run counter to those desirable in the longer-term. The public authorities must therefore perform a difficult juggling act: supporting the economy while carrying out reforms (such as those concerning higher education and research), which are needed to raise our growth potential. We need to spend more today but reduce deficits tomorrow, which means further restructuring (such as cuts in public sector staff or health and pension system reform) that will bring public finances back into balance. As regards the Eurosystem, monetary policy must be eased without jeopardising price stability (i.e. we must stand ready to absorb excess liquidity as soon as necessary). For the French economy to return to a path of strong and sustained growth, we will have to hold firm while responding flexibly to prevailing conditions.

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