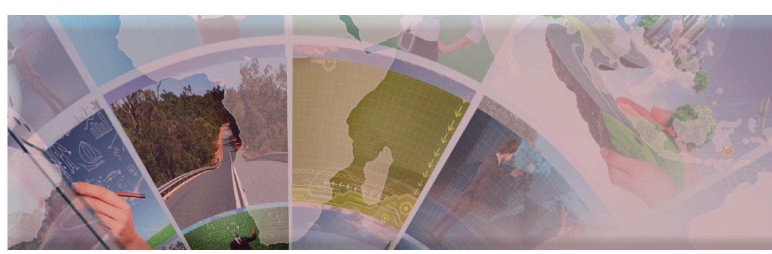
Banque de France

Introductory letter to the Annual Report

2016



Introductory letter to the Annual Report of the Banque de France

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

by
François Villeroy de Galhau,
Governor of the Banque de France

July 2017

BANQUE DE FRANCE

EUROSYSTÈME

The year 2017 offers France the possibility of fresh impetus. The French have elected a new President with a clear parliamentary majority. Our country is also benefiting from stronger growth in the European environment. This recovery must be seen as the right time for France to make a collective effort and finally catch up its lag.

The match will be strenuous but will be won on three geographical playing fields:

– worldwide, we must defend the collective rules of the game with our partners to preserve the fragile improvement in the economic environment;

– in Europe, we must seize the opportunity of the current recovery to build more robust growth, by optimising the euro area;

– lastly and most importantly, in France itself, it is down to us alone to rise to the challenge of achieving the required acceleration, by daring to reform.

I. Preserving a fragile global recovery by defending the collective rules of the game

Even though it remains moderate, the global recovery has been gathering pace since 2016. The global growth outlook has been revised upwards by the IMF,[1] to stand at 3.5% in 2017 and 3.6% in 2018, after just 3.1% in 2016.

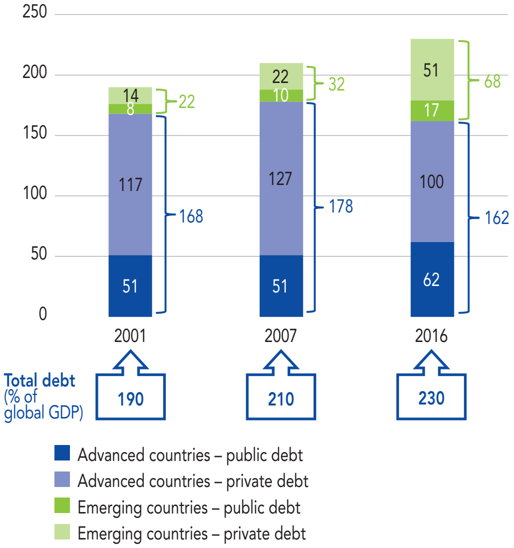
1 IMF (2017), *World Economic Outlook*, April.

Monitoring two major risks: fragmentation and financial instability

Two major risks could nevertheless affect the ongoing economic recovery: that of **fragmentation**, with the victory of Brexit, and the protectionist tendencies in the United States, after the election of the new president. France, shoulder-to-shoulder with Europe, must resolutely defend international economic relations based on commonly respected rules and multilateral institutions: their deterioration would depress world trade and economic activity. In continental Europe, the economic effects of Brexit still appear to be inexistent. But the risk of the United Kingdom adopting an inward-looking attitude already seems to be dampening UK growth (GDP growth at only 0.2% in the first quarter of 2017, compared with 0.6% per quarter on average between 2013 and 2015).

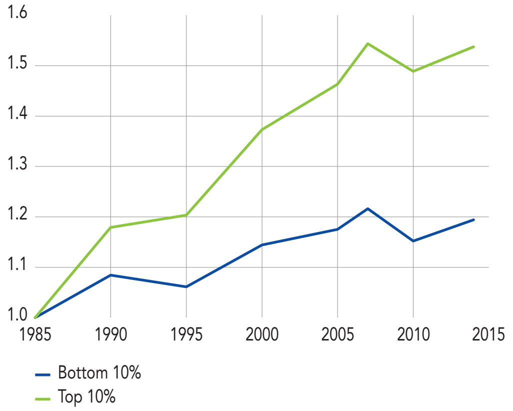
The second risk that is threatening growth, in addition to short-term market volatility, is that of **financial instability**, with the continued rise in global debt since the start of the 2000s. The 2008 crisis stemmed from this, but this trend has unfortunately not slowed down since; the public and private debt of emerging countries has risen particularly rapidly (see Chart 1). The temptation, which is emerging in the United States, to dilute the financial regulations implemented in the wake of the 2008 crisis, is all the more worrying. In international cooperation on banking regulations (Basel III), and more broadly on the whole financial sector, technical regulators have acted from the very beginning in accordance with the mandates of policy makers, particularly the G20. It has thus been possible for the capital and liquidity of banks to be substantially shored up, and security, including of the shadow banking system, has been improved. Any backtracking would increase the risks of a new financial crisis.

Chart 1 Change in public and private debt in advanced and emerging countries, excluding the financial sector
(% of global GDP)



Sources: BIS and IMF, Banque de France calculations – data expressed in current dollar and GDP terms.
Note: Private debt includes household and non-financial corporation debt.

Chart 2a Changes in the real household incomes at the bottom and top between 1985 and 2014
(OECD average, 1985 = 1)



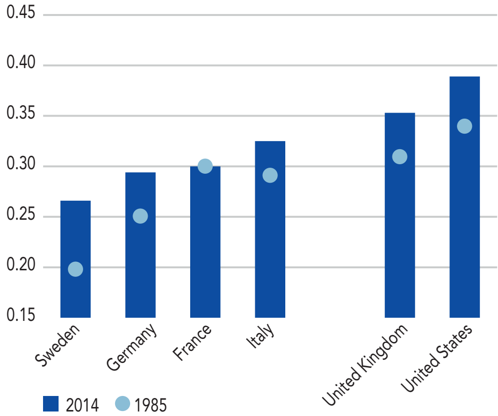
Source: OECD.
Note: Weighted average of 17 countries (Canada, Denmark, Finland, France, Germany, Greece, Israel, Italy, Japan, Luxembourg, Mexico, Netherlands, Norway, New Zealand, United Kingdom, United States and Sweden).

Seriously addressing rising inequalities

The benefits of growth have been far too unevenly distributed: since the mid-1980s, the real income gap has significantly widened in the OECD countries, in particular Anglo-Saxon countries (see Charts 2a and 2b). Populists have capitalised on this; it is even more important now to move on from expressing remorse to acting with commitment.

In order to address rising inequalities, there must first and foremost be more job creations in countries with persistently high unemployment. But beyond this, the social model is important: Europe and France, where income inequalities remain much lower (see Chart 2b), can boast positive results in this respect although they could still be improved. Active inclusion policies must primarily target

Chart 2b Change in the Gini Inequality Index (after taxes and transfers) between 1985 and 2014



Source: OECD, provisional data.
Note: The Gini Index (or coefficient) is an indicator of income inequality. It varies between 0 and 1; the higher the index the greater the inequality.

three areas: education and vocational training to foster equal opportunities; efficient tax and welfare redistribution; and regional planning. This latter challenge, sorely needed in our country, requires innovative efforts in infrastructure, particularly network infrastructure, and a modernisation of public services preserving their accessibility.

II. Seizing the European opportunity, to build more robust growth

Growth and employment are improving in the euro area. The area has enjoyed significant growth since 2015: it is expected to amount to at least 1.9% in 2017, its strongest pace in seven years. The euro area, whose collapse has been predicted by some, could instead prove to be a recovery stock: growth could be close to that of the United States – for the second year in a row –, or even higher than that of the United Kingdom. Almost six million jobs have been created in the euro area since 2013. Unemployment has come down sharply, standing at 9.5% in the first quarter of 2017, even though it remains too high, and very unevenly distributed, ranging from 3.9% in Germany to 18.2% in Spain. The current acceleration in economic growth is indeed insufficient to catch up the lag of the past years: since 2011, the cumulated per capita growth differential with the United States amounts to around five percentage points. The euro area must therefore seize the opportunity offered by this favourable economic environment to lastingly meet two imperatives.

Taking over from accommodative monetary policy: while effective, it is neither eternal nor omnipotent

The first strength of the euro area is the effective monetary policy conducted by the Eurosystem – the European Central Bank (ECB) and the 19 national central banks. Its primary objective, enshrined in the European treaties, is price stability, i.e. in practice an inflation rate of close to, but below, 2% over the medium-term. This definition is shared by most of the central banks of developed countries, including the United States and the United Kingdom: slightly positive inflation provides the necessary leeway to guard against the vicious circle of deflation and facilitates relative price adjustments in the economy.

In order to achieve this objective and fight the risks of deflation, since 2014 the Eurosystem has used a broad range of instruments: cutting key interest rates to zero and even to slightly negative territory, providing indications as to the future path of key interest rates (forward guidance), private and public asset purchase programmes, and targeted long-term refinancing operations (TLTROs). The measures implemented have yielded tangible results, making it possible to reduce their intensity since last April. Inflation, which was still negative at –0.2% in April 2016, should rise to 1.5% in 2017 and then 1.6% in 2019,[2] with "underlying inflation" (excluding energy and food) gradually taking over from the current impact of the increase in oil prices. Accommodative monetary policy has largely contributed to this: the gain in inflation is estimated at up to 0.4% per year on average over the 2015-2018 period[3] (see Chart 3). The gain in growth is of a similar order of magnitude.

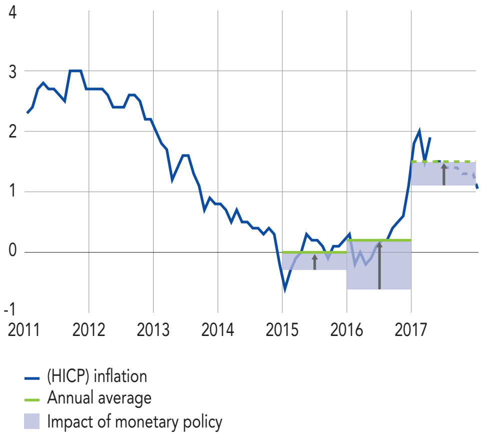
But this non-standard monetary policy is not eternal: nominal interest rates, which are still particularly low

2 According to the latest Eurosystem projections of June 2017.

3 Marx (M.), Nguyen (B.) and Sahuc (J.-G.) (2016), "Monetary policy measures in the euro area and their effects, since 2014", Banque de France, *Rue de la Banque*, No. 32, October.

Chart 3 Euro area inflation and estimated impact of monetary policy

(%)



Sources: ECB and Banque de France.
Note: year-on-year change in the HICP, as a percentage. The green line represents the average annual inflation rate. The bluish areas represent the inflation gain brought by monetary policy.

today, have started to rise since autumn 2016 and are set to increase further, in line with the pace of economic recovery and inflation growth. Monetary policy is not omnipotent either: it can provide temporary support to the economy, but it cannot lastingly raise potential growth. Only reforms can do this.

Optimising the euro area, in the three years to come

The single currency is a major achievement: in spring 2017, 72% of citizens in the euro area[4] and in France were very attached to it; this represents a significant increase of 4% in France compared to autumn 2016. French citizens clearly confirmed, in the elections, their attachment to the euro. Indeed, the euro has brought concrete benefits: increased price stability, lower interest rates, and a greater political weight and international role.

Twenty five years ago, the Europeans democratically chose to construct an economic and monetary union. And yet, while we succeeded in creating Monetary Union, Economic Union remains fairly ineffective. The insufficient coordination of fiscal and structural policies in the euro area, in particular, has affected growth: over the 2011-2013 period, it is estimated to have cost between 2 and 3 points of GDP.[5] Confidence in the economic climate has returned, but concerns remain over our collective ability to counter the next recession.

From now to 2021 and with the following elections in Germany, the economic and democratic cycle appears never to have been more favourable. France must commit to taking initiatives in order to reshape the economic and financial Europe in the three years to come. This ambitious agenda is a matter for political decision-makers; but the economic imperative can be summed up in a "growth triangle" (see Chart 4).

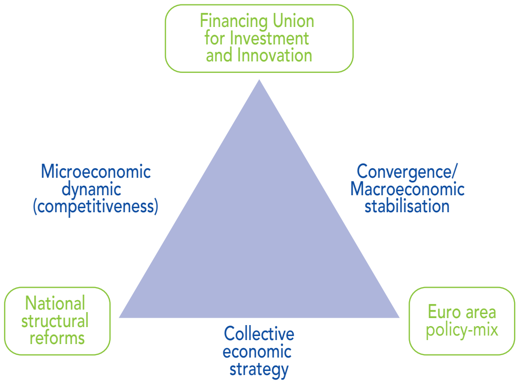
- The first point of the triangle must be the implementation of national structural reforms where they are needed, like in France and Italy. They are both in the interest of these countries, and essential for their credibility in Europe.

- But once this prerequisite has been achieved, reforms in France and Italy must be combined with fiscal or wage support in countries with leeway, such as Germany or the Netherlands. This win-win arrangement – "reforms/stimulus" – would make it possible to achieve a **more efficient euro area policy-mix**. In order to guarantee a lasting collective

4 Standard Eurobarometer survey.

5 Banque de France (2017), "The cost of shortcomings in euro-area economic policy coordination", Quarterly Selection of Articles – *Banque de France Bulletin*, No. 46, to be published in November.

Chart 4 The growth triangle



economic strategy, the position of Finance Minister for the euro area could be created. This person could draw on a stabilisation fund aimed at supporting, through lending, Member States facing asymmetric economic shocks, and further down the line on a euro area-wide budget. For all that, the existing rules applying to each Member State must continue to be observed, in particular the Stability and Growth Pact, but they must be supplemented by common institutions and policies, in order to achieve more growth and employment throughout Europe.

• The third component is the creation of a **"Financing Union for Investment and Innovation"**. The need for such a union arises from both a weakness – persistent euro area financial fragmentation – and an opportunity – a euro area savings surplus of EUR 350 billion, i.e. around 3% of GDP each year. The Financing Union would make it possible to channel that abundance of savings more effectively into investment and innovation across the euro area, in order to boost growth and pool private risks. This would require a unified governance of the existing initiatives, in order to circumvent the bureaucratic barriers between the Juncker Investment Plan, the Capital Markets Union and the Banking Union.

France spearheaded the Banking Union, underway since 2014, and the undeniable progress it constitutes. It can now take the initiative for its essential completion. The priority is to finalise the second pillar – that of resolution – including more simplified steering, in order to deal rapidly and once and for all with the problems of non-performing loans that are affecting certain euro area banks. The Banking Union and the Financing Union have become even more necessary in the wake of Brexit: with the City of London looking set to lose its "European passport", the euro area has an opportunity to "relocate" the transformation of its own savings.

III. Rising to the French challenge, with our capacity to accelerate

1. Catching up, above and beyond the improving economic outlook, three persistent lags

French growth is accelerating. After only 1.1% growth in 2016, it could reach 1.6% in 2017 and remain at this pace in 2018 and 2019.[6] Despite these favourable trends, three indicators show that France is lagging: the "speed limiters", i.e. insufficient potential growth

6 At least 1.4% growth in France in 2017 according to the June projections (see Banque de France, *Macroeconomic projections for France*, June 2017), but could reach 1.6% given subsequent revisions to the quarterly accounts.

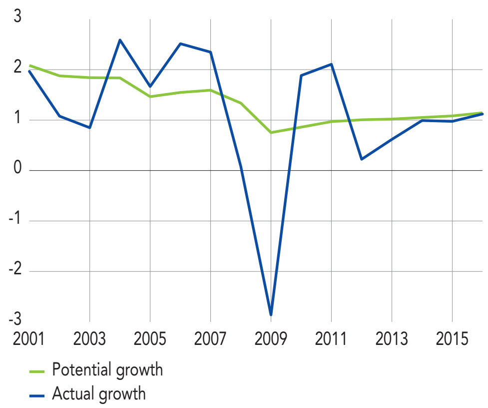
and excessive levels of structural unemployment; a lack of competitiveness reflected in our external accounts; and, consequently, the persistent growth differential between France and the euro area average.

1.1 Fifteen years ago, **potential growth** still amounted to 2% per year. Following the crisis, it declined to 1% per year and actual growth has appeared over recent years to be limited by this level, however modest it may be (see Chart 5). The low potential growth of the French economy is primarily due to the slowdown in corporate productive investment and lower productivity growth. At the same time, the **structural unemployment rate**[7] is currently estimated at more than 9%. This level is clearly unsustainable as it is more than double the full employment rate of unemployment. The actual unemployment rate is even higher, at 9.6% in the first quarter of 2017, although it started to decline as of 2015.

1.2 The **slump in our external accounts** in 2016 and early 2017, following an improvement in 2015, is a second indicator of France's lag. France is the only major country in the euro area to have a current account deficit in 2016 (EUR 19 billion or 0.9% of GDP). Our cost-competitiveness, as measured by unit labour costs, has improved since 2006 against Germany – without, however, fully catching up – because of faster wage growth in Germany and the positive impact of the Tax Credit for Competitiveness and Employment (CICE); our cost-competitiveness against the euro area excluding Germany has worsened. However, competitiveness excluding wage costs is no doubt playing a more active role, which requires better professional qualifications and the opening up of certain service markets.

Chart 5 Actual and potential growth

(%)



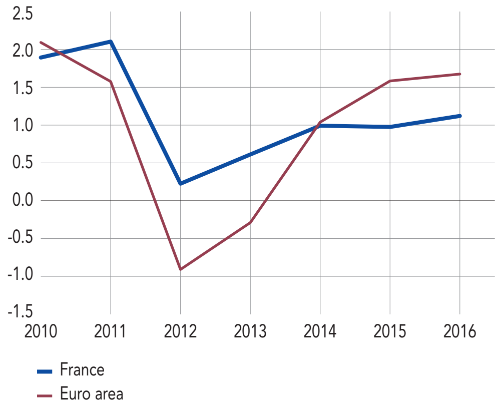
Sources: Banque de France and Insee.

1.3 Consequently, despite the progress made, France is now experiencing **a negative growth differential vis-à-vis the euro area average.** French growth, which equalled or outpaced growth in the euro area for long periods, has fallen behind since 2014 (see Chart 6a) and could remain so by almost half a point in 2017. This differential is entirely due to the negative contribution of foreign trade. As a result, during the 2014-2016 period, France, and to an even greater extent, Italy, showed a net lag (see Chart 6b). This is even more significant when compared with countries such as Germany, the Netherlands or Spain, which have already implemented the necessary reforms. They are now reaping the benefits in terms of growth and employment. And they have achieved this while respecting the European social model that we share and to which the great majority of our fellow citizens are rightly attached.

7 Or Nairu (non-accelerating inflation rate of unemployment).

Chart 6a Growth in France and in the euro area

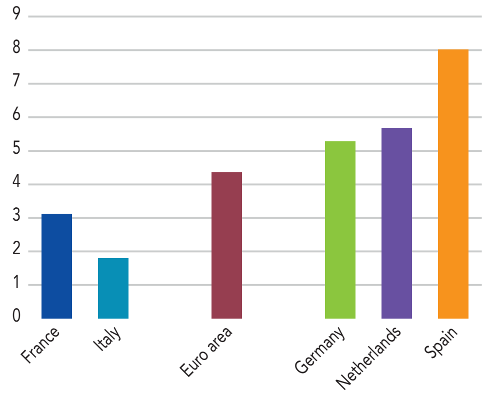
(%)



Source: Eurostat.
Note: Euro area with a constant composition, excluding Ireland.

Chart 6b Cumulative GDP growth, 2014-2016

(%)



Source: Eurostat.
Note: Euro area, excluding Ireland.

The acceleration of our economic growth should therefore aim to catch up these lags:

– a France that uses its favourable demographics to **achieve and if possible exceed the average growth rate of the euro area**, i.e. up to half a point of additional growth per year;

– a halving of the employment overhang compared with Germany, i.e. returning to the low it had briefly reached before the crisis of 2008-2009, i.e. of around 7%.

To this end, our country must regain its global competitiveness, including in terms of human skills, better quality investments, public services, and the functioning of its product and labour markets. And to achieve this, we must be more confident in our own capacity to transform, like in the reform programmes that have been so successful for our neighbours.

2. Daring to make necessary and possible reforms

The successes of our European neighbours converge on four key areas of the economy, referred to as the "4 Es" in French: *entreprises* (business), employment, education and the *État* (government).[8] France's time has come, if we dare to go far enough both on public finances and the stringency of the reforms.

2.1 Finally bringing our public spending under control again, for our competitiveness and our sovereignty

With regard to **public finances**, complying with the 3% deficit ceiling is crucial, if only to ensure France's credibility in Europe. The Cour des Comptes recently confirmed

8 Banque de France (2016), *Introductory letter to the Annual Report of the Banque de France*, May.

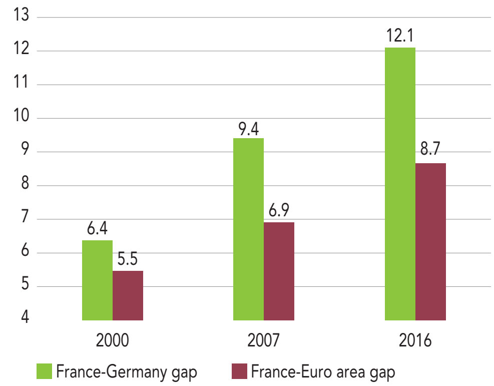
that the deficit for 2017 before the implementation of recovery measures would stand at around 3.2% of GDP.[9] Despite the reduction in the deficit in 2015 and then in 2016, growth in primary public spending (excluding the debt service cost) has regrettably accelerated: up 1.2% in real terms in 2016, after a 1.1% increase in 2015 and 0.8% in 2014. And yet, it is this overall public spending threshold that we must absolutely respect, for two reasons:

– **in the short term**, to be able to meet the objectives of the 3% deficit ceiling in 2017 and reducing the deficit thereafter. The "spontaneous" path[10] will actually keep us at a level equal to or above 3% until 2019. Increasing social security contributions is not the answer; but certain tax cuts, if they are not financed, should be deferred;

– **in the longer term**, to bring France (with public spending at 56% of GDP in 2016) closer to its euro area neighbours (an average of 46% of GDP in the euro area excluding France),[11] which have similar public services and social protection. The gap has not stopped widening (see Chart 7a). The goal of 52% set for 2022 is an intermediate step that is particularly urgent. At the very least, it requires the determined implementation of the announced EUR 60 billion in savings over five years, without including mechanical savings on debt service costs stemming from lower average interest rates.

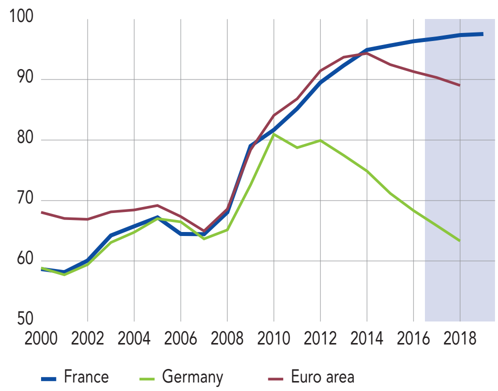
If France cannot reverse in the years to come the long deterioration of its public finances, it will expose itself to a double negative shock: a **competitiveness shock,** as it is penalised by national overheads that are far more onerous than that of our European neighbours; and a

Chart 7a Change in ratio of public spending to GDP
(gap in percentage points)



Sources: Insee, Eurostat.

Chart 7b Change in ratio of public debt to GDP
(%)



Sources: Banque de France for France; European Commission for Germany and the euro area.

9 Cour des Comptes (2017), *Report on the position and outlook of public finances* (*Rapport sur la situation et les perspectives des finances publiques*), June.

10 Banque de France (2017), *Macroeconomic projections France*, June.

11 Aouriri (M.) and Tournoux (H.) (2017), "The difference in public spending in France and Germany", Banque de France, *Rue de la Banque*, to be published in July.

sovereign debt shock, by not regaining control over its public debt before interest rates increase sharply (see Chart 7b).

It is never easy to achieve savings; but if we are determined it is surely possible. Reforming the State requires the predictability of goals and means over several years, clear priority choices and increased responsibility of managers. This would also help to make administrative functioning more intelligible and therefore effective. France still stands out in that it has five different administrative levels, with local government spending that amounts to around 12% of GDP.

2.2 Pursuing an overall, and therefore, equitable, transformation objective

A stronger France would be a France with more human talent and fewer inefficient regulations. The priority accorded to education is therefore essential to giving each citizen the best opportunities to succeed. In the short term, the ineffectiveness in particular of the **vocational training** system has been pointed out in numerous reports and analyses. Vocational training needs to become a driving force of social and professional mobility aimed more at the long-term unemployed and individuals with poor basic qualifications. Educational services should lead to better qualifications and be provided by strictly vetted and certified training professionals. This type of reform programme for vocational training, which mobilises between EUR 30 billion and EUR 35 billion each year through a hugely complex system, will be long and difficult to implement but is essential. Developing **apprenticeships** for young people should be an even greater priority: in comparison with Germany, France has less than half the number of apprentices (584,000 in 2016, including vocational contracts, versus 1,300,000 in Germany) while its youth unemployment rate is three times higher.

**

Furthermore, France is known for its plethora of regulations that reduce competition, discourage entrepreneurs and weigh on productive investment. These factors all contribute greatly to long-term unemployment and necessitate a massive, organised simplification shock. To be achieved in a balanced way, these measures need to be implemented at the same time as product and labour market reforms.

With regard to the **labour market**, a legislation that focuses on company level agreements would better reconcile economic efficiency and worker protection. A uniform legislation for all businesses is conversely poorly adapted to many of them, as well as being excessively complex and therefore obscure. There is also a problem of formalising sector level agreements and thus hampering the growth of the most productive companies. In addition, simplifying employee representative bodies by extending the Rebsamen Law of 17 August 2015 would help to encourage collective bargaining. The industrial tribunal process is long, and arbitration, the first stage of the process, is largely ineffective and rife with legal uncertainty. The legal safeguards in the event of dismissal should be increased and combined with a more mandatory scale of compensation ceilings for damages for dismissal without real and proper cause.

Economists[12] often consider that labour market reforms should be accompanied and even preceded by **product market** reforms. The economic rents of certain producers – which penalise consumers and increase inequalities – are indeed generated by anti-competitive regulations on the product markets. Reforms can quickly have quite significant positive effects, as witnessed in recent years in France by numerous job creations directly linked to the development of chauffeur-driven transport services, or the drop in prices for telephone communications. Certain reform programmes could for example target rail transport, or healthcare and the medical professions. With regard to **housing policy**, public spending in France is higher than in other European countries at close to 2% of GDP. And yet, certain personal housing benefit measures seem above all to have an inflationary effect on rents and prices and thus push up economic rents on real estate.

3 Ensuring the smooth financing of our economy, with the contribution of the Banque de France

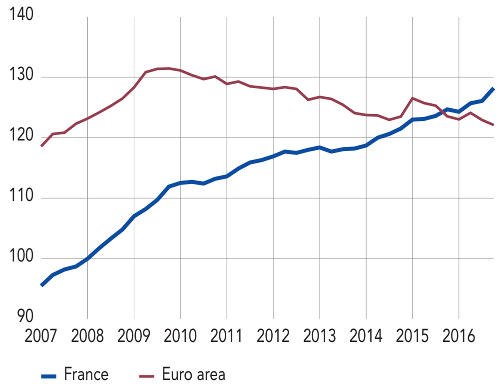
The Banque de France is committed on all these different fronts to serving the French Republic as an independent but open institution. Its duties are three-fold.

- **Ensuring a trusted currency.** Thanks to the expertise of its staff, the Banque de France actively contributes to the monetary policy of the euro area, participating in decision-making as well as its implementation. The Eurosystem operates like a genuine European federal structure, with an effective core – the ECB – but powerful national antennae.

- **Guaranteeing the smooth financing of our economy and financial stability.** To this end, the Banque de France, with the *Autorité de contrôle prudentiel et de résolution* (ACPR – the French Prudential Supervisory and Resolution Authority), ensures the soundness of banks, insurance companies and payment systems. Our financial system is now one of the most robust in Europe and of the G7 – French banks have more than doubled their capital ratios since 2008 (an increase of EUR 164 billion) – and the quality of our supervision has contributed to this. Lending to the economy is abundant, to the point that the levels of lending currently warrant vigilance: up 5.6% year-on-year in April 2017, it increased twice as fast as the euro area average and significantly faster than the growth in nominal GDP. The private debt of households and companies in France has now overtaken that of the euro area in terms of percentage of GDP (see Chart 8). We must ensure, as the High Council for Financial Stability[13] has recently highlighted, that no new bubbles develop in the housing market or in corporate acquisitions.

Chart 8 Private debt in France and the euro area

(% of GDP)



Source: Banque de France.

12 See notably Blanchard (O.) and Giavazzi (F.) (2003), "Macroeconomic effects of regulation and deregulation in goods and labor markets", *Quarterly Journal of Economics*, No. 118, pp. 879-907.

13 HCFS, press release of 26 June 2017.

French companies must also be encouraged on a large scale to use equity rather than debt financing: this financial lever is essential for innovation and only represented 64% of GDP at the end of 2016, half that of the United States (128%). To this end, part of the savings of the French public must be urgently redirected towards productive investment and expanding start-ups as well as SMEs and ISEs: this requires new long-term savings products that are less liquid but feature a form of capital protection and offer over time the higher equity-type returns.

• **Assisting French citizens nationwide** and particularly those that need it most. In 2016, the Banque de France was entrusted with the task of providing economic and financial education to the public as part of a new national strategy. The Bank's teams have helped 210,000 families to escape over-indebtedness. They also actively work side-by-side with businesses, particularly SMEs and VSEs, with their credit ratings and the appointment of VSE correspondents in every *département* in 2016.

In return for the Banque de France's independence, it must be transparent as regards its duties and exacting in terms of its results, which it regularly discloses. As a forward-looking institution, the Bank must also play its role in ensuring excellence in the management of the public's money. The strategic "Ambitions for 2020" plan[14] aims for a central bank that is more efficient, more innovative and more open – objectives that are consistent with the needs for reform of our country. The Banque de France will reduce its workforce by 20% over five years and its net operating costs by 10% over the same period, while ensuring an active local presence in every *département*.

14 See Banque de France (2016), *Activity Report*, "Transformation strategy", 2016, pp. 53-63.

**

The challenges facing France are unprecedented, but so is the window of opportunity. If our country undertakes a sustained collective effort, it can return to stronger, more inclusive, long-term sustainable growth and its voice will carry all its weight in Europe. The years to come will be France's time and Europe's opportunity.

Paris, 4 July 2017

François Villeroy de Galhau