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
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BANQUE DE FRANCE

EUROSYSTÈME

Summary

*In 2017, Europe and France experienced their strongest growth in ten years. In 2018, the world is becoming more unstable, and the euro area in particular is seeing a return of uncertainty. Economic players can nevertheless **appreciate growth**: it should remain robust, even though its pace is expected to slow somewhat in Europe. Global activity should benefit from the temporary effects of the stimulus measures in the United States, at the expense of a widening of the US trade and budget deficits.*

*We must however **step up our vigilance** with respect to risks. The uncertainty generated by protectionist tensions is weighing on corporate investment and the financial markets. Furthermore, despite the progress achieved in the area of banking regulation, the risk of financial instability remains, with the ongoing rise in global debt, in particular in the private sector of emerging countries.*

*As regards the euro area, even though Monetary Union is a success, the persistent weakness of Economic Union is a problem; the Italian situation is an even greater reason to act. France and Germany must offer their partners a "tightrope" combining responsibility and solidarity. It is necessary to both enhance **private** risk-sharing – via a genuine Financing Union completing Banking Union and the Capital Markets Union – and implement a common **public** mechanism, via a European Monetary Fund and a euro area budget. At the same time, the Eurosystem is pursuing a gradual and predictable normalisation of its monetary policy, as inflation moves lastingly towards the 2% target.*

*Against this backdrop, **France needs to seize its opportunity**. After the exemplary acceleration of reforms since 2017, the priority now is to address our two key challenges. The first concerns our persistent external deficit: among the qualitative factors that contribute to **competitiveness**, it is crucial that we improve the efficiency of our **public sector**. France's public expenditure-to-GDP ratio is 11 percentage points higher than that of its European neighbours. It is also a question of sovereignty: failure to act means that our public debt and our fiscal choices will become unsustainable in the future when interest rates rise. The government's stated target – of reducing real spending growth from 1% to 0.3% per year – must now be translated into concrete measures; any tax cuts beyond those already decided will necessarily imply even tougher spending restrictions. A more efficient and innovative public sector – which also implies efforts on the part of social and local government actors – can be a boon for French competitiveness. Through its Ambitions 2020 strategic plan, the Banque de France is endeavouring to set the example for this vital transformation of public services.*

*Our second challenge, if we want to prevent economic and employment growth from stalling prematurely, is to **reduce structural unemployment** – currently estimated at close to 9%. The serious mismatch between businesses' demand for workers and the supply of labour should be sufficient reason for everyone to support the proposed reforms to apprenticeships, professional training and education.*

Restoring our competitiveness, including in the public sector, and reducing our structural unemployment: these are the two prerequisites for lifting our medium-term or "potential" growth, which is currently too low at around 1.25%. Succeeding in these goals will require perseverance and broad-reaching efforts to concretely implement reforms – including on the part of the private sector. It is also crucial that the measures are fair, both in terms of the efforts demanded and the benefits they yield. The reforms carried out by many of our neighbours before us provide grounds for confidence: economic success is indeed compatible with the European social model; in fact it is an essential precondition for its sustainability. At a time when the international environment remains favourable but still fragile, the greatest risk would be to sit back and do nothing.

In 2017, Europe and France experienced their strongest growth in ten years. And France, in Europe, set an example with the acceleration of its reforms. Now, in spring 2018, growth remains robust but the world is becoming more unstable: the euro area in particular is seeing the return of uncertainty, notably with the situation in Italy. That said, we must not ease our efforts but rather step them up, focusing on three requirements:

– appreciate growth, in a more fragile but still favourable economic environment;

– increase our vigilance, faced with global and European risks;

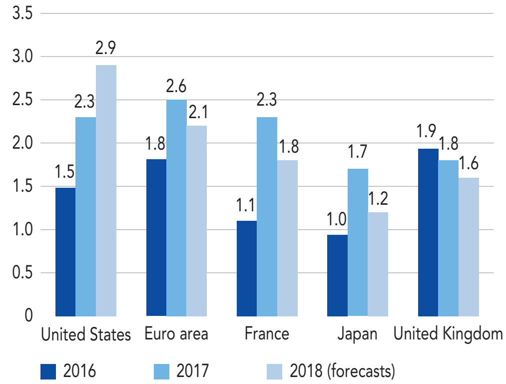
– seize France's opportunity, by addressing our two key challenges: lack of competitiveness – notably in the public sector – and structural unemployment – via training.

I. Appreciate growth which is more fragile but overall still robust

2017 ended on a very positive note: underpinned by investment and international trade, global growth accelerated to stand at 3.8%. In the euro area, the expansion was robust and widespread, with a growth rate of 2.6% (see Chart 1), which is the highest in 10 years, and still above that of the United States. It resulted in a net decline in unemployment to 8.7% at end-2017, the lowest level since 2008, and almost 8 million job creations between mid-2013 and end-2017, i.e. more than offsetting those lost during the crisis. In France, GDP growth also accelerated, more than doubling to stand at 2.3%[1] in 2017.

Chart 1 Annual GDP growth

(%)



Sources: Eurostat; IMF, *World Economic Outlook* (April 2018); ECB, *Eurosystem staff macroeconomic projections for the euro area*, June 2018; Banque de France, *Macroeconomic projections – France*, June 2018; national accounts.

At the start of 2018, economic conditions deteriorated slightly in the euro area. Despite this downturn which seems partly temporary, the economic expansion should continue in 2018, at a somewhat more moderate pace than last year, with growth standing at 2.1% in the euro area and 1.8% in France. Among the potential risks are oil prices which are moving back towards USD 80 per barrel (price of Brent). This is their highest level since end-2014, and should this persist it would pose a risk to the growth of European countries and especially France.

At the global level, growth should reach 3.9% according to IMF forecasts. In the short term, global activity should indirectly benefit from fiscal stimulus and tax reforms in the United States, whose impact on US GDP growth is slated to be around 0.7% on average in 2018-19. But this

1 Adjusted for seasonal and working day variations.

countercyclical stimulus could cause the US economy to overheat, with a moderate rise in investment and hence potential growth, and result in the trade and budget deficits widening by more than one percentage point, to 6.1% and 3.8% of GDP respectively in 2019.

Growth in Europe and France should therefore remain significant in 2018 and probably in 2019, but its momentum is likely to ebb. It is now above the "cruising speed" of the economy, estimated by economists to be around 1.4% in the euro area and 1.25% in France. As the French economy catches up its growth lag – its negative output gap, which should disappear in 2019 – it should gradually decelerate. Potential growth remains lower than before the crisis mainly because of the slowdown in productivity.[2] However, in the coming years, the structural productivity trend could be underpinned by the effects of the structural reforms carried out (see Section 3) and by a new technological shock associated with the digital economy.[3]

Growth is here, even though its pace is set to gradually slow. This is a real reason to avoid any complacency about risks, and act now to fix the shortcomings of the international and European architecture.

II. Step up our vigilance, in the face of global and European risks

Two major global risks persist[4]

The lack of predictability in the United States and Brexit in the United Kingdom are currently fuelling the risk of protectionism. According to the IMF,[5] a general rise in protectionist barriers, causing a 10% increase in import prices, would lead to a 15% decline in global trade and a 2% fall in global GDP after five years. These calculations only take into account the effects of possible future measures, and in all likelihood under-estimate the impact of the uncertainty already being generated by protectionist threats, which is weighing on corporate investment and on financial markets. In Europe, the cost of Brexit for the United Kingdom is estimated at between -2% and -8% of GDP in the long term, according to the scenarios used.

Against the detrimental temptations of unilateralism, France, with Europe and Canada notably, must continue to defend international economic relations based on commonly respected rules and institutions. Faced with the rise of populism and growing dissatisfaction, it is also important to defend the European social model and its welfare mechanisms. Income inequality has worsened considerably less in Europe than in the Anglo-Saxon world: in the United States, the global top 1% of earners captured 20% of total income in 2016, i.e. twice that of 1980, whereas their share has remained relatively stable in Europe, at around 13%.[6]

As regards **financial instability**, substantial progress has been made in the area of international banking

2 See Bergeaud (A.), Cette (G.) and Lecat (R.) (2014), "Productivity Trends in Advanced Countries between 1890 and 2012", *Working Papers*, No. 475, Banque de France, February.

3 See Brynjolfsson (E.) and Mcafee (A.) (2014), "*The second machine age – Work, progress, and prosperity in a time of brilliant technologies*", Kindle edition.

4 See *Letter to the President of the Republic*, July 2017.

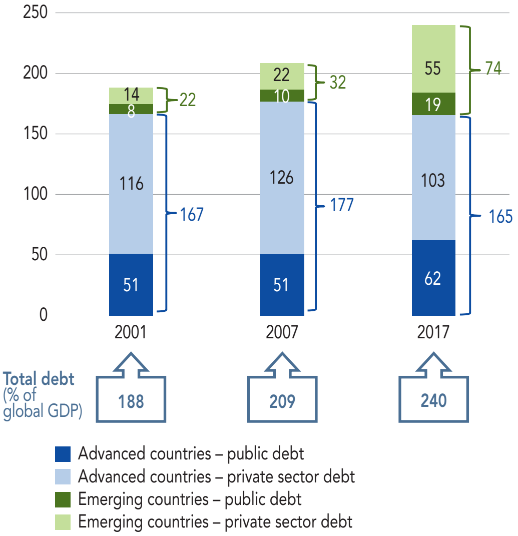
5 IMF (2016), *World Economic Outlook*, October.

6 See *World Inequality Report* 2018, coordinated by Alvaredo (F.), Chancel (L.), Piketty (T.), Saez (E.) and Zucman (G.).

regulations, with the very welcome finalisation of Basel III last December. Moreover, the United States appears to be abiding by its international financial commitments and avoiding unilateral deregulation. But there is clearly no room for complacency or respite. Total global debt continued to increase, reaching 240% of world GDP in 2017, against 229% the previous year and 209% in 2007 (see Chart 2),[7] with a marked rise in private sector debt in some emerging countries. In the past few months, we have once again observed a sudden loss of confidence and foreign exchange market pressures vis-à-vis some countries with large trade and public deficits, such as Argentina or Turkey.

Chart 2 **Change in public and private sector debt in advanced and emerging countries, excluding the financial sector**

(% of global GDP)



Sources: BIS, Banque de France calculations – data expressed in current dollars and at current GDP prices.
Note: Private sector debt includes household and non-financial corporation debt.

Furthermore, we must take account of the increasing magnitude of non-bank finance at the global level. The main focus for financial regulation is therefore no longer bank solvency, but non-bank liquidity.[8]

The Italian situation is an even greater reason to finally strengthen Economic Union in Europe

Italy, which is a major member of the euro area and the G7, has shored up its banking system. It has also benefited from the European recovery, with growth coming in at 1.6% in 2017. But public debt remains elevated at 132% of GDP and the unemployment rate is still high (11%), particularly for the young (35%). These difficulties, which are compounded by structural rigidities, have existed for a number of years and need to be addressed primarily through national reforms (see Section 3). The Eurosystem's commitment since 2012 has been decisive in reducing "fragmentation" and significantly bringing down the interest rates paid by Italian firms, households and the state. The new government's economic policy choices are still uncertain. While this letter is not the place to discuss such choices, it is important to stress that a solid shared currency – a collective asset that has belonged to 340 million Europeans for 20 years – constitutes a coherent and unified basis. Each of its members must abide by its rules, and they all share a common destiny.

7 BIS data used here are the most recent. There is a marginal discrepancy with IMF data, due to method and scope differences, but both show a significant rise in global debt.

8 See Banque de France (2018), *Financial Stability Review*, No. 22 on Non-bank finance: trends and challenges, April.

In this respect, while Monetary Union is a success, the **persistent weakness of Economic Union** is a problem: there is a risk that monetary policy will be overburdened during the next recession if the euro area does not equip itself with more powerful economic instruments. The uncertainties surrounding the new Italian government's policies constitute an additional difficulty in the ongoing negotiations, but at the same time increase the need for them: France and Germany must, at the very least, rapidly and openly offer all their partners a "tightrope" combining responsibility and solidarity. The first priority is to enhance private risk-sharing, in order to meet European entrepreneurs' investment and innovation needs, improve the circulation of the abundant savings (over EUR 400 billion surplus in the euro area)[9] and better absorb shocks within the euro area: in the United States, private financial flows between states are a more powerful damper than fiscal mechanisms. In practice, the creation of a true Financing Union notably requires the acceleration of the Capital Markets Union and the completion of the Banking Union; here, the second pillar on the resolution of failing banks is more important still than a possible common deposit guarantee scheme. And it is essential to remove barriers for pan-European banks.

However, a common public mechanism is indispensable, alongside national economic policies: it would combine the transformation of the European Stability Mechanism into a European Monetary Fund, including a real crisis prevention role, and the implementation of a euro area budget. This budget would be used to finance certain "common goods" for the benefit of all, such as digital technology, the energy transition and security, and would contribute to stabilisation.

A growing challenge: the gradual normalisation of monetary policies against the backdrop of below-target inflation

The economic expansion has brought with it a new phenomenon, both for the euro area and for other advanced economies: strong growth is being accompanied by persistent too-low inflation. Following the sharp swings in inflation in May due to rising oil prices (1.9% in the euro area after 1.3% in April), average inflation in 2018 should stand at 1.7% (of which 1.1% for core inflation, excluding energy and food). This justifies the Eurosystem keeping in place its accommodative monetary policy at the top of the cycle, and pursuing a gradual normalisation. But in this context three questions need to be answered: does the Eurosystem have the right objective? Will inflation remain persistently below target? Has monetary policy delivered positive results?

The right objective?

The primary objective of the ECB, established by the Treaty, is to maintain price stability. Since 2003, this objective has been defined as inflation rates below, but close to, 2% over the medium term. The aim is to prevent both too-high annual inflation and deflation. A slightly positive inflation target notably provides enough leeway to safeguard against deflationary dangers. As a matter of fact, most of the other central banks of advanced economies, including the United States and Japan, have also adopted an inflation target of 2%. In the case of the Eurosystem, since the price stability

9 12-month current account surplus for the period ending in March 2018 – source: ECB.

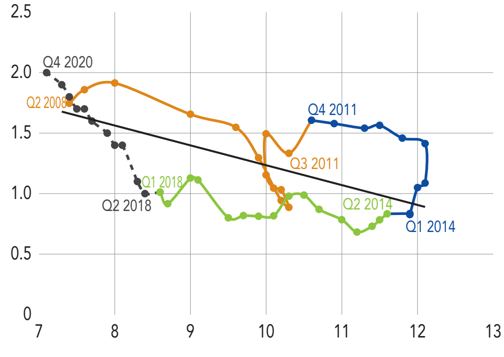
objective applies to the euro area as a whole, a strictly positive target provides a larger adjustment margin if there are differentials between countries, by limiting the risk that some countries might experience a negative inflation rate.

Will inflation remain persistently below target?

Aside from the strong but temporary impact of oil price fluctuations, one of the keys here lies in a well-known economic debate. Brought to light at the end of the 1950s, the Phillips curve establishes an inverse relationship between unemployment and inflation (initially wage growth). Recently, however, the significant decline in unemployment in the euro area has not resulted in a sharp acceleration in inflation; does this mean that the Phillips curve has disappeared, dimming the prospects for exiting accommodative monetary policy? Studies by the Banque de France[10] show that the Phillips curve is alive and kicking in the euro area (see Chart 3), even though it is flatter than it was in the 1970s and 1980s: the decline in the unemployment rate is having a less significant impact on inflation, due to structural factors such as heightened global competition. Cyclical factors such as the sharp fall in oil prices in 2014-15 also weighed on inflation. Furthermore, the Phillips curve may differ across countries, including within the euro area: unemployment remains high, notably in France. It is therefore necessary to supplement monetary policy with structural policies that raise potential growth and lower structural unemployment, rather than calling into question necessary wage moderation (see Section 3).

Chart 3 Euro area Phillips curve

(Horizontal axis: unemployment rate, %; Vertical axis: core HICP, % change y-o-y)



Sources: Eurostat; ECB, *Eurosystem staff macroeconomic projections for the euro area*, June 2018.

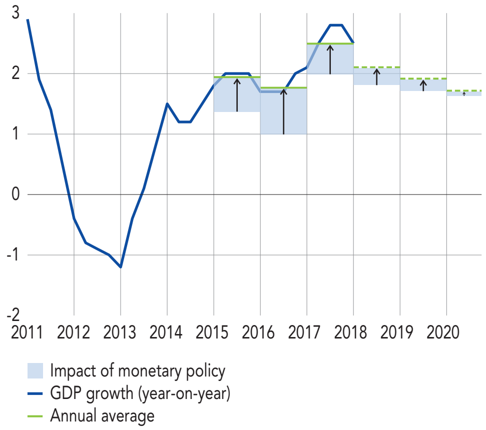
What have the costs and benefits been?

In order to address the risks affecting the euro area, since 2014 the Eurosystem has increasingly used a "quartet" of monetary policy instruments: private and public asset purchase programmes, the slightly negative deposit facility rate, indications as to the future path of key interest rates (forward guidance), and the provision of liquidity and credit to banks. These non-standard measures have contributed to the acceleration of growth by fostering particularly favourable financing conditions and stimulating domestic demand. According to ECB estimates, they should contribute a cumulative 1.9 percentage points to GDP growth over the 2016-20 period (see Chart 4). They should also have a positive impact on inflation of 1.9 percentage points (see Chart 5). The Eurosystem forecasts, with an increasing degree of confidence, that inflation will reach 1.7% in 2020 (with core inflation of 1.9%), compared with just 0.2% in 2016.

10 See Berson (C.), de Charsonville (L.), Diev (P.), Faubert (V.), Ferrara (L.), Guilloux-Nefussi (S.), Kalantzis (Y.), Lalliard (A.), Matheron (J.) and Mogliani (M.) (2018), "Does the Phillips curve still exist?", *Rue de la Banque*, No. 56, Banque de France, February.

Chart 4 Euro area GDP growth and estimated impact of monetary policy

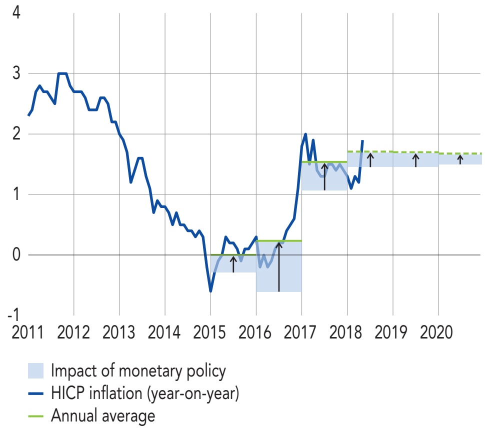
(%)



Sources: ECB and Banque de France.

Chart 5 Euro area inflation and estimated impact of monetary policy

(%)



Sources: ECB and Banque de France.

As regards the possible negative side effects of monetary policy, to date no general signs of excessive debt accumulation or asset price bubbles in the euro area have been observed.[11] Since 2014, public and private debt[12] in the euro area have fallen on average by almost 11 percentage points of GDP. In this regard, France is nevertheless an exception: its private sector debt has risen by 9 percentage points since 2014 and stood at 130% of GDP at end-2017, which is the highest of the major euro area countries. This calls for specific measures via domestic macroprudential policy. This is the responsibility of the *Haut Conseil de stabilité financière* (HCSF – High Council for Financial Stability) which thus decided on 11 June to activate for the first time a countercyclical capital buffer, with a moderate level of 0.25%. It has a preventive aim: accumulating precautionary reserves during cyclical upswings, as is the case at present, in order to prevent credit rationing during future downturns.

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Bolstered by the credibility of the initial results, the ECB Governing Council gave further clarification on 14 June on its strategy of gradual and predictable normalisation of monetary policy. In doing so, it is helping to reduce uncertainty and anchor the expectations of economic agents. Net asset purchases should end in December; the first interest rate rise could come as of the summer of 2019. That said, monetary policy will remain accommodative. In particular, keeping a large stock of assets on the Eurosystem balance sheet – given the reinvestment of the principal payments from maturing securities – will continue to maintain

11 See ECB (2018), *Financial Stability Review*, May.

12 Private non-financial sector debt: households and businesses.

favourable long-term financing conditions by reducing term premia at the long end of the yield curve.

III. Seizing France's opportunity

For the past year France has been benefiting from a positive trend, even more so than other euro area countries. Business climate indicators remain well above their long-term average and, after the uncertainties of the presidential campaign, international investors now seem to appreciate the solidity of the French institutional framework and the pace of the reforms.

Some of the reforms have already been adopted. In the **labour market**, following on from the El Khomri Law of 2016, the Pénicaud Ordinances of 2017 have increased labour flexibility while at the same time preserving the bulk of France's employment protection. **Tax reforms** have been introduced to reduce or shift the tax wedge on labour and capital, and bring the French tax system more in line with that of other advanced economies. The CICE (Tax Credit for Competitiveness and Employment) has helped to drive the rebound in employment observed since the end of 2015 and will be converted into a permanent cut in employer social security contributions as of 1 January 2019.

More generally, the government and parliament have announced a raft of reforms over the past year. Our country may have been slower than others to respond, but it is now doing better than others in facing up to an obvious imperative: the need to take advantage of the return to growth and confidence in order to implement an audacious reform strategy and boost tomorrow's potential growth. An ambitious agenda of reforms is guaranteed to deliver results provided it is **comprehensive** – reforms interact positively together – and **perseverant** – for all of our neighbours, it took two or three years to actually reap the benefits of the reforms. The announcement and parliamentary adoption of the reforms is important, of course, but what matters even more is their actual **implementation** by all stakeholders – including by the private sector.

Moreover, it is the overall consistency and perseverance of the reforms that will guarantee the necessary **fairness** of the strategy: because everybody has to be asked to make efforts – including those receiving private or public rents – and because everyone will then benefit – first and foremost those who are re-entering or joining the labour market, including the young; but also the most vulnerable, who need to see assurances that we can at last guarantee the long-term financing of national welfare.

Beyond this broad picture, there are two specific challenges that the French economy faces for 2018:

– competitiveness, and in particular the efficiency of public spending;

– employment, and primarily the reform of professional training and education.

First challenge: restoring French competitiveness, notably through more efficient public spending

Despite the improvement in the economic environment, France is lagging behind the euro area in terms of growth: between 2014 and 2017, cumulative GDP growth in France was 2.4 percentage points lower than in the euro area. This shortfall is not due to domestic demand, which remains robust, but almost exclusively to the external component of growth (see Chart 6). France's current account has been systematically in deficit since 2007 (EUR -13.1 billion in 2017). Its trade deficit is almost entirely attributable to intra-euro area trade, as it is in surplus with the rest of the world.

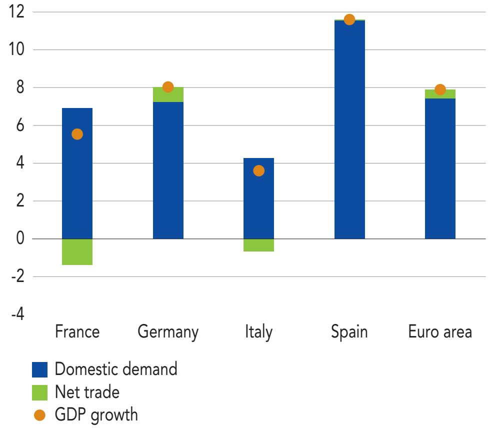
This situation illustrates the persistence of France's competitiveness problem. Part of it is down to the cost of labour, which weighs on firms' cost competitiveness. The slowdown in French unit labour cost growth relative to Germany since 2013, as a result of competitiveness reforms in France – the CICE and Responsibility Pact – and more dynamic wage growth in Germany, has still not been sufficient to offset the sharp rise observed in the 2000s. Since 1999, the cost of labour has increased by 6% more than in Germany (see Chart 7). Wage moderation is still urgently needed in France in view of the external deficit, and this will not prevent average household purchasing power from rising markedly – by a forecast 1.2% in 2018 and 2.0% in 2019. Conversely, countries with a lasting external surplus – such as Germany and the Netherlands – are in a position to boost wages, which would help to correct the imbalances in the euro area.

On the qualitative side, our overarching priority is to improve public sector efficiency

Aside from this issue of cost-competitiveness, an increasing portion of our weakness seems to stem from non-cost related factors (see Chart 8), which are more difficult to explain and therefore to remedy.

Chart 6 Cumulative contributions to GDP growth, 2014-2017

(%)



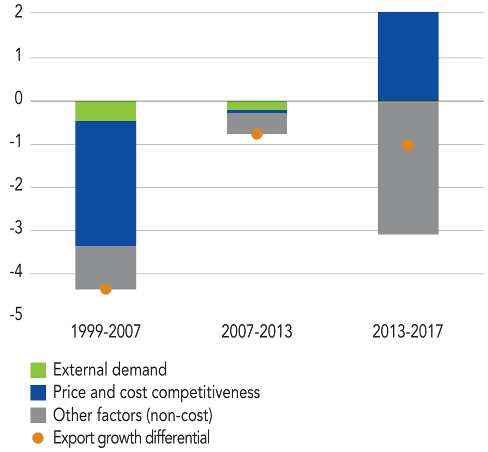
Source: Eurostat.

Chart 7 Relative labour costs, ratio of France to Germany

(100 = 1999)

Source: Eurostat.

Chart 8 **Differential between French and German real export growth**
(average annual growth, %)



Source: Banque de France.

A first contributor, at microeconomic level, is the positioning and strategy of our businesses, which often operate in less high-end segments of the market than their German counterparts. A second contributor is the qualification of our labour force (see below). Lastly, competitiveness also depends on the efficiency of our public sector. Through their role in regulating the financial system, and labour and product markets, public authorities can help to shift the allocation of production factors towards the most efficient enterprises, and ultimately improve the overall competitiveness of the economy.[13]

In this regard, the first priority is to **cut public spending**: at end-2017, public spending accounted for 56% of GDP, which is 11 percentage points higher than the average for our neighbours with a comparable social and public sector model (45% for the euro area excluding France). This gap in efficiency is damaging our competitiveness: the 4 percentage point increase in France's expenditure-to-GDP ratio since 1999 has translated into a 2 percentage point rise in the tax-to-GDP ratio – especially through increases in social security contributions – whereas expenditure and tax ratios have remained stable in the euro area and even declined in Germany.

But there is also a challenge related to our **sovereignty**. Failure to control public spending leads to higher debt: since 2010, our debt-to-GDP ratio has ballooned by 12 percentage points to 97% at end-2017, whereas in Germany it has fallen by 17 percentage points over the same period. This will place a heavy burden on France's budgets in the years to come when interest rates rise.

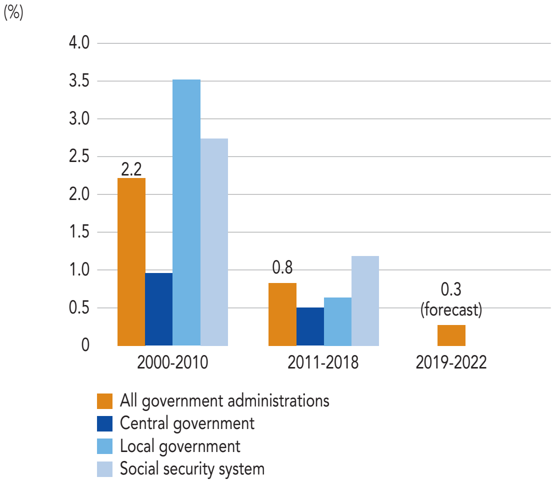
Bringing France's government debt back to sustainable levels – around 60% of GDP within 20 years, which is the upper limit set by the European Treaty and close to the current level in Germany (64.1% at end-2017) – is possible. But meeting this target will require major efforts and perseverance with regard to public spending over the coming years. Assuming direct taxes and social security contributions remain stable, **public spending growth of 0.3% per year in real terms** over the period 2019-22 would be consistent with our obligations under the preventive arm of the Stability Pact,[14] to which we will now be subject, and would already

13 See Aghion (P.), Bergeaud (A.), Lequien (M.) and Melitz (M.) (2018), "The Impact of Exports on Innovation: Theory and Evidence", *Working Papers*, No. 678, Banque de France, April.

14 This would imply a primary structural adjustment (i.e. a reduction in the government deficit excluding the cyclical component and interest payments on government debt) of around 0.35% of potential GDP per year, which is consistent with the requirements of the Stability and Growth Pact.

lead to a visible reduction in the path of government debt. The government's stated intention in its April 2018 Stability Programme of curbing spending (see Chart 9) is therefore to be commended; but it is imperative that it meets this objective, and that it rapidly sets out the concrete steps it will take to do so, particularly as it implies a radical break with the past, and with the recent trend in spending growth (1.1% per year in real terms in the period 2017-18). France also appears to be planning further tax cuts – which are always popular, but rarely adequately financed. To keep debt on the same downward trajectory, this would mean making even bigger efforts on spending – and even cutting real spending growth to zero. Alternatively, it might be preferable to limit the tax cuts to the very significant ones already decided at the end of 2017.

Chart 9 Average annual growth in real public spending in France, net of tax credits



Sources: Insee and government forecasts (2018-22 Stability Programme).

An adjustment of this size is not without precedent in other European countries – Germany already went through an extended period of cuts to real spending at the start of the 2000s. Over the past two decades, 21 countries in the European Union have managed at least once to lower their public spending by a minimum of 3 percentage points of GDP, which is our government's target.[15] In France, the bulk of the rise in public spending over the past two decades has come from welfare spending – including pensions. Another unique French trait is the fact that it has five overlapping layers of local administration, and that local government spending accounts for 12% of GDP.

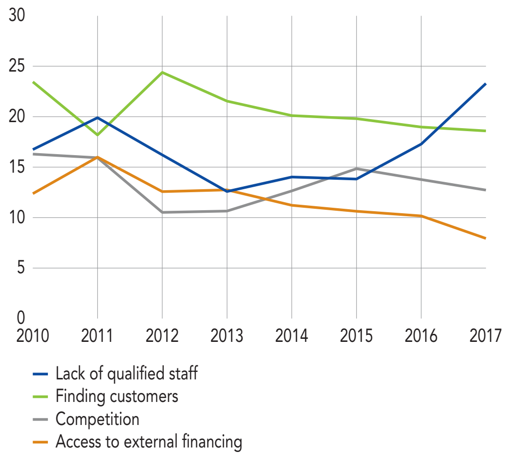
Obviously, transforming the public sector is a difficult task. Rather than making indiscriminate and increasingly inefficient cuts, it calls for making targeted savings and choosing our priorities carefully – at times it may even be necessary to raise spending in certain areas. The method used also matters: ministries and public service bodies should be set multi-annual budgets with challenging but visible targets; managers and public sector workers need to be made more accountable through the delegation of responsibilities and simplification of structures; and of course public services and processes should be increasingly digitalised. An effective and innovative public sector can be a major boost to French competitiveness.

15 See Aussilloux (V.), Gouardo (C.) and Lenglart (F.) (2018), "*Baisser le poids des dépenses publiques : les leçons de l'expérience des pays européens*", *La note d'analyse*, No. 67, France Stratégie, May.

Second challenge: to prevent economic and employment growth from stalling, structural unemployment needs to be reduced through reforms to professional training and education

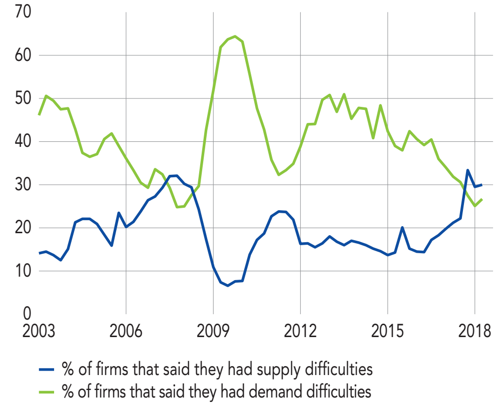
In the case of France's current economic expansion, the problem is no longer cyclical but rather structural. This can be illustrated by the following unacceptable paradox: the main obstacle facing businesses today is a shortage of labour (see Chart 10) even though France has an unemployment rate of close to 9%. This serious discrepancy between the demand for and supply of labour appears to reflect both a deterioration in skills, as evidenced by the OECD's surveys,[16] and the impact of technological shocks or global competition. More broadly, and for the first time since 2007, businesses are struggling to a greater extent with supply constraints than with insufficient demand (see Chart 11).

Chart 10 Biggest challenges faced by French SMEs
(% of respondents)



Source: ECB.

Chart 11 Supply and demand difficulties reported by manufacturing firms
(% of respondents)



Source: Insee, *Quarterly business survey* (*goods-producing industries*).

Economic growth, and therefore employment growth, both risk stalling at a time when 2.6 million[17] French citizens are still without a job.

This mismatch between labour supply and demand is symptomatic of France's persistently high level of structural unemployment. The structural unemployment rate has remained consistently above 7% since 1985, and is estimated at 9% for 2018 by the Banque de France and international organisations. Not only does this weigh on our production capacity, it also undermines social cohesion.

16 See the OECD's PISA (Programme for International Student Assessment) and PIAAC (Programme for the International Assessment of Adult Competencies) surveys.

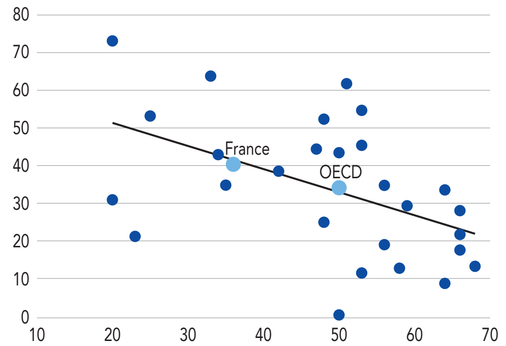
17 2.6 million unemployed according to ILO statistics in Q1 2018; 3.4 million Category A jobseekers in April 2018 according to statistics from *Pôle emploi* (the national job centre). The difference between the two figures essentially consists of individuals who are not in work and have registered with *Pôle emploi* but are not included in official ILO statistics as they are not actively seeking work and/or not immediately available to work.

To reduce structural unemployment, we need to target four priorities: **apprenticeships**, professional training, education and unemployment benefit. Germany has twice the share of young people in apprenticeships as France (15% compared with 7% in France), and the unemployment rate for young people is three times lower (6.0% compared with 20.7%).[18] The reform currently being examined by parliament appears to address the complexity of the French system and the lack of appeal of apprenticeships both for young people and for businesses.

In addition, all employees, and not just the young, should be given the opportunity to adapt their skill-sets. **Professional training** needs to be made more effective at filling job vacancies. Of the ten job categories expected to face serious recruitment difficulties in 2018, eight require less than a year of training. The French professional training system (see Chart 12) has three major shortcomings: it is too complex; it is not efficient enough given the amount it costs (EUR 32 billion per year); and it is unfair as it disproportionately benefits those who are most qualified (see Chart 13). The ambitious – and very necessary – reform currently under discussion is aimed at correcting these failings.

Chart 12 **Long-term unemployment and professional training in OECD countries**

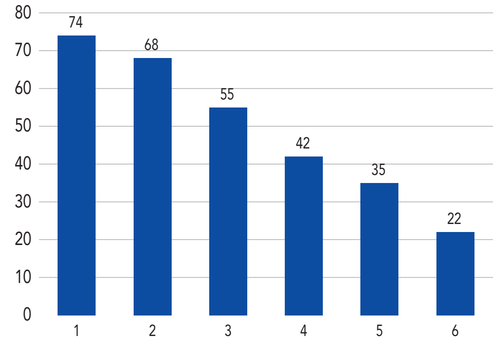
(Horizontal axis: rate of participation in professional training, %; Vertical axis: % share of total unemployed who have been out of work for more than 12 months)



Source: OECD.

Chart 13 **Rate of participation in professional training**

(% of adults – proportion of adults who attended at least one training course over the previous year)



1 University degree or equivalent (long course)
2 University degree or equivalent (short course)
3 Baccalaureate
4 CAP-BEP (vocational/technical qualification)
5 National diploma (middle school certificate)
6 No primary school diploma or certificate

Source: Insee, 2016 *Adult Education Survey* and Q4 2016 and Q1 2017 *Employment Surveys*.

Education reforms – at primary and secondary school level, and better career orientation at university – naturally have a less immediate impact than changes to apprenticeships and professional training as they only deliver returns over the space of a generation. But they are absolutely essential if we want to build a France with more human talent and greater equality of opportunities.

18 Figures on apprenticeships are for end-2016, the latest date for which data are available; unemployment figures are for April 2018.

Compared with the OECD average,[19] France has too little social mobility and too much inherited inequality. Lastly, the **unemployment benefit system** could do more to reallocate labour across sectors and activities, including by starting to apply sanctions more systematically if jobseekers have not tried hard enough to find work or have refused a reasonable offer of employment.

A Banque de France that is committed to efficiency and to improving the general public's economic and financial literacy

The Banque de France is independent and open to Europe – a trusted institution that is committed to serving the everyday needs of the French public via its three core missions: Monetary Strategy, Financial Stability and Services to the Economy. The counterpart to this independence is that we have a duty of transparency towards the public regarding the results of our missions. But more specifically, the Banque de France is striving to meet two major objectives, both of which dovetail with the aforementioned goals of improving public sector competitiveness and training.

First, the Banque de France is determined to carry through its own transformation, in order to provide an even more efficient public service. This is the target of the **Ambitions 2020** strategic plan, a roadmap that is built around three core commitments: in Europe, to be the central bank for markets, the benchmark in supervision and a major player in the cash industry; in France, to be a trusted and outstanding public service provider; and for our managers and staff, to provide a simpler, more modern working environment. By end-2017, the Banque de France had already reduced its headcount by 9.6% relative to 2015, and its net operating expenses by 4.1%. In 2017 it also opened up its Lab, an innovation laboratory that works with start-ups and fintechs, as well as publishing its first customer rating – 86% – which measures levels of satisfaction among individual customers and SMEs.

The Banque de France is closely involved in efforts to enhance **economic and financial literacy**. As the steering body for France's national financial education strategy, it is tasked with coordinating the actions of all stakeholders in this field. In January 2017 it launched an educational web portal for the general public known as *Mes questions d'argent*, and in October it signed an agreement with the Ministry of Education aimed at raising awareness of financial issues among teachers and students. More broadly, it is also committed to helping the most vulnerable households by striving to reduce overindebtedness and increase banking inclusion.

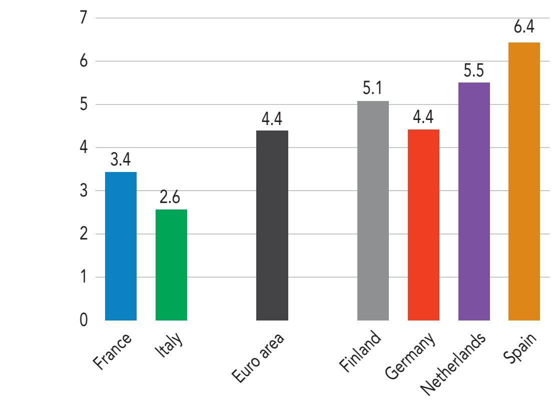
**

Tackling these two challenges – boosting competitiveness, including in the public sector, and reducing structural unemployment – is fully compatible with the European social model and with fair growth; indeed, it is an essential precondition for both of them.

Meeting these challenges will help to lift potential growth in France, by stimulating productivity and increasing the available labour force. And increasing potential growth is a prerequisite for safeguarding the social model that France shares with its European neighbours, as it will notably guarantee the long-term financing of the health and pensions systems.

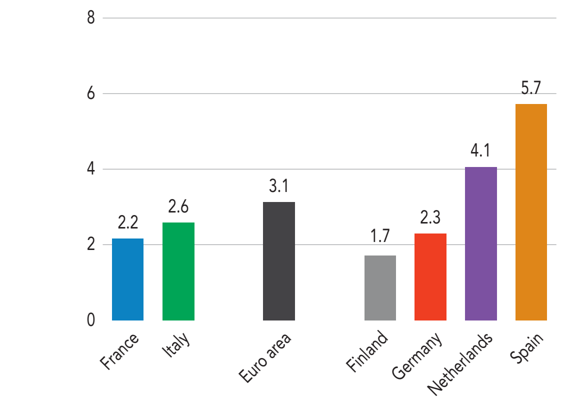
19 OCDE (2018), *Opportunities for all: A framework for policy action on inclusive growth.*

Chart 14 Cumulative GDP growth, 2016-2017



Source: Eurostat.

Chart 15 Cumulative growth in market sector employment, 2016-2017



Source: Eurostat.

The experience of our neighbours shows that it is indeed possible to have a collective mobilisation in support of these goals, while also maintaining our European social model (see Charts 14 and 15). Finland is the latest euro area country to have done so, after several others before it.[20]

Europe can and should be proud of its social model – euro area countries all have in common the three main components of this model: a high standard of public services and particularly education, less inequality and intense social dialogue. This social model is not incompatible with economic success, provided the necessary reforms are implemented. Many of our neighbours have successfully managed to achieve this compatibility, and France can in turn work towards it with confidence. These national reforms are essential in order to lock in the favourable effects of the Eurosystem's monetary policy. However, they do not remove the need for vital reform at the euro area level (see Section 2); on the contrary, they make it even more legitimate and urgent. If France "seizes its opportunity" today with its own strategy, it will be in an even stronger position to ask that Europe follow suit. At a time when the international environment remains favourable but still fragile, the biggest risk would be to sit back and do nothing. "We must dare or resign ourselves to everything."[21]

Paris, 18 June 2018

François Villeroy de Galhau

20 In June 2016, Finnish trade unions and employers' confederations signed a tripartite reform agreement with the government. Finland rapidly saw an increase in its pace of GDP growth, to around 3% in 2017. The unemployment rate fell to 8.4%, and the forecasts for the next few years are also very positive.

21 Titus-Livius.