Banque de France

Letter to the President of the Republic

2019

Achievements and challenges of the euro, 20 years after its creation

BANQUE DE FRANCE
EUROSYSTÈME

Achievements and challenges of the euro, 20 years after its creation

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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Summary

In early 2019, the euro celebrated its 20th anniversary. Since its inception, it has been a tremendous economic and political ambition. Its achievements are decisive; and the challenges it faces are almost as great: hindsight must therefore guide future actions.

The euro has delivered its two founding promises: ***price stability****, with an average annual inflation rate of 1.7% in Europe, almost three times lower than the 20 years preceding it, and* ***exchange rate stability****, which is essential for businesses operating in the Single European Market. It has thus garnered high levels of confidence among the 340 million Europeans: this confidence is the greatest achievement and the greatest obligation of an efficient, decentralised and independent Eurosystem of central banks.*

Moreover, the euro has led to a sharp decline in the financing costs of France and its citizens. At a time when purchasing power is the focus of attention, it is important to quantify our progress: much lower inflation, i.e. 1.4% per year on average since 1999; more contained prices for the most frequently purchased products, including the famous baguette (increasing only 1.6% per year on average); and consequently a purchasing power per capita that has risen by a cumulative 20% since 1999, which far exceeds that of the rest of the euro area. Admittedly, this does not always match perceptions, partly because these averages do not reflect people's individual situations. But criticisms have also been levelled at the excessive facilities that the euro appears to have generated for our country, by letting up on wage competitiveness and by favouring government deficits through low interest rates. The example of our neighbours nevertheless shows that the key here resides in our national choices, rather than in our shared currency.

These achievements of the euro are not a reason for complacency, but rather call for continued efforts to tackle three challenges. The first challenge is to ***increase resilience****: the financial crises of 2007-09 and 2011-12 required very accommodative monetary policy. This has been effective, with an estimated almost 2% of additional growth and inflation in Europe between 2016 and 2020, and has contributed to the creation of 10 million jobs since 2013. But this non-standard policy must be gradually adapted, in relation to the length of the current economic slowdown. Furthermore, the euro area has not yet completed its Banking Union launched after the crisis, and we must aim to have more pan-European, cross-border banks.*

Second, in order to ***better share prosperity****, the euro area must not only boost growth but equally its convergence. In the past 20 years, per capita growth and employment have increased almost as much as in the United States; but North-South convergence and with it mutual trust, have deteriorated since the crisis. The solution calls for determined domestic reforms – including in our country –, the use of available fiscal leeway and, lastly, strengthening Economic Union. As regards the latter, better channelling the EUR 340 billion savings surplus towards the financing of investment and innovation in Europe- would be just as decisive as the public measures currently being discussed.*

The third challenge is to ***affirm sovereignty, through the international role of the euro****. This is more recent, for obvious geopolitical and economic reasons, to better protect our businesses. But more broadly it must illustrate an ambition: rather than allowing a wait-and-see attitude to prevail before the next crisis, we must now consolidate all the achievements of the euro, and optimise its potential to the benefit of all European citizens.*

This "Letter" is traditionally the occasion to consider the main challenges of our time, and propose economic policy recommendations. Unlike in previous years, in 2019, we will focus on a specific theme central to the Banque de France's responsibilities: the euro, whose 20th anniversary has just been celebrated by Europe. It has been the single currency of the European economy since 1 January 1999, even though banknotes and coins were not put into circulation until early 2002.

Called for since the outset by the leaders and democracies of Europe, the euro is a tremendous economic and political ambition. It is also the focus of recurring debates on topics ranging from purchasing power in France, to its ability to stabilise Europe and to strengthen it so that it can withstand global tensions. Twenty years after its creation, it therefore seems essential to make a substantiated assessment of the achievements of the euro, but also to address the challenges that remain in order to consolidate this success.

I. Measuring the achievements of the euro

There are two ways to assess the achievements of the single currency: first, *for the euro area as a whole*, its two founding objectives (price stability and exchange rate stability) have been met, which explains European citizens' strong attachment to their shared currency. Second, for France and its citizens, these shared benefits are rightly accompanied by more specific debates.

1.1 Achievements for the euro area, in terms of the founding objectives

Price stability

The European Central Bank (ECB) and the national central banks of the 19 countries that have adopted the euro – which together make up the Eurosystem – have had a clear mandate since the outset. This mandate was democratically defined in the European treaties:[1] "maintaining price stability". Price stability preserves household purchasing power; it builds confidence in the value of the currency and consequently reinforces the confidence of economic players in all their decisions for the future, from investment to contract conclusion.

Alongside this primary objective, the Eurosystem also supports the Union's general economic policies, in particular those contributing to full employment and balanced growth,[2] and the stability of the financial system".[3] Some observers advocate a "dual mandate" to target both inflation and growth or full employment, as is the case with the US Federal Reserve (the Fed), for example. This would nevertheless have been politically unattainable given Germany's traumatic experience with inflation, and in practice it makes little difference ex-post:[4] European monetary policy also contributes to growth and employment (see below).

1 See Article 127 of The Treaty on the Functioning of the European Union.

2 See Article 3-3 of The Treaty on the European Union.

3 See Article 127-5 of The Treaty on the Functioning of the European Union.

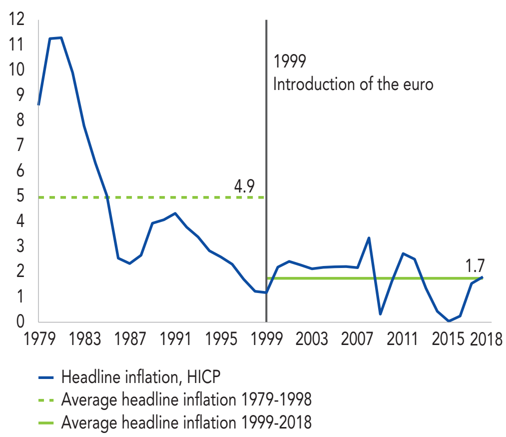
4 Speech at the Banco de Portugal, François Villeroy de Galhau, 22 February 2019.

In 1998, the ECB established a precise definition of this price stability that it went on to clarify in 2003: maintaining inflation rates below, but close to, 2% over the medium term. Two main reasons justify this target being above zero:[5] (i) to ensure a safety margin to safeguard against the risk of deflation and too low nominal interest rates; and (ii) to account for a possible overestimation of inflation figures.[6] Other major central banks such as the Fed and the Bank of Japan have since followed the example of the ECB and adopted the same 2% inflation target in 2012 and 2013 respectively.

Twenty years after the introduction of the euro, the achievements are tangible: average inflation has stood at 1.7%, which is close to its target (Chart 1). Compared with the 20 years preceding the euro (1979-98), consumer prices have risen almost three times more slowly since 1999.

Chart 1 Euro area annual inflation rate

(%)



Note: HICP, Harmonised index of consumer prices.
Sources: Eurostat, AWM dataset and Banque de France calculations.

Exchange rate stability

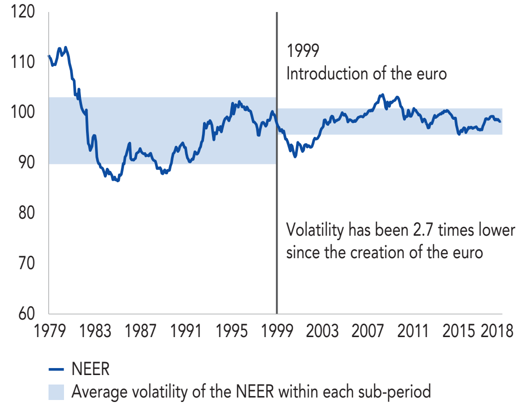
Another key objective of the euro was to foster exchange rate stability between the 19 Member States. The euro has had the obvious advantage of simplifying daily life for European citizens and companies. Before the euro, a country could, admittedly, temporarily shore up the competitiveness of its exports by devaluing its currency at the expense of its European partners. The positive impact of devaluations was nevertheless debatable: higher import prices decreased purchasing power and hence consumption; devaluations reduced a country's wealth. Moreover, price rises associated with devaluations mechanically affected the wealth of savers. Furthermore, exchange rate turmoil could seriously affect trade within the Single European market, as well as overall growth: this was observed during the crises of the European Monetary System in 1992, and the subsequent recession in 1993 (a 0.8% decline in the countries that make up the euro area today).

More generally, the introduction of the euro helped to reduce exchange rate fluctuations for French exporters (Chart 2). It totally eradicated volatility within the euro area, where France conducts almost 50% of its trade, and at the same time, exchange rate risk also decreased with the rest of the world, particularly with the yen and the dollar. The euro-dollar exchange rate thus remained more stable: the euro traded at USD 1.17 on 1 January 1999 and at USD 1.14 at end-2018, with an average rate of USD 1.21 between 1999 and 2018.

5 "The ECB's monetary policy strategy after the evaluation, and clarification of May 2003", speech by Jean-Claude Trichet, 20 November 2003.

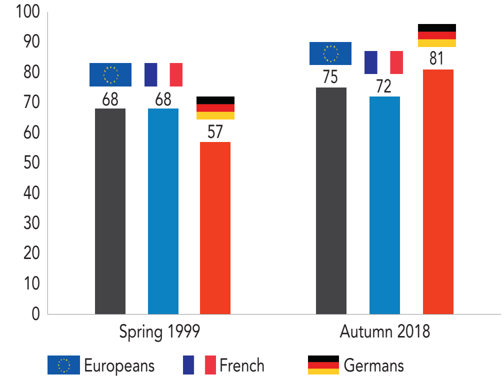
6 Indices can underestimate declines in implicit prices corresponding to the improved quality of goods. Known as the "Boskin effect" from the name of the report published in the United States in 1996 by this economist.

Chart 2 France's nominal effective exchange rate and average volatility before and after the creation of the euro
(100 = 2010)



Sources: Bank for International Settlements, Banque de France calculations.
Note: The average volatility of the NEER is established using the coefficient of variation of the indicator calculated for each period.

Chart 3 European citizens' support for the euro in 1999 and 2018
(%)



Sources: European Commission (Standard Eurobarometer).

Overall, the volatility of France's nominal effective exchange rate (NEER[7]) was 2.7 times lower during the 20 years following the introduction of the euro than during the 20 years preceding it. Our businesses therefore take less risk when trading with their European partners.

Citizens' confidence, partly also thanks to efficient institutions

Thanks to this price and exchange rate stability, the euro benefits from the growing confidence of the 340 million Europeans who share it. Today, the number of citizens favourable to the euro is at an all-time high (Chart 3): 75% of euro area citizens – and 72% of French citizens – support "an economic and monetary union with one single currency, the euro".[8]

This confidence is a decisive achievement at this stage, often acknowledged in national political debates. For the institutions in charge of currency, i.e. central banks, this confidence is both a recognition and an obligation.

• The recognition of a credibility, guaranteed by **independence**[9]: central banks have the duty to fulfil their mandate without being influenced by the media or politicians. And yet, independence is still sometimes misunderstood in our democracies. It is a fair question, but on both sides of the Atlantic, the governments that are most critical of independence are the very ones that have the greatest need for it: their unsustainable fiscal policies, without the anchor of a credible central bank, would threaten price stability.

7 The nominal effective exchange rate (NEER) is a trade-weighted indicator of the value of a currency compared with a basket of foreign currencies.

8 European commission Standard Eurobarometer, question 31, autumn 2018.

9 Article 130 of The Treaty on the Functioning of the European Union.

Box 1

A federal and decentralised Eurosystem

EUROSYSTEM

19 national central banks (NCBs) that adopted the euro — SHAREHOLDERS OF → European Central Bank (ECB)

NCBs' subscribed share of the ECB's capital based on the capital key reflecting the size of the different euro area countries.

- 26.4% Deutsche Bundesbank
- 20.4% Banque de France
- 17% Banca d'Italia
- 12% Banco de España

PRIMARY OBJECTIVE: **MAINTAIN PRICE STABILITY**

DECISION-MAKING

THE GOVERNING COUNCIL

6 members of the ECB's Executive Board
President: Mario Draghi
+
19 Governors of the NCBs including the Banque de France

1 member = 1 vote

COLLEGIAL DECISION-MAKING BASED ON THE WORK OF THE COMMITTEES

DECENTRALISED IMPLEMENTATION BY NCBS

IMPLEMENTATION

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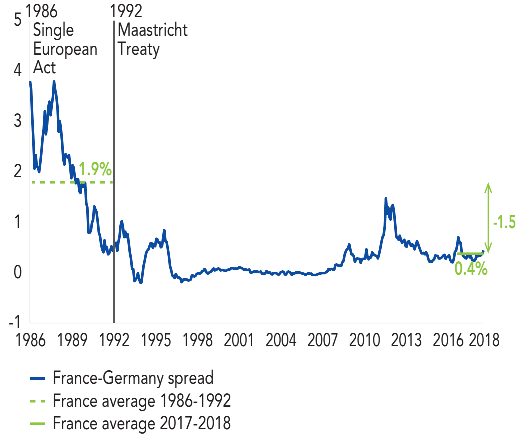
- Execution of monetary policy operations
- Management of certain foreign reserves in the Eurosystem
- Largest producer of banknotes in the Eurosystem (over 1 billion banknotes/year)

• Independence entails an essential obligation: being democratically accountable to its elected representatives and citizens with regard to the fulfilment of its mandate. Since the creation of the euro, each year, the President of the ECB is summoned to four hearings before European parliamentarians representing the citizens; the President holds eight press conferences and, since 2015, the ECB systematically publishes an account of its monetary policy meetings. Moreover, actions must be carried out at the most local level: this is the purpose of a decentralised Eurosystem (Box 1). At the national level, the Banque de France is regularly summoned to hearings by the French parliament, and strives to develop its dialogue with economic and social players.

Chart 4 10-year yield spread between France and Germany



Source: Eurostat.

1.2 Achievements for France and its citizens

Our country and all of its citizens have benefited, like the rest of Europe, from these positive effects, and thus from a significant improvement in their financing conditions. In addition, two more specific questions need to be explored in greater depth: how has purchasing power changed since the introduction of the euro? Has the euro caused excessive facilities for our country?

Favourable financing conditions

Thanks to the euro, a more robust and more trusted currency, France can now borrow at far lower interest rates. This is true first and foremost for the state, and therefore for the taxpayers. Over the 1986-92 period, when we had a single market without a single currency, the ten-year government bond yield spread[10] between France and Germany was 1.9% on average; today it is only 0.4% (Chart 4). Each year, France therefore saves at least EUR 35 billion on its debt servicing, or the equivalent of its annual defence budget.

Purchasing power dynamics

Purchasing power is a constant focus of attention, especially in the past few months in France. Naturally, it is complicated for at least two reasons:

• Purchasing power results from changes in prices and in the cost of living – inflation, which central banks are responsible for controlling – as well as changes in incomes. For each of these terms (see below), perceptions may differ from statistical measurements.

• Moreover, these measures capture averages, which cannot reflect the individual situations to which each French citizen is most sensitive. It is also therefore

10 Interest rate differential between government bonds issued by the various Member States.

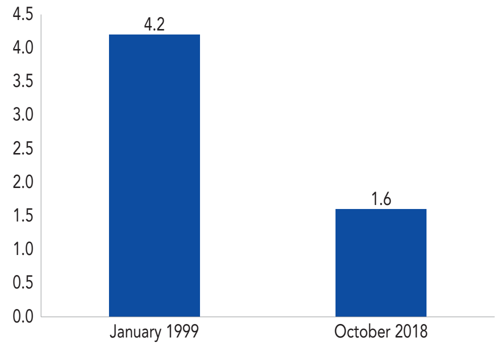
Box 2

Decrease in the cost of bank lending to households and businesses between 1998 and 2018

Interest rates on bank loans to households and small and medium-sized enterprises (SMEs) have also fallen considerably and currently stand at historically low levels. This reduction can be observed in all the main euro area countries. In France, the nominal interest rate on new housing loans to households fell on average from 5.6% in December 1998, to just 1.5% in December 2018; it is among the lowest in the euro area.

Chart a Average rate on investment loans to SMEs

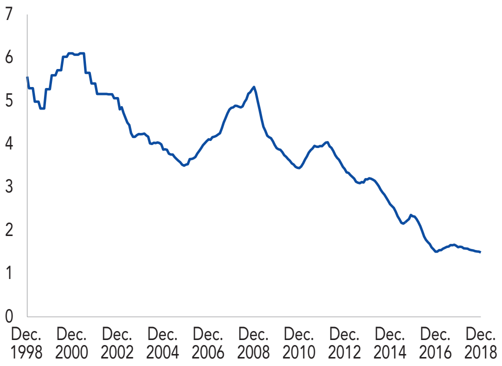
(%)



Source: Banque de France.

Chart b Average rate on new housing loans to households

(%)



Source: Banque de France.

important to be mindful of the inequalities and distribution effects[11]; but the averages observed here remain very meaningful.

Since 1999, **prices** have increased much less rapidly in France, which contributes favourably to household purchasing power. Between 1979 and 1998, consumer prices had risen by 5.1% per year on average in France, against only 1.4% since then. This difference is considerable: before, the price level doubled after 14 years, whereas at 1.4%, it would take 50 years.

These figures, rigorously established by INSEE, are nevertheless often contested: the perception of French citizens is that the euro changeover brought with it

11 See for example INSEE (2018). *Household income and wealth*, 2018 edition, "Insee Références" collection, June.

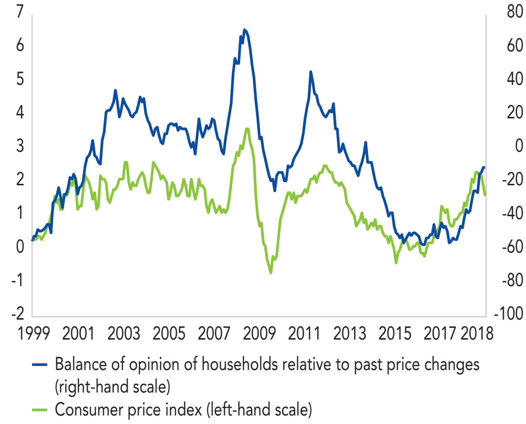
significant price rises, even though the INSEE index only rose by 1.9% in 2002, when the euro came into circulation for the general public (Chart 5). One explanation for this[12] is that consumers appear to pay closer attention to price rises than falling or stable prices. Furthermore, they focus on changes in the prices of the most frequently purchased products, some of which, during the euro changeover, due to rounding effects, were subject to upward pressure.

Historical price series for the baguette and consumer goods nevertheless show that price increases have been moderate since the introduction of the euro (Box 3).

12 INSEE (2017) "Moderate inflation since the euro changeover", *Insee Focus*, No. 87, May, and INSEE (2019), "Fiscal stimuli in the Eurozone against a backdrop of tensions", *Conjoncture in France*, March.

Chart 5 **Comparison between perceived inflation and actual inflation in France**

(price index year-on-year and as a %, balance of opinion in percentage points)



Source: INSEE.

Box 3

Historical price series for the baguette and consumer goods

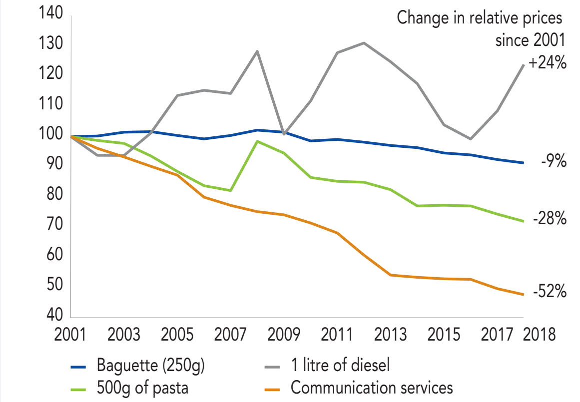
At the end of 2001, just before the introduction of euro banknotes and coins, the baguette cost on average around FRF 4.40, or EUR 0.67. At the end of 2018, it cost EUR 0.90, i.e. a rise of 30% in 17 years, or 1.6% per year on average, which is only slightly higher than the headline inflation rate of 1.4%. Another way to consider this is whether you need to work more today than in 2001 to buy the same baguette. In this respect, in relation to the average wage, the relative price of a baguette has fallen by around 10% since 2001. This is also the case for many goods and services. For instance, since the creation of the euro, rents, the prices of pasta, communication services, etc. have risen more slowly than the average wage per capita. Since 2001, the relative prices of communication services have fallen by over 50% in relation to the average wage, and the price of 500 grams of pasta has declined relatively by 30% (Chart below).

However, other prices rise when for example raw material prices go up. In total, the price of a litre of diesel has risen by 24% in relation to the average wage per capita since 2001, with large fluctuations according to the year and oil price swings.

.../...

The price perception of many products also depends on the ability of households to defer an expense or even put it off indefinitely. Certain expenses such as housing expenditure, food, healthcare, insurance, fuel, etc. are known as "constraints",[1] as households cannot easily do without them. These expenses account for a larger share in France than in other large euro area countries. This share has increased by three percentage points, from 50% in 2001 to 53% in 2018. **Housing expenditure** contributes the most to this rise for two reasons: the increase in the size of dwellings and the decrease in the average number of occupants per household (as people tend to live apart). This can result in a qualitative improvement, but it directly affects the perception of purchasing power. Furthermore the way households feel about their purchasing power is also affected by changes in house prices which started to rise again at the end of 2015. Over the past few years, "discretionary income" per capita[2] in France has increased less rapidly than gross disposable income per capita.

Ratio of basic consumer goods prices to average wage per capita in France
(100 = 2001)



Sources: INSEE and Banque de France calculations.

1 Expenses known as "constraints" are those that cannot be put off or avoided: all housing expenditures; food spending (excluding alcohol and tobacco); health expenditure and social protection spending (creches, childcare, retirement homes); insurance and financial costs; vehicle and transport operation expenses (category including notably fuel for and maintenance of personal vehicles) and telecommunications services expenditure.

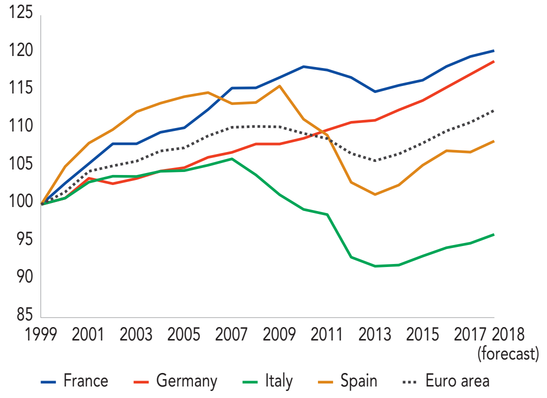
2 "Discretionary income" is calculated as follows: "gross disposable income" minus spending on "constraints".

Purchasing power dynamics do not only depend on price changes: **income** changes are naturally also a factor. It is important to reason in terms of purchasing power per capita, i.e. the ratio of changes in purchasing power to changes in the number of inhabitants.

Since 1999, and up to 2018, purchasing power rose by a cumulative 20% per capita in France (Chart 6) and 16% per consumption unit.[13] This trend can be broken down into three phases. **Between 1999 and 2007**, purchasing power per capita increased on average by 2% per year, driven notably by wage dynamics. **Between 2008 and 2013**, purchasing power per capita inched down by **0.1%** per year on average. With the crisis, nominal wages slowed, employment rose less rapidly that the total population and financial income declined sharply. **Between 2014 and 2018**, purchasing power per capita increased again at an average rate

13 Other methods for assessing purchasing power also exist. For example, INSEE publishes data on purchasing power "by household" and "by consumption unit" (CU). CUs adjusts the concept of a household to take into account the fact that some expenses such as rent, insurance, internet subscriptions, electricity bills, etc. are shared among household members. But purchasing power per capita is the only method that allows for international comparisons.

Chart 6 Cumulative changes in purchasing power in the euro area
(100 = 1999)



Sources: INSEE and Eurostat.

of around **0.9%** per year. This recovery was primarily driven by strong employment dynamics, and by the gradual improvement in wages and, more generally, incomes as a whole. In 2019, purchasing power per capita should continue to rise at a rate of around 2%, or a 12-year high. In particular, it will be underpinned by the emergency economic and social measures adopted in December 2018.

Purchasing power per capita is thus more dynamic in France than in the other large euro area countries. In France, between 1999 and 2018, it rose by a cumulative 20% (1% per year on average over 19 years) compared to 12% in the euro area.

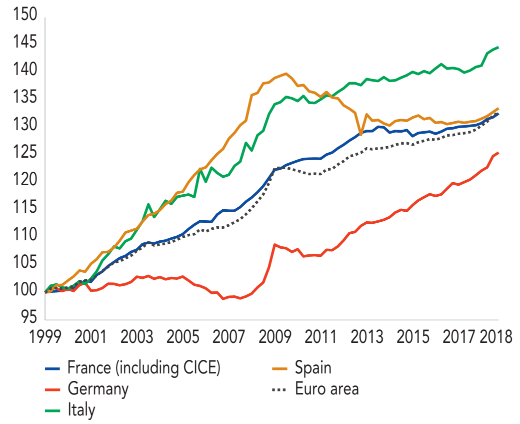
This higher purchasing power growth of French citizens is primarily due to a smaller rise in living costs (a cumulative 27% over 20 years, compared with the European average of 35%). But it also reflects certain income sharing choices: in general, France preferred to raise wages per employee rather than total employment; as regards the latter, it rose by 13% against 15% for the euro area average over the past 20 years, and the French government chose to increase public and social transfers instead of rebalancing public finances. This also raises other questions as to the facilities generated by the euro.

Excessive facilities, at the expense of our competitiveness and our public finances?

There are two aspects to the question as to whether the euro has caused excessive facilities for France:

• The **decline in our competitiveness in Europe** since 1999, largely due to the sharp rises in labour costs in the first decade, which were much higher than that of productivity. Consequently, unit labour costs increased more rapidly in France than in Germany, despite the turnaround in this trend since 2013 (Chart 7).

Chart 7 Unit labour costs in the euro area
(100 = Q1 1999)



Note: CICE, Tax Credit for Competitiveness and Employment.
Source: Eurostat.

Our country seems to have learned the lessons from this; the euro reduces external constraints, but does not dispense with the need for efforts to improve domestic competitiveness, both in quantitative and qualitative terms.[14]

• The **continued rise in our public debt**, which has admittedly been facilitated by lower interest rates thanks to the euro and more recently by very accommodative monetary policy. However, our tendency towards deficit and debt is much older than these accommodative policies. Since 1980, the government debt-to-GDP ratio has increased steadily in France, rising fivefold from 20.8% to 98.4% at the end of 2018. Conversely, since the euro, other countries, such as Germany, Austria and the Netherlands, have managed to improve their public finances. The key to rebalancing the accounts is not therefore to tighten monetary policy but to stabilise public spending, in real terms.[15] In France, the latter reached 56% of GDP in 2018, or 12 percentage points higher than the average for our European neighbours, which nonetheless have a comparable social and public sector model (44% for the euro area excluding France). This efficiency gap weighs on our competitiveness, through the resulting heavy taxes on businesses and households. It is also a question of sovereignty that we have to address: otherwise, there is a risk of our debt snowballing, if future interest rates exceed the growth rate.

14 Letter to the President of the Republic, May 2016 (p. 9) and June 2018 (pp. 9 and 10).

15 Letter to the President of the Republic, July 2018 (pp. 11 and 12).

16 Hartmann (P.) and Smets (F.) (2018), "The first twenty years of the European Central Bank: monetary policy", *Working Paper Series*, No. 2219, ECB, December.

II. Meeting the challenges of the euro

The euro is a success, both in terms of its initial objectives and the public confidence it inspires. But at a time when the economy is slowing down in Europe and tensions are high internationally, we must rally behind the euro if we are to address the challenges it faces. Its achievements cannot be taken for granted and it is still a long way from reaching its full potential. Thus we have three priorities: increasing resilience; better sharing prosperity; and affirming sovereignty at the international level.

2.1 Increasing resilience: the response to the financial crises

The global financial crisis of 2008-09 and the 2011-12 financial crisis in Europe necessitated both a proactive monetary policy stance and the handling of financial fragilities in the euro area through the Banking Union. Both must now be adapted over the long term.

Gradually adapting non-standard monetary policy

At the time of the 2007-09 crisis, the ECB had already considerably expanded its operations.[16] But with the 2011-12 crisis, the euro had to be steadied by a decisive European Council at the end of June 2012 and Mario Draghi's famous "whatever it takes" ("[the ECB is ready to do] whatever it takes [to preserve the euro]") in July of the same year. From 2014 onwards, confronted with the risk of deflation, the ECB mobilised a quartet of non-standard instruments: (i) forward guidance on key interest rates; (ii) the adoption of a negative deposit facility rate for commercial banks since 2014 and set at -0.4% since 2016; (iii) the implementation of private (in 2014) and public (in 2015) asset purchases;[17] and (iv) a substantial provision of liquidity to banks[18] to support bank lending to the economy.

Has this policy been effective so far? Estimates largely agree: the Asset Purchase Programme facilitated a significant reduction in long-term sovereign bond yields of 100 basis points for Germany and more than 150 basis points for France. The package of non-standard measures will have added an estimated total of 1.9% to inflation and growth over the 2016-20 period,[19] thereby contributing significantly to the 10 million net job creations in the euro area since 2013.

Encouraged by this improvement, the Governing Council began to gradually normalise its monetary policy in 2018. But when confronted with the current slowdown in the euro area, with only 1.1% of projected annual growth in 2019 after 1.8% in 2018, will the Eurosystem be able to exit its non-standard policy stance? And at the same time, does it have the means to deal with a euro area economic environment that could prove to be lastingly degraded, falling short of the 1.6% growth and 1.5% inflation still envisaged for 2020? The common response to these two apparently conflicting questions lies in the active combination of the clarity and flexibility available to the Eurosystem. The process of normalisation follows a very clearly defined sequence: after the successful phasing out of net asset purchases in January, the next potential step is to raise key interest rates but they will remain at their present levels at least through the end of 2019. Then, after an extended period, there will be a gradual reduction in the reinvestment of principal payments from the substantial stock of assets still held by the Eurosystem (almost EUR 2,600 billion).

This timetable can be flexibly adapted as required to reflect actual changes in the economic data and the intensity of the various instruments will have to be pragmatically calibrated accordingly. In keeping with its mandate, the monetary policy stance will remain accommodative for as long as necessary to achieve the medium-term inflation target.

The decisive response to the sovereign debt crisis, the Banking Union must be consolidated

The recapitalisation of ailing banks and the fragmentation of the European financial area contributed to the sovereign debt crisis of 2011 and 2012, with significant tensions in southern Europe, in Italy, Spain, Portugal and Greece. The European Council thus decided to create the Banking Union, based on the introduction of three pillars in logical succession. The first pillar, the **Single Supervisory Mechanism**, became fully operational in 2014 and attributed overall responsibility for euro area banking supervision to the ECB, in cooperation with national supervisory authorities such as the ACPR[20] in France. The second, less known, pillar, the **Single Resolution Mechanism**, came into operation at the beginning of 2016 and in principle should guarantee that in case of difficulties, all large euro area banks are able to follow a resolution process in accordance with the same rules and at a minimal cost to the taxpayers and to the real economy. The third pillar, the European Deposit Insurance Scheme, often receives

17 Asset Purchase Programme (APP).

18 Targeted Longer-Term Refinancing Operations (including TLTRO II and III).

19 ECB (2019), Economic bulletin, March.

20 *Autorité de contrôle prudentiel et de résolution* (ACPR – Prudential Supervision and Resolution Authority).

greater public attention, but it should not be the focus of our efforts until the first two pillars function better in practice and national obstacles have been overcome; we are not there yet.

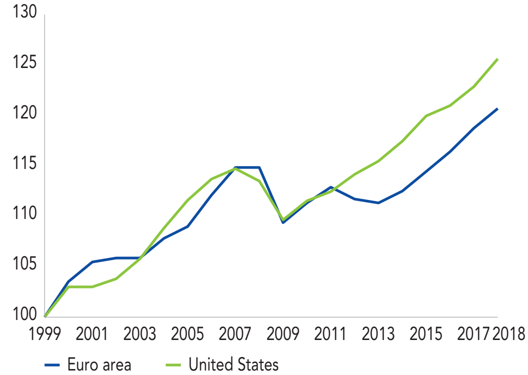
Lastly and most importantly, an effective and beneficial Banking Union is impossible without genuine pan-European banks and cross-border consolidation: in the United States, the top five commercial banks now account for more than 40% of business activity and operate across state lines. In the euro area, the market share of the top five banks is less than 20% and their operations are essentially domestic. Furthermore, 2018 saw the lowest number of European banking mergers since 1999. This need for a genuine "single banking market" has been further reinforced and broadened by Brexit, which is bad news not only for the United Kingdom, but for Europe as well. However it can also in part represent an opportunity to strengthen financial integration in the euro area within a "financial Eurosystem", and repatriate European savings intermediation in Europe.

2.2 Better sharing prosperity: increasing growth, but also convergence

Contrary to a widely shared perception, GDP per capita has grown almost as rapidly in the euro area as in the United States since the introduction of the euro: between 1999 and 2018, cumulative GDP per capita growth reached 21%, compared with 26% in the United States, with the gap arising from the European crisis of 2012 (Chart 8). Equally, the United States and the euro area have seen largely similar increases in employment over the past 20 years (Chart 9).

Chart 8 Comparison of real GDP per capita

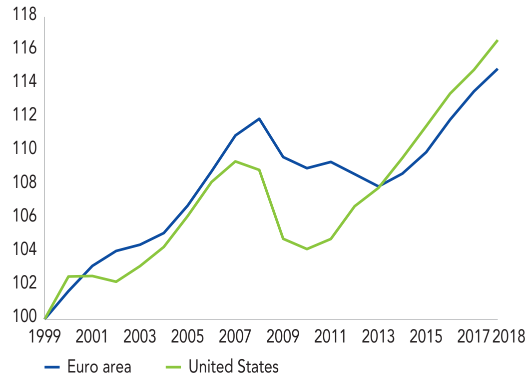
(100 = 1999)



Sources: World Bank and Eurostat.

Chart 9 Comparison of changes in employment

(100 = 1999)



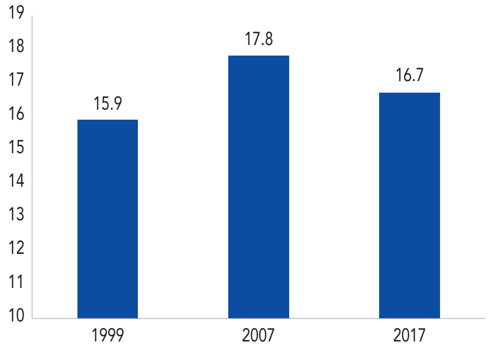
Sources: World Bank and Eurostat.

Furthermore, the euro area has welcomed seven new members[21] into the fold since its creation, which demonstrates its appeal. Nevertheless, for a long time, with the exception of the catch-up during the 2000s (Chart 10), the euro has not done enough to promote

21 Cyprus, Estonia, Latvia, Lithuania, Slovakia, Slovenia and Malta.

Chart 10 "Catch-up" countries' share of total euro area GDP in 1999

(%)



Note: "Catch-up" countries refer to countries with GDP per capita less than or equal to median income in 1999, i.e. Spain, Portugal, Greece, Cyprus, Latvia, Lithuania, Estonia, Slovakia, Slovenia and Malta.
Sources: Eurostat and Banque de France calculations.

the convergence of income levels between partner economies. On the contrary, since the crisis we have witnessed ever-greater divergence between growth trends: the share of so-called "catch-up" countries in total euro area GDP declined from 17.8% to 16.7% between 2007 and 2017. More generally, mutual trust between member states and particularly between the North and the South of the euro area appears to have deteriorated.

There are a variety of reasons for this divergence but the banking and financial systems of the most vulnerable countries were the worst affected by the financial crises of 2008-09 and 2011-12, creating local funding gaps. The completion of the Banking Union (see above) should therefore also contribute to convergence.

Moreover, achieving increased growth and convergence involves three main initiatives: firstly, continuing national reforms, but also the use of certain fiscal leeway and the strengthening of the Economic Union.

Continuing national reforms, conducive to lasting growth and employment

The euro has not removed the need for ambitious national reforms, which fortunately is a subject of democratic debate in each of our countries.[22] The case of Spain and Portugal, where growth is once again above average, confirms that the main key to convergence is reform: reforms are compatible with our European social model. France is already reaping the benefits of the reforms introduced in recent years, particularly strong employment growth, accelerated by the CICE competitiveness and employment tax credit, during the past three years (785,000 net job creations between 2016 and 2018). These new jobs, alongside the emergency measures adopted in 2018, contribute to our robust domestic demand and the better resilience of our economy today. In 2019, and for the first time since 2005, the French economy should thus report far better growth than the German economy (1.4% compared with 0.7%)[23] and should outpace the European average.

In this context, France must stay the course in its ambition for lasting reform. Growth and employment are currently stymied notably by the recruitment difficulties faced by businesses. This situation is paradoxical and unacceptable in a country where 2.4 million people are still unemployed[24] but reflects a structural unemployment rate, which, at almost 9%, is far too high. The priority is therefore to target the four levers that will help to reduce structural employment: apprenticeships, professional training, education and unemployment

22 Banque de France, *Letter to the President of the Republic*, May 2016, July 2017 and June 2018, p. 16.

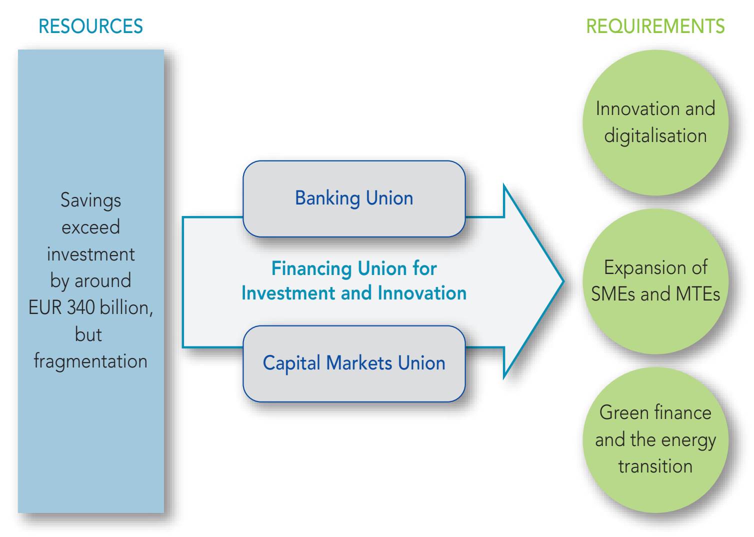
23 OECD, March 2019.

24 According to the International Labour Organization (ILO) definition.

Box 4

Mobilising private savings in the euro area

The euro area has an abundant, and rarely mentioned, resource at its disposal: a savings surplus[1] relative to investment, which amounted to EUR 340 billion in 2018. As economists explain, it is the equivalent of the euro area's overall external surplus, at 3% of euro area GDP. This resource is currently invested outside the euro area, even though the potential investment requirements of the euro area are substantial, for innovation and digitalisation,[2] the expansion of SMEs and MTEs by bolstering equity capital,[3] the energy transition, which is naturally essential, or certain infrastructure requirements.



Allocating the European private savings resources to these requirements necessitates more efficient cross-border financing channels – savings are not always in the countries where the need arises – and more efficient "transformation": savings are often safe and short-term, while financing products should be longer-term and riskier. This requires a more effective Banking Union, but also a "Capital Markets Union". There is a political consensus in principle for this, but faster progress in terms of its technical content now appears essential.[4]

The combination of the Banking Union and the Capital Markets Union would make for a genuine "Financing Union for Investment and Innovation", whose name in itself would underline the decisive – and achievable – challenges of the euro area.

1 The overall surplus is equal to the private sector surplus less public sector financing requirements.

2 A European Investment Bank assessment performed for the European Union estimated an annual requirement of EUR 140 billion.

3 Equity financing in the euro area represents a total of 80% of GDP, far less than in the United States (122%). This difference contributes to Europe's innovation lag.

4 ECB (2018), "Establishing the capital markets union", *Financial integration in Europe*, May, p. 56 onwards.

benefit. With regard to apprenticeships and professional training in particular, the "Professional Future" Law passed in 2018 is a powerful lever and must now be imperatively and patiently implemented by all public and private players. At the same time, the reforms to encourage the smooth functioning of the goods and services market must continue as they can bring rapid and substantial gains in consumer purchasing power.[25]

Using fiscal leeway, where available

Beyond national reforms, the use of fiscal leeway where it is available is essential. Due to their high debt and public spending levels, however, France and Italy, for example, have very little leeway (see above).

Germany and the Netherlands, on the other hand, have slightly activated their fiscal policies but without committing to a genuine stimulus package. Countries that enjoy fiscal leeway could now exploit it to support growth in their own country and in the euro area too. And thanks to policy synergies and spillover effects between countries, better coordination of fiscal and structural policies would give a greater boost to this support compared with isolated measures alone. According to several studies,[26] the benefits of this type of coordination could represent an increase of 1-2 percentage points of GDP, particularly when central bank key interest rates reach their floor.

Parallel strengthening of the Economic Union

The euro area needs national reforms **and** European cooperation rather than national reforms **or** European coordination as it has been framed for far too long as part of a fruitless North-South debate. A main objective of this strengthening is the stabilisation of the economic outlook: when confronted with negative shocks, monetary policy must not and cannot be the only game in town; thus, while these economic reversals may only hit certain countries – asymmetrical shocks in peripheral countries for example – stronger economic stabilisation mechanisms are needed. Attention often focusses on the **public** mechanisms debate: the European Stability Mechanism (ESM) introduced in 2012 was a powerful tool for the ex-post management of the crises experienced by certain countries such as Ireland and Greece. However, the ESM should also help prevent crises: the access criteria to its "precautionary credit lines" remain far too restrictive. In addition, the Economic Union should also be provided with a common fiscal capacity, which can contribute to convergence and competitiveness, but without losing sight of the ambition for a stabilisation function too. If this condition is respected, it would support the single monetary policy and price stability in the common interest of all euro area countries.

At the same time, **private** risk-sharing and stabilisation mechanisms, which are less frequently considered, are at the very least just as important and effective, as we can see in the United States where the capital markets play a more important role as a buffer between states than fiscal transfers.[27]

25 In a recent speech to the French Competition Authority, the Prime Minister announced a package of measures for the automobile industry and the health and housing sectors.

26 Arce (O.), Hurtado (S.) and Thomas (C.) (2016) "Policy spillovers and synergies in a monetary union", Banco de España; Gaspar et al. (2016), "Macroeconomic Management When Policy Space Is Constrained: A Comprehensive, Consistent, and Coordinated Approach to Economic Policy", IMF; Banque de France (2017), "The cost of deficiencies in euro-area economic policy coordination".

27 Sorensen (B. E.) and Yosha (O.) (1998), "International risk sharing and European monetary unification," *Journal of International Economics*, Vol. 45(2), Elsevier, August, pp. 211-238.

2.3 Affirming sovereignty: the international role of the euro

Expanding the international role of the euro does not figure in the ECB's mandate and was not among its priorities in 1999. Nonetheless, the euro has gradually emerged as an alternative to the US dollar. The euro is the second most widely-used currency in the international monetary system, accounting for 34% of the total value of international transactions, which is close to that of the US dollar (40%). However, although the use of the euro internationally grew significantly in the beginning, it has tailed off since the financial crises of 2008 to 2012, and lags far behind the dollar in terms of both currency reserves and international debt (20%).

Now that the euro's popularity within Europe is assured, it must grow in importance internationally, primarily for obvious geopolitical reasons of European sovereignty.[28] The US dollar is a clear advantage in the exercise of American power, while China is now concerned with the internationalisation of the renminbi. But there are also economic reasons: as globalisation has expanded over the past 20 years, wider use of the euro would help to protect our businesses against foreign exchange risks or legal disputes abroad. The concrete measures to promote the euro identified by the European Commission in December 2018[29] are therefore timely. The development of fully unified European instant payment systems and integrated capital markets, and the later creation of a secure and broad euro-denominated security, would contribute to both the international expansion of the euro as well as its domestic consolidation.

**

In 20 years, the euro has become more than a trusted currency: it is a major achievement and a source of pride for Europe. It has overcome significant initial scepticism from the rest of the world and has weathered the strains of two severe crises, and the ECB has lived up to its promise on price stability, with an average annual inflation rate of 1.7%. The euro has thus, and above all, earned the strong support of 340 million Europeans: the citizens of Europe are attached to their currency, and aim to keep it.

But this success is not a reason for complacency: as a currency without a state, the euro is still a unique construction. It was born of a rare alignment between German unification and the political inspiration of Jacques Delors, Helmut Kohl and François Mitterrand but has since mainly grown up during crises, out of necessity rather than planning. While ambitious proposals had been brought to the table, it now seems that there is an unspoken temptation to postpone much of the progress until the next crisis. This would be dangerous, and it would be a great pity: because all the paths favoured in this letter are accessible – without revising treaties or making substantial fiscal transfers – from a Financing Union to an expanded international role; and because the euro deserves better than a wait-and-see attitude in order to optimise its potential to the benefit of all European citizens.

Paris, 2 April 2019

François Villeroy de Galhau

28 Mario Draghi (2019), *Sovereignty in a globalised world*, Speech given at the University of Bologna, 22 February.

29 European Commission (2018), "Towards a stronger international role of the euro", communication, December.