BANQUE DE FRANCE
EUROSYSTÈME

Letter to the President of the Republic
2020

French and European economies put to the test by Covid-19

Letter submitted to
the President of the French Republic,
the President of the Senate and
the President of the National Assembly

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SUMMARY

The Covid-19 shock to our economy has been of unprecedented severity: after the plunge of 32% in economic activity at the end of March, the recovery initially followed a "half-V" shape with the losses coming back to 9% by end-June, and is now expected to gradually flatten out in the form of a "bird's wing". Despite this certain rebound, unemployment should peak temporarily next year, and the French economy is not expected to return to its pre-crisis level until 2022. This global shock is slated to be greater overall than that of the 2008-09 financial crisis, but less pronounced than the depression of the '30s.

Fortunately, the public authorities reacted quickly: public support has played a massive role in protecting households and SMEs, although at the price of a historic deficit. France has stood out for the success of its state-guaranteed loans (SGLs) and its high level of short-time work compensation. As of March, European monetary policy stepped in to create a "liquidity shield" via banks and the markets: interest rates are the lowest in the world and volumes are almost unlimited, ensuring the smooth financing of the economy and governments. In this way, we have made sure that the health and economic crisis has not been compounded by a financial crisis.

We now need to move from the emergency phase towards reconstruction. In the face of considerable concerns and impatience, which are prompting an ever-increasing amount of ad-hoc aid, the government cannot do everything, and should not do it on its own. Rather than expecting too much from fiscal and monetary policies alone, or from illusions of a public debt cancellation or its conversion into perpetual debt, we can collectively build an economically stronger "post-crisis France", by meeting two demanding conditions. The first is the establishment of a "triangle of confidence" for private sector agents, to help them plan for the future. The confidence of **households** is key to ensuring that their EUR 100 billion of additional savings are channelled into consumption: this requires a fiscal guarantee, in the form of overall tax stability, a social guarantee with unemployment insurance, and a training guarantee. In order to address the profound changes in employment and combat inequalities, the most effective reforms in France are those promoting apprenticeships, professional training and education. The confidence of **businesses**, which drives their investment decisions, requires renewed efforts towards simplification and support for their post-crisis capital needs. In this respect, public funding, in the amount of between EUR 10 billion and EUR 20 billion, will need to be selective – investing only in viable companies – and partnership-based – with private professionals. Lastly, confidence in banks is contingent on them remaining sound.

The other pillar of the reconstruction, to support businesses and households, is the cooperative interplay between three major economic policies, whereas Europe has become overly accustomed to a lack of coordination. **Monetary policy** must remain independent, but can make a significant contribution in accordance with its price stability mandate: in response to a shock that is further weakening inflation, which until 2022 is expected to remain well below its target of close to 2%, the Eurosystem will maintain very low interest rates and very abundant liquidity for as long as necessary. The central bank can buy time through monetary creation, but it cannot create wealth. **Domestic fiscal policy** has been deployed massively, and in France is close to its limits with public debt set to reach 120% of GDP at the end of 2020 – a twofold increase in only twenty years. In the short term, the focus should be on temporary spending, while resisting the ever-present temptation to make permanent, unfunded tax cuts. After 2022, if we set the "Covid debt" aside in a sinking fund for a decade, it will be even more important that we start to reduce our ordinary debt by finally stabilising our public spending in real terms. Finally, the decisive novelty will be a genuine **European fiscal policy**. In order to address the increased risks of a north-south divide, such a policy is crucial and must go beyond negotiations over allocations between countries in order to promote common structural progress: investment in both the climate and digital transitions, and a carbon tax, underpinned by the re-establishment of the rules on state aid, if the single market is to be preserved. In the face of the serious failures of the United States and China, a more united Europe can also have greater influence on multilateralism and developing economies, which are once again being overlooked in the crisis.

In the midst of so much uncertainty, we need to remain confident that we can overcome this shock. And not through quick-fixes that would again weigh on the future, but through our work and through determined and fair solutions. It is through the quality of our collective game and our dialogue, in France and in Europe, that we will be able to regain our confidence. In that case, this harsh crisis will also have been an opportunity to transform towards a more innovative and sustainable economy.

This "Letter" is traditionally the occasion to consider the main challenges of our time and propose economic and monetary policy recommendations. In 2019, it marked the 20th anniversary of the euro. This year, it naturally focuses on the Covid-19 crisis. In order to save lives, drastic restrictive measures have been introduced worldwide that have severely affected global economic activity, far beyond the scope of the initial health shock. Never in peacetime has there been such a dramatic reduction in economic activity. The snapshot at the end of June 2020 confirms the severity of the shock, as does the unprecedented scale of the support provided (1). But we now need to move from the emergency to reconstruction: this requires a "triangle of confidence" for private sector agents and the coordinated deployment of public policies (2).

1

The emergency: faced with a shock of unprecedented severity, marshalling a massive and on the whole effective response

1.1 An unpredictable shock of unprecedented magnitude

The French economy has suffered an unpredictable shock of unprecedented magnitude and severity. What was initially an external shock – from China – became in the space of a few weeks a massive domestic shock that paralysed whole sectors of our economy for almost two months, as of 17 March *(see Figure 1)*. What was initially a supply shock has also become a demand shock. And what was once temporary will also have persistent effects.

Overall, the two months of strict lockdown "cost" the French economy around 6 percentage points of annual GDP, with very pronounced differences across sectors: business services were far less affected than services to individuals, with accommodation and food service activities being the hardest hit; the agri-food and pharmaceutical industries were little affected, in contrast with the automotive and aeronautical industries.

The second phase, which began on 11 May, has been marked by a significant recovery in economic activity, which is discernible in our monthly business surveys (a loss of activity of 17% at end-May, compared with –9% at end-June), and is expected to flatten out in the form of a "bird's wing" (*see Chart 1*). This intermediate phase of recovery is projected

Figure 1 How the health crisis spread to the European economy

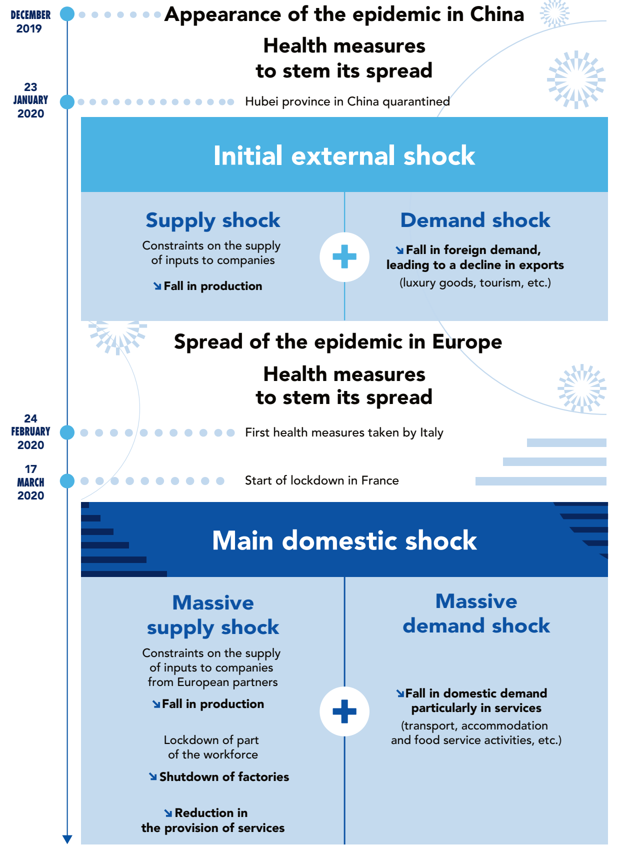
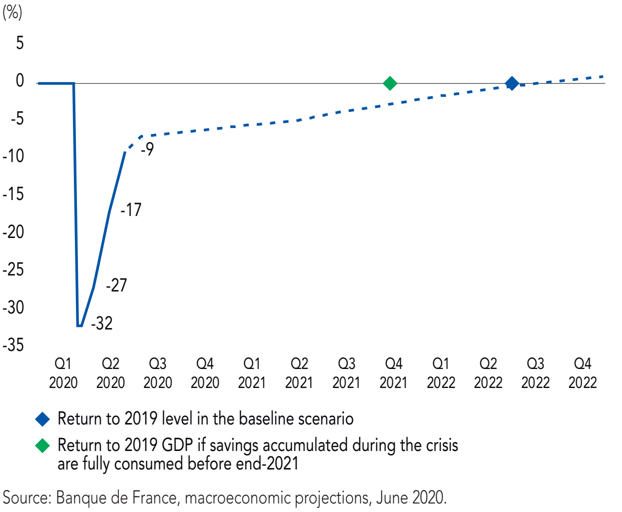


Chart 1 A recovery in the form of a bird's wing



Source: Banque de France, macroeconomic projections, June 2020.

Box 1

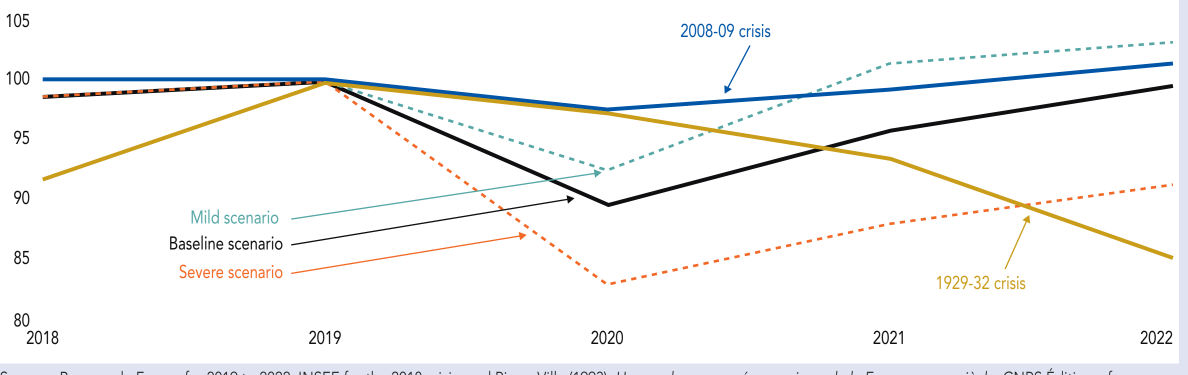
COMPARISONS BETWEEN THE CURRENT CRISIS AND PREVIOUS CRISES

The economic shock caused by the Covid-19 crisis is unique in the economic history of our country: it has been both a deep and very sudden crisis *(see chart)*. GDP is projected to fall by 10% in 2020 in the baseline scenario, compared to a decline of just 2.8% in 2009 in the wake of the financial crisis. During the Great Depression, it fell by 15% over three years (between 1929 and 1932). However, the rebound is expected to be significant in 2021 and 2022, also due to the more rapid and convergent economic policy responses than in previous crises.

From a strictly economic perspective, the recession caused by Covid-19 displays some similarities with, but also differences from a wartime situation. The shock is of course less severe and less persistent, but the fall in consumption and private investment in both cases is sudden and massive, while savings increase significantly. The budget deficit and public debt rise sharply, and monetary policy aims to safeguard financial stability and ensure the smooth financing of the economy. But fortunately, in this relatively short shock, there is no material destruction, especially of productive capital.

Comparison with previous crises and recovery scenarios

(2019, 2007 or 1929 = 100)



Sources: Banque de France for 2019 to 2022, INSEE for the 2018 crisis, and Pierre Villa (1993), *Une analyse macroéconomique de la France au xxe siècle*, CNRS Éditions, for the1929 crisis.

to cost the French economy about four additional points of GDP. According to the Banque de France macroeconomic projections published on 9 June,[1] economic activity is thus expected to decline by 10% in 2020 before rebounding by 7% in 2021 and by 4% in 2022. Despite this catch-up, France is only expected to return to its pre-crisis level of activity during the course of 2022. However, two different scenarios are possible: (i) a mild scenario where improved confidence among households prompts them to consume their savings, and leads to a return to "pre-crisis" conditions by end-2021; and (ii) a severe scenario where health restrictions remain in place due to fears of a "second wave".

Consequences for the different economic players

Households are at this stage relatively protected, with the average loss of income limited to 15% of the total in 2020 – a large share of which is accounted for by the self-employed – which is well below their share in national

1 Banque de France, *Macroeconomic Projections France*, June 2020.

disposable income (61%). This overall situation must not, of course, mask the plight of the most fragile households, which have suffered income losses[2] that warrant specific public support, which is expected to reach EUR 1 billion in 2020. Although mitigated by the short-time work scheme, the deterioration in the labour market will nevertheless be significant: according to our forecasts, **the unemployment rate** could temporarily peak at over 11% in mid-2021, before falling below 10% by 2022. The average decline in purchasing power should be limited in 2020 (–0.5%), due to compensation payments and very low inflation (just 0.4%). In 2021 and 2022, purchasing power is projected to rise again, increasing by a total of 4% per capita over five years, as of 2017. Overall, household consumption is expected to have fallen considerably more than household income during the lockdown, resulting in a **savings glut, or significant "forced savings"**, that could reach EUR 100 billion in 2020, or a "reserve" of more than 4% of GDP, or 8% of household consumption.

As regards **businesses**, the massive liquidity support has already been effective, but the irrecoverable losses in turnover will have impaired the solvency of some firms. Overall, they are expected to shoulder 24% of the shock in 2020, i.e. more than their share in national income (13%). **Public support** has played its role massively – and fortunately so – during the crisis: in 2020, general government will bear around 61% of the cost of the shock. But this will cause public debt to rise by at least 20 percentage points to stand at 120% of GDP by the end of 2020.

Severe impacts for all European countries, but with some differences

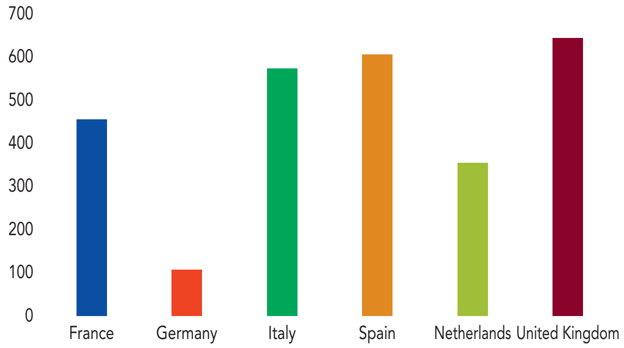
The health shock has affected European countries to varying degrees, but the economic shock has been more symmetrical due to the restrictive measures that have ended up being substantial in all countries.

For 2020 as a whole, the recession is expected to be widespread in Europe (–8.7% for the euro area) and worldwide,[3] including in the United States (–6.5%),[4] in the baseline scenario, without a second wave. The countries less affected in 2020 should, however, see less of a rebound in 2021 and 2022: Germany is only expected to return to its pre-crisis GDP level by the end of 2021, followed by France, before Italy and Spain. Nevertheless, asymmetric factors such as the size of the different national stimulus packages, could increase the divergences between the main euro area countries. As a result, a coordinated response is necessary at the European level *(See Part 2)*.

Chart 2 Health and economic shocks in Europe

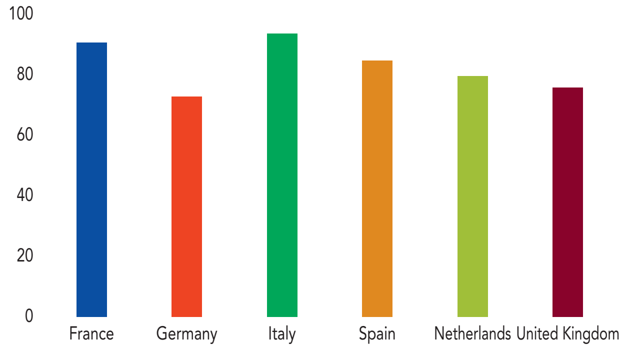
a) The health shock

(Number of deaths per million pop., at 2 July 2020)



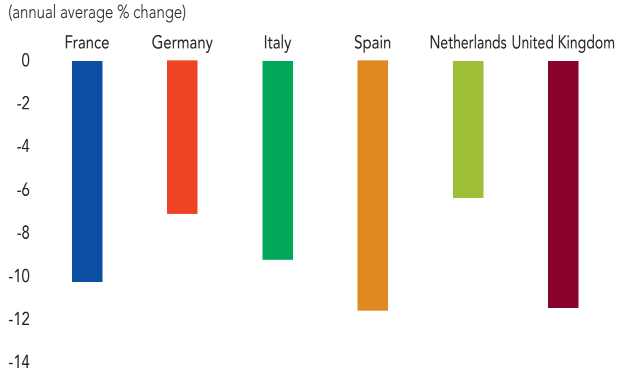
b) Stringency of the lockdown

(Oxford Stringency Index - maximum value during lockdown)



c) The economic shock – 2020 recession

(annual average % change)



Sources: a) Worldometers; b) University of Oxford; c) ECB Eurosystem, projections, June 2020; OECD for the United Kingdom.

1.2 Strong responses

Confronted with this unprecedented and totally unforeseeable crisis, **strong, rapid and convergent responses** were implemented to stem the impact of a severe economic shock. The lessons of 2008 have not been forgotten. Seldom has there been such a clear consensus on the direction and scope of the measures to be taken, including among economists. In France, public authorities implemented a "liquidity shield", comprised of unprecedented fiscal and monetary measures, to help businesses of all sizes weather this shock and thereby protect their employees.

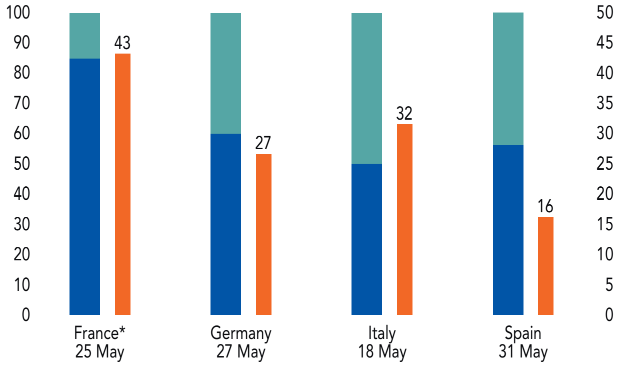
Fiscal policy: protecting businesses to help households

The **fiscal measures** put in place by the government centred first on the deferral of taxes and social security contributions, a solidarity fund for the self-employed and above all short-time work initiatives. France has thus learned from the success of Germany and its *Kurzarbeit* in 2009.[5] Our arrangement – one of the most generous and expensive in Europe *(see Chart 3)* – has so far enabled us to avoid what has happened in the United States, i.e. 19.5 million job losses in eight weeks. The measures also include state-guaranteed loans (SGLs), repayable over one to six years and for an amount covering up to 25% of annual turnover. To date, these SGLs have been more successful than anywhere else in Europe in two respects: in terms of their total amount (which is expected to be over EUR 120 billion) and in terms of their "targeting" of VSEs (41% of the total amount) and SMEs (34%). Conversely, Italy, the United Kingdom and the United States have experienced difficulties in ensuring that guaranteed bank loans effectively reach SMEs and VSEs.

It is difficult to compare the overall sizes of programmes in different European countries, given the announcement effects and non-budgetary measures (such as guarantees or simple deferrals of charges). Germany has clearly made greater use of its financial leeway, which it had built up again since the 2009 crisis. Its fiscal stimulus package (as a percentage of GDP) appears at this stage to be about twice as large as those of Italy and France, and even greater than that implemented in Spain. It is still difficult to predict how effective it will be: in particular, the temporary cut in VAT seems costly and its effects ill-targeted, between imports, corporate margins and a lasting increase in consumption. Moreover, Germany has mustered a capacity of EUR 100 billion to take financial stakes in strategic companies experiencing difficulties (compared with EUR 45 for Italy and EUR 21 billion for France).

Chart 3 France has a higher level of short-time work compensation per employee and the highest share of employees covered by the scheme

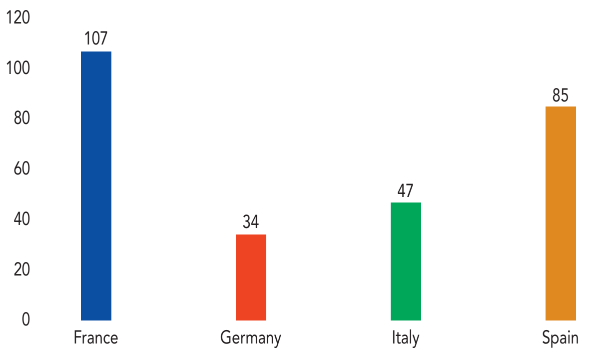
(%, for an average full-time wage, with 100% of hours unworked)



Source: Banque de France, estimates based on national legislation and national accounts.

Chart 4 State-guaranteed loan amounts by country

(EUR billions)



Sources: Ministry of the Economy (France - 19 June), Ministry of Finance /KfW (Germany - 31 May), Ministry of Economic Development (Italy - 26 June), ICO (Spain - 15 June).

2 See Albouy (V.) and Legleye (S.) (2020), "Conditions de vie pendant le confinement : des écarts selon le niveau de vie et la catégorie socioprofessionnelle", *Insee Focus*, No. 197, June.

3 The forecasts cited are from the Eurosystem staff Broad Macroeconomic Projection Exercise (BMPE) of June 2020, and are consistent with those of the Banque de France.

4 Source: US Federal Reserve.

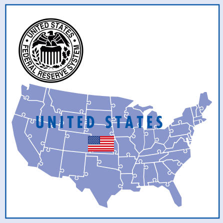
5 A scheme put in place to safeguard employment, consisting of a temporary reduction in working times, with unemployment insurance paid by the government for the hours not worked.

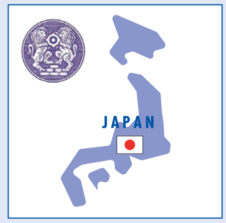
Table 1 Main monetary policy measures taken between early March and June 2020

(EUR billions)

THE MONETARY POLICY MEASURES TAKEN BY THE MAIN CENTRAL BANKS PURSUED SEVERAL OBJECTIVES:

- maintenance of low interest rates (short and long-term)
- refinancing of banks to allow to them to provide liquidity to their customers, in particular SMEs
- help for firms that raise funds in the capital markets
- smooth transmission of monetary policy to all actors and in all countries





2020	EUROPEAN CENTRAL BANK*	FEDERAL RESERVE	BANK OF JAPAN	BANK OF ENGLAND
MARCH	Exceptional provision of liquidity to banks: reduction in the interest rate on TLTRO III and increase in the envelope to **EUR 2,900 bn** Extension of eligible collateral Additional asset purchases of **EUR 120 bn** up to the end of 2020 Pandemic Emergency Purchase Programme (PEPP)** of **EUR 750 bn**: flexible purchases of private and public assets up to end-2020 + purchases of short-term commercial paper	Fed funds rate cut to a range of 0-0.25% Launch of new round of quantitative easing (QE) Purchases of corporate bonds Measures to ensure the functioning of money markets	Additional purchases of exchange-traded funds (ETFs) and corporate bonds Provision of loans to banks using corporate debt as collateral	Key interest rate cut to 0.1% Expansion of the asset purchase programme Provision of liquidity to banks with incentives to lend to SMEs Unlimited purchases of treasury bills
APRIL	New PELTRO and reduction in the interest rate on TLTRO III	Purchases of short-term notes from states, counties and cities Repurchases of loans to SMEs (Main Street Lending Program)	Purchases of treasury bonds to control the yield curve	Temporary increase in the size of the government's overdraft account with the Bank of England (Ways and Means Facility)
MAY			Provision of subsidised loans to banks for the financing of SMEs	
JUNE	Increase in asset purchases under the PEPP to **EUR 1,350 bn** up to mid-2021		Provision of additional loans to banks to finance businesses	Additional purchases of sovereign bonds

* Forward guidance and the tiering system remain in place.
** The PEPP has an impact on interest rates but, thanks to its flexibility, its primary objective remains the safeguarding of a single monetary transmission mechanism.

Source: Banque de France.

Monetary policy: a liquidity shield for the economy via banks and markets

The major central banks worldwide took decisive action to ensure the smooth financing of the economy. From as early as March and in the space of a week, central banks thus showed that they are never "out of ammunition", contrary to earlier fears. In theory, there is no limit to the size of central banks' balance sheets: that is precisely what makes them unique.

The ECB was among the pioneers in providing **immediate and virtually unlimited liquidity** to support financing channels for all economic players: businesses, governments and households. During the course of two successive meetings, the ECB Governing Council took a number of exceptional decisions. On 12 March, using the so-called "TLTRO III" facility, it made up to almost EUR 3,000 billion of loans available to **banks**, to allow them to continue financing businesses, particularly SMEs and VSEs. The interest rates on this refinancing are the most favourable in the world, at –1% for banks if they at least maintain their stock of outstanding loans. On 18 March, the Governing Council supplemented its action by adopting a totally unprecedented EUR 750 billion Pandemic Emergency Purchase Programme (PEPP) for economic agents that finance themselves via the **markets**: governments and large corporations. At its 4 June meeting, the Governing Council increased the purchase envelope for the PEPP to EUR 1,350 billion, and the horizon for net purchases made under the PEPP was extended to at least the end of June 2021.

There has been no formal coordination between the major central banks, except for the very rapid establishment of swap lines[6] that has prevented international liquidity in dollars and, to a lesser extent, in euro from drying up. However, the broad convergence of the monetary objectives and instruments adopted everywhere in the space of just a few days has been striking *(see Table 1)*.

The Banque de France, in particular, took action on five fronts

To combat this crisis, the Banque de France immediately acted on five key fronts:

- Through its network, it continued to provide support for households in difficulty and businesses, particularly VSEs and SMEs. **National Credit Mediation** played an essential role, thanks also to the work of the Banque de France directors in each *département*. In the second quarter of 2020, it handled 6,600 cases – six times as many as in the whole of 2019 – the vast majority of which were VSEs, with a success rate of 55%.
- The **supply of banknotes and coins** was ensured at all times throughout the country. This helped to preserve confidence in the currency, which is a key task of central banks. Banknotes – which carry no particular risk of contamination – must therefore continue to be accepted at all retailers.
- The Banque de France contributed, notably through its business surveys of thousands of companies, to the production of **analyses on the economic effects of the crisis**. It actively contributed to the definition of the Eurosystem's monetary policy and its implementation at the national level.
- Our **monitoring of the financial markets** and our operational intervention were significantly increased after the severe tensions in March *(see Box 2)*.

Box 2

PURCHASES OF COMMERCIAL PAPER WITHIN THE FRAMEWORK OF THE PEPP, AN ILLUSTRATION OF THE BANQUE DE FRANCE'S ROLE

The health crisis very quickly led to a virtual paralysis of the commercial paper market. In response, the Eurosystem extended its outright purchases of securities within the framework of the Pandemic Emergency Purchase Programme (PEPP) to include short-term notes issued by companies, in particular short-term (less than one year) negotiable debt securities issued on the commercial paper market (the NEU CP in France – negotiable European commercial paper). Given its expertise in the French short-term securities market, the Banque de France played a key role in defining the technical arrangements for the commercial paper purchase programme and its implementation as of 27 March, in close cooperation with the ECB. This new programme made it possible to provide a very rapid response to the urgent and substantial cash requirements of French companies. Just three weeks after the launch of the programme, issuance volumes returned to a level comparable to those seen at the beginning of the year. These interventions also encouraged investors to gradually return to this market, particularly money market funds.

6 Agreement between two central banks to exchange currencies *(https://www.ecb.europa.eu/explainers/)*.

- Lastly, the *Autorité de contrôle prudentiel et de résolution* (ACPR – Prudential Supervision and Resolution Authority) enhanced **its monitoring of the financial soundness of banks and insurance companies**. The French financial sector entered the crisis in a robust position, thanks in particular to the Basel III regulations for banks and the Solvency II regulations for insurers – which had nevertheless come under frequent criticism up to then. French banks are at this stage a key driver of the solutions, and not the cause of a crisis which is first health-related and second economic, but not financial. European and French supervisors have, in the very spirit of the regulations, encouraged the use of counter-cyclical "buffers" and flexibilities to enable banks to absorb this exceptional shock and maintain their capacity to finance the real economy.

2

Now, successfully rebuilding through a combination of private sector confidence and cooperation between macroeconomic policies

After the emergency phase comes the time to exit the crisis. Given the anxieties felt by the general public and economic agents, this next phase is generating a lot of impatience and "noise", with demands for ever more industry-specific rescue plans and ad-hoc aid. To put it another way, the strong – and indispensable – presence of the government and central bank during the emergency phase may have created a dependency: collectively, we are expecting too much for tomorrow from fiscal and monetary policies alone. The government cannot do everything and should not do it on its own. We might even be tempted by miracle cures from the public sector – but public debt cannot simply be written off and is therefore nearing its limits; the central bank can buy time through monetary creation, but it cannot increase wealth. We have to rebuild more positively, focusing on two pillars:

- It is private sector agents – households and businesses – that hold the key to the reconstruction (2.1), through their confidence – which is a core lever, albeit less measurable – through their work, and through their productive investment.

- However, national and European authorities can step in to assist private sector agents if they succeed in cooperating over the long term, and to an extent as yet unseen in Europe (2.2).

Only when these demanding conditions are met can a "post-crisis France" emerge that is economically stronger than the "pre-crisis France": in that case, this crisis will also have been a chance to transform towards renewed labour, through training and digital technologies, towards a more innovative and sustainable economy, and towards more assertive European responses to the global tensions.

2.1 The triangle of confidence for private sector agents: households, businesses and banks

There can be no growth without confidence. And no confidence without "reassurance" from the public sector, which can now take the form of three "confidence pacts" with the main actors in the private sector: households, businesses and banks.

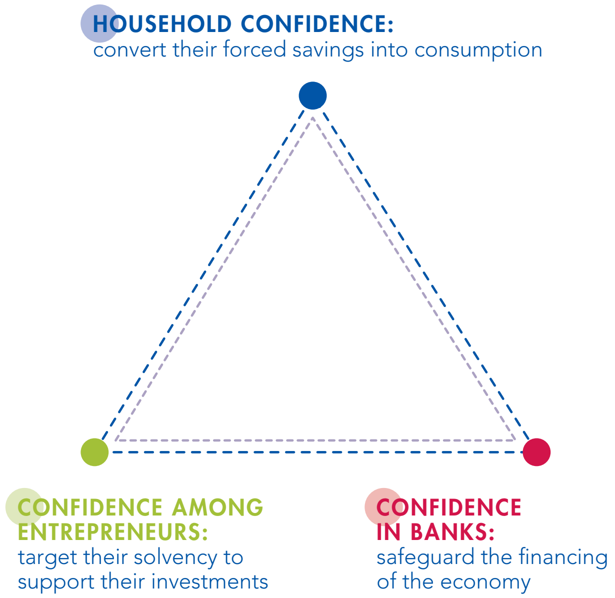
Household confidence: a fiscal and social guarantee combined with strong mobilisation on training

The first lever for exiting the crisis is household confidence. As with the action taken by Roosevelt, who in 1933 managed to rebuild the trust of American citizens after it had been shaken by the bank collapses, the decisive challenge we now face is to revive demand among households who have built up a significant savings reserve *(see above)*.

Household confidence will be contingent on an improvement in the health situation, but also on two economic reassurances. There is a serious risk that households will turn these forced savings into precautionary savings, driven by two fears: fear of a fiscal tightening in the near future, to finance government deficits – what economists call "ricardian" savings – and fear, of course, of a rise in unemployment. We therefore need to rule out any hikes in household taxes, which would have a recessionary impact, and avoid repeating the mistake made by certain European countries, including France, after the 2011 crisis, of increasing taxes too rapidly at the risk of stifling the recovery. This could take the form of a **guarantee that taxation will remain stable for several years**: France cannot afford to make any more tax cuts either, after those initiated in recent years.

We then need to provide reassurance that we will continue to provide substantial unemployment benefits, coupled with a commitment on training. Uncertainty over future retirement pensions would also risk fuelling precautionary savings.

Figure 2 The private sector confidence triangle



Fostering employment

Allaying concerns and limiting inequalities also means better preparing French people for tomorrow's world and for new jobs. Indeed, this should even be made a requirement, in return for the social guarantees. The primary solution is to provide professional training and apprenticeships. In this respect, attitudes towards apprenticeships are – finally – changing, and last year saw a 16% rise in the number of young people opting for this form of education. But there are still fewer young people in apprenticeships in France, Italy and Spain combined than in Germany. With regard to professional training, the implementation of the *Avenir Pro* law, approved by the French parliament in 2018, should absolutely be continued.

The short-time work scheme was rolled out extensively during the lockdown *(see Part 1)*. However, leaving aside its high cost (estimated at EUR 31 billion in the 2020 amended budget law), it now seems necessary to take a more selective approach in assisting the recovery. The so-called "ordinary law" scheme underwent an initial adjustment at the start of June, and a second is planned for the start of October. A new long-term scheme is being implemented in parallel (the APLD or extended short-time work programme): it will be more generous, but contingent on the signature of a collective agreement at the industry or firm level. However, this should not prevent firms from restructuring, within the normal collective bargaining framework, if warranted by their individual economic circumstances.

In the period when unemployment is rising, which is expected to last until mid-2021, it will be important to prioritise measures aimed at reinforcing workers' skills and assisting labour mobility (especially for individuals in those sectors more durably affected by the crisis). For young people just entering the job market, the focus should be more on schemes aimed at encouraging them to stay in education, or at making internships and apprenticeships more attractive. Subsidies for hiring workers could also be envisaged, provided they are temporary and well-targeted.

Between 2016 and 2019, France succeeded in creating a net one million jobs: after the exogenous shock of the crisis, our country needs to get back on track with this progress.

Business confidence: reducing broadspread support but targeting firms' solvency

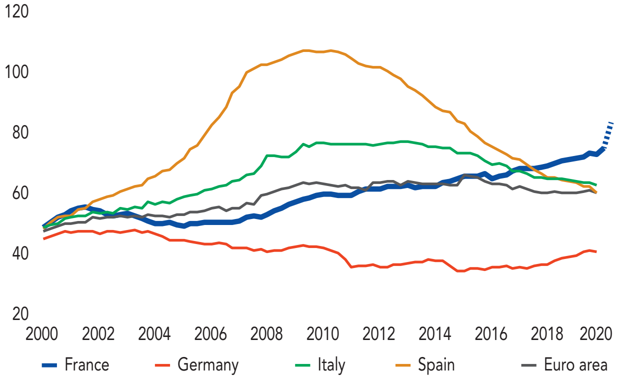
During the emergency phase, businesses rightly benefited from a "cash shield" and from broadspread assistance, notably in the form of the short-time work scheme. The challenge now is to redirect these schemes towards **selective public investment**, in order to provide long-term capital support to viable companies weakened by the crisis, as Germany plans to do. Without this, business investment will be significantly curtailed, reducing the capacity of our entire productive apparatus to respond to technological and climate-related challenges: reconstruction does not mean restarting in exactly the same way as before. It means being able to innovate, and for that we need the confidence that comes from having sufficient capital.

According to Banque de France analyses, firms' gross debt will increase by nearly 10%. This is the biggest rise in Europe, at a time when French companies are already carrying above-average levels of debt *(see Chart 5)*. At end-June, however, the rise was largely offset by considerable increases in their deposits. As a result, their net funding requirement should increase to a more limited extent, although still to around EUR 80 billion.

Beyond industry-specific rescue plans and cancellations of taxes and social security charges, the right solutions could take several forms. An immediate "carry-back" of 2020 tax losses to profits from previous years offers the advantage of being simple and applying only to those companies that were profitable before the Covid crisis, and can therefore

Chart 5 Consolidated debt of non-financial corporations

(% of GDP)



Sources: Banque de France and ECB.

Note: For France, forecast at end-June 2020 based on known flows in April and May.

Box 3

THE PRINCIPLES OF PUBLIC QUASI-EQUITY

Public investment in this case would be **without voting rights**, but in return the shares would **pay higher dividends**. It is vital to be **selective**, to avoid financing "zombie" firms and losing massive amounts of funds. A systematic contribution from private investors will therefore be necessary – 100% public financing is an almost certain guarantee of losses – and the investments will have to be analysed by specialist players (funds, BpiFrance) and not primarily by administrative or political decision-makers, including those at the local level. The projects will also need to be viable over the long term, including on a climate-related and environmental, social and governance (ESG) level: public investment should not be aimed at preserving yesterday's world.

Converting state-guaranteed loans (SGLs) into quasi-equity runs a significant risk of leading to "adverse selection" or the "automatic selection" of the least viable companies. It would be better simply to extend the term of SGLs, where necessary, from the initial one year to a maximum of six years. Another idea that seems ill-suited would be to allocate households' forced savings to this type of funding, as they would be investing in potentially high-risk turnaround funds.

be assumed to be viable. The measure, which is neutral for public finances over the long term, had an impact of EUR 5 billion in 2009. In parallel, the rescheduling of all payment arrears owed by local authorities and hospitals would boost firms' cash levels by several billion euro. But there will also be a need for **public quasi-equity schemes**: for listed companies, the government is already planning partial and/or temporary nationalisations. For the vast number of unlisted VSEs, SMEs and ISEs, numerous ideas have been put forward: crowdlending with government support, hybrid bonds, preferred shares and so on. The amount needed is estimated at between EUR 10 billion and EUR 20 billion. No instrument is really ideal, and we will probably need to try out a few in parallel, but always applying a few clear principles of selection *(see Box 3)*.

Alongside this public investment, it will be important to speed up and simplify collective restructuring and liquidation proceedings, along the lines of the schemes available in the United States, by continuing the recent progress and ensuring these measures are effectively implemented. It is also clearly in our interests, despite widespread assumptions to the contrary, that we rapidly **re-establish the European rules on state aid**, given the size of Germany's financial firepower, and to maintain a level playing field within the single market.

In addition, restoring confidence among entrepreneurs means making massive efforts towards **simplification**, including, as far as possible, with regard to the health and safety standards that are weighing on production. But more broadly, our country needs to get out of this French mindset that rewards (badly) the increasing application of rules with ever-more tax credits and costly aid.

Confidence in banks: preserving their soundness to ensure the smooth financing of the economy

As key players in the financing of our economy, French banks provided the vital liquidity shield that companies so badly needed during the acute phase of the crisis. At end-2019, they were in a much more comfortable position than in 2008: their Common Equity Tier-1 ratio (CET1) had more than doubled to 14.4% from 5.8% previously; their liquidity coverage ratio (LCR) was well above 100%, at 132%.

Nonetheless, we will need to keep a close eye on how the rise in corporate defaults potentially affects the soundness of European banks. The average structural profitability of European banks is already half that of their American peers, resulting in very low stock market valuations that would make it difficult for them to raise additional private capital. Strengthening firms' solvency *(see above)* would be a good preventive step to take upstream, in order to safeguard the soundness of the banks. It will also be important to monitor closely the macroprudential risks: these notably include the current high equity market valuations, and the non-bank sector[7] which has been less regulated since 2009.

2.2 The triple mobilisation of macroeconomic policies

Alongside this private sector "triangle of confidence", the other challenge is to ensure a high standard of cooperation between the three public macroeconomic policies: monetary policy, national fiscal policy and European stimulus. Achieving this, while also respecting the independent decision-making of each policy – first and foremost the independence of monetary policy – is an unprecedented challenge for Europe, which is overly accustomed to non-coordination.

A monetary policy that will help, but in the name of its own objectives

While remaining within the framework of its mandate, the ECB still has the capacity to take strong action to counter the crisis.

After the urgency of the first few weeks *(see section 1.2)*, the ECB's monetary policy must continue to support economic activity, for the sake of its own mandate of price stability. The Covid crisis has led to an economic shock of unprecedented proportions and left the economic outlook shrouded in extreme uncertainty. In the short and medium term, **the shock is having a deflationary impact**, notably due to the slump in demand as well as in oil prices. Inflation is currently very low, at 0.1% in June in France and 0.3% in the euro area, although it is proving tricky to accurately measure prices during the lockdown *(see Box 4)*. According to various forecasts, euro area inflation should remain below 1% overall, at least until 2021.

These weak price movements come on top of a decade during which inflation, at an average of 1.3%, remained consistently below our target of "below but close to 2%". This inflation target must have three defining characteristics, all of which are interlinked; it must simultaneously be:

- **symmetrical**: if our central target is perceived as a ceiling, we are less likely to reach it. Clearly, therefore, the Eurosystem will be prepared in the future to occasionally exceed 2%;

- **flexible**: the Eurosystem cannot guarantee 2% either all the time or straight away;

- **medium-term**. This medium-term target needs to be viewed in two ways: it is forward-looking, to guide inflation expectations; but it cannot completely ignore the past. Should we go as far as targeting an **average** level of inflation of close to 2%, and therefore explicitly compensate, at least temporarily, for any undershooting or overshooting of the target over time? This question remains open, and will be part of the "strategic review" of monetary policy that the ECB will pick up again in September.

The need to support the recovery with low rates and abundant liquidity for a long time

Against this backdrop, and in order to meet its inflation target, the Eurosystem has always made clear its commitment to guaranteeing favourable financial conditions throughout the euro area. To achieve the primary objective of price stability, as the President of the ECB reiterated, "the (effective) transmission of monetary policy is just as important as monetary policy itself".[8] This transmission concerns all economic players, all financing channels and all countries.

The size of the PEPP (EUR 1,350 billion) is impressive, but its greatest innovation lies in its flexibility, especially in terms of the allocation of purchases between countries. While there is a risk that the effects of the crisis may in some cases be asymmetric, the Eurosystem will not allow adverse market dynamics to lead to unwarranted interest rate hikes in some countries, and a fragmentation that might compromise the effective transmission of monetary policy. This increased responsiveness is even more justified given the exceptional and temporary nature of the PEPP.

The recovery looks set to be heterogeneous and gradual, and it is difficult to measure how long it will take to get back to a new normal, or to estimate the scale of the long-term losses that will affect potential growth. But in order to fulfil its price stability mandate over the long term, the Eurosystem will keep interest rates at very favourable levels for as long as necessary, along with highly abundant liquidity; it also remains prepared to be as innovative as necessary with its instruments.

7 Banque de France, *Assessment of risks to the French financial system*, June 2020.

8 C. Lagarde, interview given to the European press, 19 May 2020.

Box 4

THE HEALTH CRISIS APPEARS TO BE CAUSING A DEFLATIONARY SHOCK

Overall, the Covid-19 health crisis is a deflationary shock to the French economy. In May 2020, the year-on-year change in the Harmonised Index of Consumer Prices (HICP) was 0.4%, after 0.4% in April, 0.8% in March and 1.6% in February. This trajectory is notably linked to the drop in oil prices, which had a knock-on effect on petrol prices (–20% year-on-year in May 2020), but the decline in inflation can also be seen in a large number of other products, such as wearing apparel and footwear (–2.6%). Conversely, a small number of items saw sharp jumps, notably unprocessed food (vegetables, fruit, meat) which was up 12% on the year. During the lockdown, the measurement of inflation was temporarily but significantly disrupted by the abrupt shift in the structure of products consumed by households.

In the months ahead, price pressures should remain on the whole deflationary. The additional costs linked to the health and safety measures that certain commercial activities are required to apply (hairdressers, mechanics, transportation services, etc.) could lead to occasional price rises. But the prospect of a very gradual recovery in activity and a deterioration in the jobs market should help to keep overall inflation low over the coming quarters.

Inflation forecasts for the euro area and France

(%)

	2020	2021	2022
Euro area	0.3	0.8	1.3
France	0.4	0.5	0.9

Sources: ECB *Eurosystem staff macroeconomic projections for the euro area*, June 2020; Banque de France *Macroeconomic projections, France*, June 2020.

Two vital anchors and no miracle cure

In its founding Treaties, and under the legitimacy afforded to it by economic actors and public opinion, the ECB's measures are bound by two interlinked anchors: its price stability mandate and its independence. It is subject neither to the approval of national governments, nor to the pressures of the markets or of passing trends. It is thanks to this independence that the ECB can effectively support the economy, without jeopardising the confidence that euro area citizens have in the euro (76% confidence rate).[9]

Since the outset, this mandate and this independence have in no way prevented the ECB from innovating or from acting rapidly and forcefully. On the contrary, they create the conditions that ensure the ECB's action is efficient: according to several broadly convergent estimates, in the period from 2014 to 2018,[10] monetary policy boosted cumulative euro area growth by between 2 and 2.5 percentage points and inflation by around 1.5 percentage points; the effects for France are similar. The euro area created more than 11 million jobs between 2013 and 2019, of which two million stemmed from the impact of monetary policy.

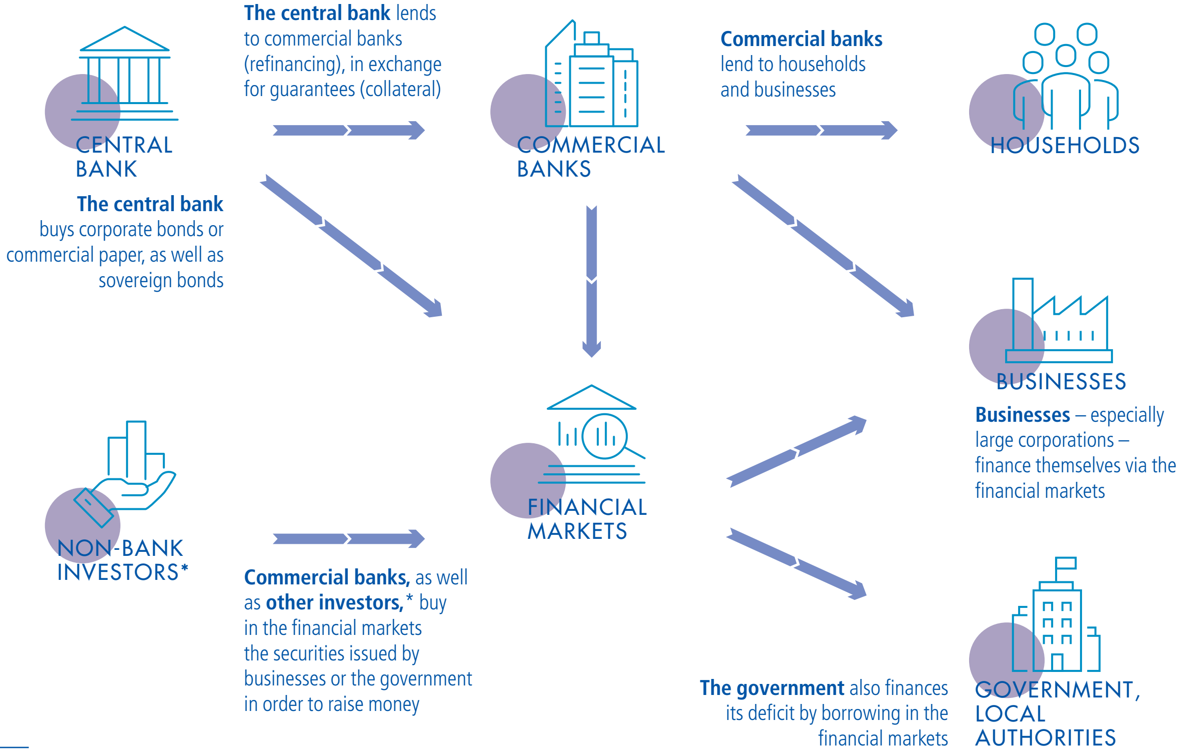
This efficiency may lead to the – misguided – belief that monetary policy is all-powerful. True, the specific feature of a central bank is its ability to create virtually unlimited money: traditionally through the printing of banknotes, but in a modern economy via the creation of "reserves", in other words money in the deposit accounts that commercial banks hold with the central bank *(see Figure 3)*. **However, the money created by central banks is never simply "given away" permanently**: it is **loaned** for a limited period; and it goes into the economy so that it eventually comes back to the central bank.

In the current context of an unprecedented rise in public debt, there is a strong temptation to give in to what the economic research calls "fiscal dominance",[11] where the central bank has to obey another objective: the financing of public debt. This can take different forms, including two that are frequently cited: the cancellation of the public debt held by the central bank, or the related idea of converting it into perpetual debt.

A debt cancellation would be tantamount to the monetary financing of deficits, the prohibition of which is one of the founding pillars of the agreement creating the euro *(see Box 5)*.

But assuming the Banque de France were to cancel the debts it currently holds (more than EUR 400 billion of French public sector securities at end-May 2020), it would book

Figure 3 Actors and mechanisms that support the financing of the economy



*Funds, insurers, firms, private individuals, etc.

an equivalent loss on its balance sheet, and, given that the state is its only shareholder, the country's collective wealth would be reduced by the same amount. In addition, the bank deposits linked to this monetary creation would have to be remunerated by the central bank. This is not expensive at the moment as the remuneration rate on deposits is negative – as it is on debt. But it could become expensive when the rate returns to positive territory, and would thus cost as much as short-term debt. Moreover, if, as some people are suggesting, the central bank committed to never raising its interest rates, then that would trigger a potentially uncontrollable inflationary spiral, which clearly runs counter to the mandate entrusted to the Eurosystem, and to the interests of citizens. As for **perpetual debt**, in return for lending with no prospect of repayment, investors would demand high risk premiums and therefore interest rates, which would be much more expensive than on the current debt.

Thus, the Eurosystem cannot and should not work a monetary miracle, either legally or, above all, from a fiduciary perspective: any suspicion of "fiscal dominance" would lead to monetary mistrust, to a loss of confidence in the value of money, as observed in the past (in Hungary, Austria, Germany or Poland in the interwar years, or in Israel at the start of the 1980s), and recently in certain emerging market economies (Argentina, the Lebanon). Whenever a currency is devalued, it is the poorest who suffer the most.

9 European Commission, *Standard Eurobarometer*, autumn 2019.

10 See notably Rostagno (M.) et al. (2019), "A tale of two decades: the ECB's monetary policy at 20", *Working Paper Series*, ECB, No 2346, December, and Hartmann (P.) and Smets (F.) (2018), "The first twenty years of the European Central Bank: monetary policy", *Working Paper Series*, ECB, No 2219, December.

11 Sargent (T.) and Wallace (N.) (1981) "Some unpleasant monetarist arithmetic", *The Quarterly Review*, Federal Reserve Bank of Minneapolis, *Fall*, 1-17.

Box 5

WHY CAN'T THE ECB DIRECTLY FINANCE GOVERNMENTS?

The ECB has been entrusted with a very clear mandate by the European Treaties:[1] its primary objective is to "maintain price stability", in other words to avoid prolonged periods of excessive inflation – as seen in Germany in the post-war period – or deflation – as seen during the 1929 crisis – which always have a destructive impact on the economy. Price stability preserves household purchasing power; more than that, it builds confidence in the value of the currency and consequently reinforces the confidence of economic players in all their decisions for the future.

This strict mandate is the counterpart to the central bank's independence: in a democracy, an independent authority has to stick to the mandate entrusted to it by the representatives elected by the people. However, by maintaining low interest rates and purchasing large quantities of sovereign securities from investors, the Eurosystem will continue to provide significant aid to state governments. But it does so completely independently, and in the name of its own mandate of price stability.

The ECB cannot therefore directly finance governments. First, from a **legal** perspective, the "contract of trust" established between those countries that share the euro explicitly prohibits the ECB from directly financing governments (Article 123 of the Treaty on the Functioning of the European Union). Second, from an **economic** perspective, the amount of money put into circulation cannot remain durably disconnected from the amount of wealth produced; this could lead in particular to high levels of inflation which would destroy savings and bring back instability.

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

A three-phase national fiscal policy

To combat the effects of the crisis, fiscal policy has played its full countercyclical role. The post-crisis period will therefore be a delicate balancing act for public finances, between fostering a rapid recovery and ensuring long-term sustainability. To strike this balance, fiscal policy will need to accompany the **three phases of the exit from the crisis**.

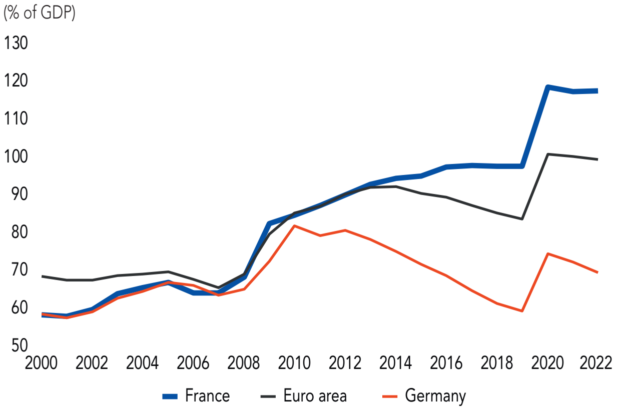
- In 2020, **steadfastly repairing and countering the recession** through spending that should remain, as far as possible, **temporary** or indeed reversible. This is particularly justified in light of the repeated temptation to lower taxes: France cannot currently afford tax cuts, and their economic efficiency often turns out to be disappointing. Our country loves coming up with new and inventive ways of applying taxes, without going through the first phase, which is to control spending. The reasonable promise to make now – and one that is new to France – would be to guarantee that taxes will remain stable, as this would reassure households *(see above)* and provide businesses with some degree of predictability. In the current economic and financial context, the overall deficit (which is expected to be around 10% of GDP in 2020) is not unbearable, **provided** the structural deficit is kept stable.

- In 2021 and 2022, avoiding tightening policy too early to assist the recovery, but without extending the exceptional measures implemented in 2020 in response to the health crisis.

- After 2022, **managing the long-term reduction in public debt**. It is possible to distinguish between: (i) the "Covid debt" (close to 20% of GDP) which we need to set aside in a sinking fund and only start paying back after about a decade, as with the European Covid debt; and (ii) "ordinary debt" (around 100% of GDP) which at long last needs to be reduced. The current shock will make it even more important to have a medium-term debt reduction policy that is communicated clearly and fully embraced. This will mean making our spending more efficient: the counterpart to no tax hikes – which should be at the heart of our confidence pact with households and businesses – will have to be a control on public spending, which at end-2019 still stood at over 55% of GDP, more than 10 percentage points higher than in neighbouring euro area countries that nonetheless have comparable social models.

Keeping growth in primary public spending – excluding debt interest payments – on its pre-crisis trend (1% per year in real terms between 2010 and 2019) would not allow us to reduce the debt-to-GDP ratio over the long term. It is therefore essential that we aim to **stabilise primary spending in real terms** (while maintaining the same tax-to-GDP ratio). This would allow us to bring our "ordinary" debt ratio (i.e. excluding Covid) back to 80% of GDP in the space of a decade. The multiplier effects of spending on potential economic growth are greater for public investment and spending on the future, such as on education or research. Conversely, public sector wages, welfare benefits and tax cuts have a lower multiplier effect.

Chart 6 Change in public debt in France, Germany and the euro area since 2000



National sources for Germany and France, ECB for the euro area.

France's status in Europe will ultimately depend on our level of debt. In the past 20 years, French debt has doubled as a share of GDP, rising from the 60% ceiling stipulated in the Treaty – and which our country complied with in 2000 – to 120%. In the 2009 crisis, we still had the same level of debt as Germany. But since then, France's debt has risen much faster than the euro area average (by 36% of GDP).

Collective wisdom therefore recommends not exceeding 120%.[12] Failing this, as our debt level continued to rise faster than Germany's, investor confidence would fall, and France would "slide" more towards southern Europe.

An innovative European recovery plan to meet the challenges of the "post-Covid world"

The Covid-19 crisis has been an unprecedented "stress test" for the European project, and there is still a strong risk of increased divergences. But this crisis can also be an opportunity to find stronger European responses to the challenges of an uncertain world – one that has been profoundly shaken and where cooperation is limited.

A European policy that should target potential growth and the integrity of the single market

Boosting potential growth, which risks being curtailed by the crisis, is an objective shared by all European countries. In the face of a shock as large as the Covid crisis, it is only inevitable that national investment will reach its limits. To counter the decline in investment in 2020 and 2021, estimated at more than EUR 800 billion,[13] the key challenge will be to meet our shared structural objectives. The first of these is the **ecological transition**, which should under no circumstances become a casualty of the crisis. A carbon tax is generally considered to be the most effective tool for combating climate warming. The European Commission's proposal, aimed at reinforcing the European emissions trading system with a carbon border adjustment, deserves our full support. Another priority is the **digital transition**, which, more than ever, will be the main driver of future productivity.

A credible recovery plan

The Franco-German initiative of 18 May this year was a major step forward for European financial solidarity. The creation of a shared debt instrument – which has been incorporated into the Commission's plan and has financial firepower of EUR 750 billion, of which EUR 500 billion is for outright fiscal spending – is the political signal the markets were waiting for from Germany, especially after the ruling by the court in Karlsruhe on 5 May. It finally brings the European policy mix back into balance: monetary policy will no longer be the only component – "the only game in town".

Despite these advances, which still need to be approved by all 27 Member States, the Commission's proposal will need to make sure it does more than simply redistribute the individual national allocations – over 90% of the EUR 750 billion Next Generation EU subsidy package falls under Pillar 1, which is direct aid to Member States – in order to meet the two key challenges of a shared recovery:

- **providing genuine "European value added"**, thanks to additional investments that have positive **cross-border** repercussions;
- strengthening the component for supporting the **solvency of European firms**, which is still too limited and could be managed by the European Investment Bank (EIB).

The Financing Union for Investment and Innovation

The euro area also has an abundant resource at its disposal: a surplus of private savings over investment which amounted to EUR 360 billion last year. Improving the allocation of these savings means creating more efficient cross-border financing channels – the savings are not always located in the same place as the investment need – and more efficient

12 Cour des Comptes (State Audit Office), *La situation et les perspectives des finances publiques*, June 2020.

13 The European Commission's proposal for a recovery plan, 27 May 2020 (*https://ec.europa.eu/commission/*).

"transformation": private individuals tend to prefer short-term, secure saving instruments, whereas financing needs are often longer term and carry a higher risk.

We need to combine a more efficient Banking Union and a Capital Markets Union to make a genuine "Financing Union for Investment and Innovation". European governments all agree on the principle, and the Commission is still in the process of finalising its new report; but it is now time to finally put those words into action.

Promoting multilateralism

In response to a health shock that respects no borders, the measures taken by national governments and central banks have been robust but uncoordinated. Worse still, the tensions linked to the exit from the crisis are fuelling uncooperative behaviour, most strikingly on the part of the current US administration, and the Chinese authorities who are entrenched behind their own Covid propaganda. The disruption caused by the health crisis is increasing the temptation towards protectionism. Strong divergences remain over what form the post-Covid world should take, and especially over the priority that should be given to tackling climate change and inequalities. In addition, despite the rapid mobilisation of the IMF and World Bank, the amount of aid given to emerging and developing economies (the IMF has so far provided USD 83 billion in response to the crisis) pales in comparison to the rescue packages implemented in major economies: the fiscal stimulus package put in place by G20 countries amounts to nearly USD 5,000 billion. Of course, the temporary debt moratorium granted to the poorest countries (USD 35 billion) has added to the international solidarity effort. However, without US agreement, the IMF has been unable to boost allocations of its special drawing rights (SDR), or to sufficiently increase the resources made available to developing countries.

Against this backdrop, Europe, along with Canada and Japan, must do more to champion the cause of multilateralism. Failure to do so will mean the virus will have been defeated on a health-related level, but will have won on an economic and political level by generating even more divisions, and even more losses in collective wealth.

* *

The pandemic that has severely impacted our country has also shaken many of our previous certainties. One thing is sure, however: we can get over this shock. We will need to be clear-sighted and tenacious, to avoid giving in to the illusion of public sector miracle cures. The recovery will be demanding, and it will take two or three years to make up the best part of the economic losses. But the solutions presented here are within our reach, if we all work together and share the burden fairly. We now have to aim for a comprehensive approach to the recovery strategy. Clarity is more important than responsiveness, to enable businesses and households to plan for the future. The key is to restore confidence. It is through the quality of our collective game and our dialogue – in France but also in Europe – that we shall overcome this stark challenge.

François Villeroy de Galhau

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