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Macroeconomic Outlook for France and the euro area and implications for monetary and financial stability policies

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Macroeconomic Outlook for France and the euro area and implications for monetary and financial stability policies

Denis Beau, First deputy-governor of the Banque de France.

Dear all,

I am delighted to be talking to you today at this new edition of the Central Banker seminar.

I would like to express my warmest thanks for the invitation.

I am going to present to you our perspective at the Banque de France on the evolution of the macroeconomic situation in the euro area and in France and its implications for the conduct of our monetary and financial stability missions.

1. Macroeconomic outlook

With regard to the macroeconomic situation, we all have seen that the euro area economy has been affected by an unprecedented series of shocks in recent years. The deterioration of the economic outlook since the beginning of 2022 is due in particular to the war in Ukraine and the lockdown in China, which have fuelled what we qualify as a "slow-flationary" shock. This shock initially threatened to turn into a "stagflationary" one. **[slide 2]**. This threat has not materialized so far. The most recent data and surveys point rather to a significant slowdown in euro area economic growth followed by a recovery thereafter.

Several factors contributed to this slowdown, starting with **the pressures on energy and other imported commodity prices caused by the war in Ukraine, which acted as an « external tax shock » to the euro area economies.** According to our assessment, the resulting deterioration in terms of trade cost the French economy an extra 1.4% of GDP in 2022 compared with 2021 (compared with 1.9% for the euro area), and led to a surge in inflation that translated into a real income shock for both households and businesses.

This terms of trade shock should subside in 2023 as pressures on import prices fade with the easing of energy prices, and is expected to represent an additional economic cost of around 0.5% of GDP in France compared to 2021 when conditions were more normal. It should then remain limited in 2024 and 2025.

Supply-side bottlenecks in terms of supply and recruitment also played an important role. They are easing, but they should continue to constrain the economic activity economy somewhat. The third factor I would like to highlight is the adverse geopolitical environment, with Russia's unjustifiable war in Ukraine, which has been weighing on business and consumer confidence.

Therefore, according to the ECB macroeconomic projections released on March the 16th, annual average real GDP growth for the euro area is expected to slow to 1.0% in 2023 (from 3.6% in 2022), before rebounding to 1.6% in 2024 and 2025.

[slide 3].

For the French economy, the perspectives are broadly similar. Economic activity is expected to grow at a limited pace in 2023, before recovering in 2024 and 2025. GDP should grow by 0.6% in 2023¹. Economy should then grow by 1.2% in 2024 and 1.7% in 2025. We should therefore effectively escape the recession in France as well as in the euro area as a whole.

[slide 4]

Regarding prices developments, since its resurgence in 2021, inflation has continued to rise in 2022 at a rate not seen since the 1980s. In 2023, against a backdrop of lower energy prices, inflation in the euro area began to ease to +8.5% at the end of February. In France, according to the results of the harmonized consumer price index, inflation stood at 7.3%, the lowest level in the euro area, thanks in particular to the tariff shield, but it remains well above the Eurosystem's inflation target.

At the Banque de France, **we believe that the current sharp acceleration in inflation is fundamentally due not to excess liquidity, but to the bottlenecks stemming from the faster-than-expected rebound in activity in the aftermath of the pandemic, as well as to the sharp rise in energy and food prices, which was largely exacerbated by the war in Ukraine.**

In 2022, the surge in energy prices on international markets was the main inflationary shock for the French economy. Although this shock was passed on to retail energy prices in 2022 in a limited manner, due in particular to the tariff shield, it was also transmitted indirectly and with a delay of a few months to the other components of inflation, via the repercussions of the increase in producers' costs.

Thus, inflation in France and the euro area has spread very widely and has become more "domestic" and more "broad-based", with all the other components of inflation rising: according to the February results, core inflation (which excludes energy and food) now stands at 5.6% in the euro zone (and 4.6% in France), and the rise in prices is spreading to goods and services - which account for the other half of total inflation.

It is this more "domestic" inflation that central banks are responsible for, and which they must not allow to persist.

According to the latest ECB macroeconomic projections, headline inflation is expected to fall significantly in the course of 2023 while remaining at elevated levels, driven by downward energy-related base effects,

declines in energy prices and easing pipeline pressures.

Headline inflation is expected to fall below 3.0% by the end of 2023 and to stabilise at 2.9% in 2024, before moderating further towards the inflation target of 2.0% in the third quarter of 2025 while averaging 2.1% for the year. In contrast to headline inflation, core inflation as measured by HICP inflation excluding energy and food will, on average, be higher in 2023 than in 2022, reflecting lagged effects related indirectly to both past high energy prices and the strong depreciation of the euro. Both will dominate in the short term. **The effects on core inflation from the more recent energy price decline and the euro's recent appreciation will be felt only later in the projection horizon. The expected decline in inflation in the medium term also reflects the gradual impact of monetary policy normalization.**

2. Implications for monetary policy

So what are the implications of the macroeconomic situation and outlook that I have just described for monetary policy in the euro area?

[slide 5]

From the monetary policy point of view, this new outlook has had the effect of **changing the nature of the main risk it must reduce: the risk to price stability we face is no longer that of inflation "too low for too long" but that of inflation "too high for too long".**

As of the end of 2021, the Eurosystem responded to the inflationary shock with a rapid and clear **shift in monetary policy stance**. After discontinuing its net asset purchases (as of the announcement in December 2021 for the PEPP), the ECB Governing Council decided to raise its key rates at an unprecedented rate, by a total of 250 basis points in five months, between July and December 2022. As soon as inflation clearly became more widespread and more persistent, we acted quickly and with force. As a consequence, at the end of 2022, monetary policy reached what we consider "the neutral rate" zone, which is the theoretical equilibrium rate at which there is neither monetary expansion nor contraction of inflation. The Banque de France estimates that, in real terms, this neutral rate is currently close to 0% in the euro area and hence around 2% in nominal terms.

Clearly with the interest rate increases decided in January and in March we have gone beyond that neutral rate, and as a result, have entered into a "restrictive" territory in the technical sense.

In March the Governing Council decided to do what it had said in advance what would do, that is, to raise rates by 0.50%. By acting in this way, I believe that **it has sent a strong signal of confidence which is twofold. It is both confidence in its strategy to fight inflation and confidence in the solidity of European banks.**

We are now entering a more open phase in which the elevated level of uncertainty reinforces the importance of a data-dependent approach to the Governing Council's policy rate decisions. Going forward, it would then move from a form of "autopilot", which has existed until now, to what we could refer to as "instrument piloting" meaning that it will decide, meeting by meeting, based on economic data. As it has been stated by Christine Lagarde in the latest monetary policy statement, future monetary policy decisions will be determined by an assessment based on three criteria:

- the inflation outlook in light of the incoming economic and financial data,
- the dynamics of underlying inflation,
- and the strength of monetary policy transmission.

In the context I have just described, a critical role for monetary policy will be to ensure that inflation expectations remain anchored, especially as long as inflation remains high. So far, this has been the case, and there is no sign of a potential price-wage loop at work. But vigilance must remain key.

The Governing Council forecast and commitment is that inflation should slow to close to 2 percent in 2025, as its current drivers fade and the normalization of monetary policy takes effect in the economy and in price-setting mechanisms.

3. Consequences on financial stability outlook and policies

I will now turn to the consequences the current economic and monetary environment have on financial stability and the policies we pursue to maintain it.

The Covid turmoil and the immediate impact of the war in Ukraine on financial stability have been well absorbed in Europe and in France. In 2023, the financial sector globally is facing renewed headwinds with heightened geopolitical risks, high inflation, the phasing-out of accommodative monetary policy, high debt levels in the private and public sector and a deteriorated economic outlook. **In addition financial markets are going through a new period of uncertainty and volatility, triggered by idiosyncratic events in the US and Swiss banking systems.**

While euro area banks saw their share prices tumble, **I would like to underline that their capital, funding and liquidity positions have not been affected by any metric. This reflects the continued resilience of the euro area banking sector, starting with the French one**, which has been recalled over the last days by Christine Lagarde, Andrea Enria and for the French banks in particular by François Villeroy de Galhau. **This stability relies in particular on the following key pillars**, which has been developed overtime from the interplay of banks efforts, the overhaul of regulatory framework implemented in the aftermath of the global financial crisis and a demanding and intrusive supervision:

Firstly, liquidity [slide 6]:

1. Liquidity risk management requirements, both the LCR and the NSFR, apply to all banks regardless of their size;
2. Liquidity ratios are comfortably higher than regulatory minimums (LCR is currently above 160% and NSFR roughly at 125%);
3. The composition of High Quality Liquid Assets shows a predominance of cash (56%);
4. Funding sources are well diversified, (Customer deposits from Households (30%); Central banks deposits and other liabilities (19%); Customer deposits from NFCs (16%);

Secondly, regarding the hotly debated Interest Rate Risk in the banking book, the EBA Guidelines, building on the Basle standards, are applicable to all banks meaning that interest rate risk is evaluated, managed and mitigated. In this regard, let me emphasize that unrealized losses from securities are taken into account in CET1. Moreover, for LCR calculation, all securities in the HQLA set must be measured at fair value, regardless of the accounting portfolio in which they are recorded.

Thirdly, solvency [slide 7] and leverage ratios are robust and above their regulatory requirements:

1. CET1 **ratio nears 15, 5%**, management buffer remains significant across the industry and the Leverage ratio hovers around 5,6%.
2. Our **regulatory framework also offers clarity to investors regarding the hierarchy of creditors and recently the EBA, the ECB and the SRB reiterated the seniority of AT1 holders towards shareholders.**

Finally, profitability has improved and cost of risk remains low:

1. Rising rates have helped the increase in net interest income, which has been the main contributor of rising profitability.
2. Although the cost of risk edged a bit higher, it remains at very low levels compared to previous quarters, especially during Covid-19 crisis (it is currently below 0,5%).

It is certainly too soon to draw firm lessons from the recent events. However, **it at least vindicates the choice we collectively made almost 10 years ago in the euro area when the banking union was set up to apply international standards to all the banks operating in its jurisdiction.**

However this is certainly no time to be complacent and, as it was underlined by Andrea Enria during his last hearing at the European Parliament, **both euro area banks and their supervisors are therefore currently focusing on the risks and risk management that are most relevant, given the fast pace of change in the interest environment.** In addition, **the current turmoil and the need to maintain strong vigilance vis-à-vis banks should not let us forget the elephant in the room.** Given the interest rates and liquidity risks that are currently shaking markets, the **NBFI entities remain vulnerable.**

The recent market volatility could trigger sudden increases in liquidity demand, due to higher margin calls from derivatives positions of NBFI or sudden outflows from investors, as seen during the 2020 March market turmoil. However, as no financial stress resembles one another, Money Market Funds have been stalwarts of stability this time around as they have been the recipients of large inflows since March 1st 2023, especially dollar-denominated money market funds. But such trends can change quickly, and highly leveraged entities are the most exposed to this risk of liquidity stress.

Therefore, **with regards to NBFI, there is still work to do.** We should ensure for instance that liquidity mismatch in open-ended funds and MMFs, as well as the excessive use of leverage in some non-bank, non-insurance intermediaries, are properly dealt with. The interaction between these two sources of vulnerabilities were at the centre of notable financial incidents such as the collapse of Archegos, and the LDI episode in the UK.

Last but not least, the recent failure of Silvergate, whose demise can be traced back to the failure of major exchange FTX, had ripple effects on major stablecoins. So did the failure of Silicon Valley Bank as it held major holdings of the USDC stablecoin. **The interlinkages between the banking and crypto sector have shone the light on the need to continue to overhaul the regulatory framework applicable to unbacked crypto assets and stablecoins.**

France (like Japan) has been a pioneer developing a confidence prone regulatory framework when adopting in 2019 its so-called PSAN registering regime for digital assets services providers. More recently, the EU has also made strides by adopting the Markets In Crypto Assets Regulation, which by 2025 when fully implemented, will significantly bolster the regulatory treatment of crypto.

There is a need for a global approach in this field. To that end, the Financial Stability Board (FSB) published in 2022 a proposed framework for the international regulation of crypto-asset activities. The core components of this framework are proposals for recommendations that promote the consistency and comprehensiveness of regulatory, supervisory and oversight approaches to crypto-asset activities and markets. This framework also proposed revised high-level recommendations for the regulation of “global stablecoins” to address associated financial stability risks more effectively. **Time is ripe now for action and resolute deployment.**

Let me conclude my remarks in stressing that, as we are continuously learning after each episode of stress, we will **need to draw all the lessons of the impact of the current turbulent environment, exacerbated by the speed of social media and digital finance, on the regulatory framework applicable to the financial industry.** We at the Banque de France are fully committed to this objective, both at the European and international levels.

I thank you for your attention.

¹ Revised upward by 0.3 pp compared with the December 2022 projections.

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