FOR INFORMATION

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January 11, 2021

To: Members of the Executive Board

From: The Secretary

Subject: **France—Statement by the European Central Bank Representative**

Board Action:	Executive Directors' **information**
Additional Information:	For the Executive Board discussion on France to be held on Wednesday, January 13, 2021.

11 January 2021

Statement by Rasmus Rueffer (ECB Representative) and Dimitrios Rakitzis (Advisor) on France – 2020 Article IV Consultation

IMF Executive Board Meeting

13 January 2021

We would like to thank Messrs. Buissé and Rozan for their informative Buff statement, and Staff for their balanced report. We broadly agree with Staff and share many of the main findings, in particular those related to the challenges facing the French economy and priorities ahead. We associate ourselves with the statement of Mr. Pösö and would also like to highlight the following items for emphasis.

We broadly concur with Staff's views on the growth outlook and the challenges identified in the Staff Report, noting that there remains considerable uncertainty on the horizon. The IMF Staff's growth estimates for France appear to be somewhat more subdued in the medium-term in comparison to the December 2020 Eurosystem staff projections. However, considering the still very high uncertainty on the medium-term growth outlook, we consider such differences as marginal. The Staff Report also identified a number of long-standing challenges weighing on the pre-crisis outlook, including high public and private debt, sluggish productivity growth and inequality of opportunities. We agree that the Covid-19 crisis accentuates pre-existing weaknesses and that there is further scope to improve resilience and build buffers to reduce the economy's vulnerability to shocks. On that note, we share the view that there is room for further structural reforms aimed at boosting productivity and employment, allowing the necessary reallocation of workers towards more dynamic sectors, as well as climate-related investments and digitalization.

On the risks for real activity, we agree with Staff's assessment that downside risks are still prevailing both in the short and medium term. While we do not see a tightening of financial conditions to be an imminent risk for the French economy as a whole, we concur with Staff that increased leverage poses some solvency risks to the corporate sector. In the short term, given the favorable financing conditions, the materialisation of this risk will depend on the developments of profit margins and turnover and thus of future sale revenues, which fell strongly in 2020 due to the pandemic and the consequent adopted lockdown and social distancing measures. We also agree with Staff that the near-term risks are dominated by the virus dynamics. In addition, other downside risks include a possible increase in social tensions and acceleration of de-globalization developments.

We broadly agree with the unemployment and inflation outlooks. With regard to the labor market, Staff expects a strong increase in the unemployment rate related to continued depressed activity, especially in labor-intensive service sectors, which we broadly agree with. Again, in view of the significant uncertainty any differences in the inflation outlook can be considered to be rather marginal. Regarding Staff's comparison between inflation rates in France and the ECB's inflation objective (featured in paragraph 1 of the Staff Report) we would like to stress that the ECB's inflation objective is defined in terms of price developments for the euro area as a whole and not for individual member states. The

report may thus be misleading and it is not clear from the text what the purpose of this comparison between national inflation rates and euro area wide objectives is.

On fiscal policy, we agree that the French authorities' response to the COVID19 crisis was appropriate. The policy response provided strong and timely support to both companies and households, alleviating the severe impact on the economy. While the Staff Report's presentation of the outlook for the next few years is broadly balanced, it should be acknowledged that uncertainty remains unusually high in the short term. The Staff Report correctly points out that the initial policy response leaned towards contingent and liquidity measures; however, we would deem very useful to have more analysis on the extent to which fiscal space considerations played a role as well as a comparison with peer countries that struck a different balance.

We concur with Staff on the importance of using fiscal policy to fight the pandemic and limit scarring, while at the same time developing plans for a medium-term expenditure-focused consolidation. Fiscal policies will continue to play a key role in ensuring that long-term costs to economic activity are limited and that the adjustment is equitable. At the same time, IMF staff rightly stresses that continued fiscal support in the short term should be combined with a plan for a tighter stance in the medium term, also reflecting the projected continued rise in the debt ratio. In this context, we would like to highlight the importance of basing such plan on realistic expectations regarding the growth dividend from recently announced reforms; such a plan would also benefit from a growth-friendly prioritisation on essential parts of spending which improve the structural position of public finances and enhance resilience. Further, we share the Staff's view that successful fiscal consolidation requires sharing the burden of adjustment across all government levels.

Turning to financial issues, we broadly concur with Staff's risk analysis. We agree that the banking sector incurred limited losses so far, but profitability deteriorated and is expected to remain under pressure due to higher provisions for impairment. Regarding the outlook for financial stability, a repricing of risks and increased volatility in asset prices could lead to a renewed sharp tightening of financial conditions, disproportionally affecting a large and interconnected financial system such as the French one. Moreover, the COVID-19 crisis accentuates pre-existing weaknesses, such as the high and growing corporate indebtedness. This was spurred by the provision of state guaranteed loans, as corporations borrowed large amounts to cope with working capital needs and to increase cash holdings. Risks in commercial real estate (CRE) have increased in a market that was characterised before the pandemic by signs of overvaluation, strong investment dynamics and CRE lending and large CRE bond issuance. In the longer run, vulnerabilities in the residential sector could also materialise due to high household indebtedness and depressed job market.

We broadly agree with staff's recommendations for the financial sector. In particular, we concur that regulatory flexibility should be temporary and time-bound. At the same time, exit from government support should avoid cliff-effects that increase credit risk and weaken the solvency of financial and non-financial companies. Lastly, the report could put more emphasis on signalling the importance of communication to ensure that bank capital buffers remain usable to absorb losses and limit deleveraging. In particular,

should credit losses materialise, averting bank deleveraging hinges on banks' willingness to let capital ratios decrease and use capital buffers. Finally, we agree that guidance by the supervisory authorities to limit dividend pay-outs, while certain support measures are in place, is prudent and should continue until the shock is weathered. The ECB issued a recommendation in March and July 2020 on dividend distributions and asked banks not to pay dividends or buy back shares until end of 2020. Further communication regarding the year 2021 has been published in December.

We agree with Staff that the authorities' decision to reduce the countercyclical capital buffer (CCyB) to zero was appropriate. The release of the CCyB in the second quarter of 2020 was intended to allow banks to use capital to absorb losses while minimising the restriction of credit supply to the real economy in times of stress. The CCyB should be maintained at the current level for as long as the COVID-19 related shock continues to weigh on economic activity, with potentially negative impacts on credit supply and the financial system. Capital buffers have been designed with a view to allowing banks to withstand stressed situations like the current one and France was among a limited number of countries to have built releasable capital in the build-up face of the systemic risk cycle.

Like Staff we also view that structural policies should support a sustained economic transformation. The fallout of the COVID-19 pandemic highlighted some structural vulnerabilities in the French economy, but also represents an opportunity for transformation towards a more digital and greener economy.

We would like to underline that policies need to strike a balance between supporting the labor market, while allowing a reallocation of resources as a result of the pandemic. The government has revamped the regime of activité partielle with a view to protecting jobs during the COVID-19 pandemic. While these measures have helped to save jobs, the crisis may lead to increased reallocation needs towards digital and greener activities. In this regard, it is important to continue to invest in life-long training of the workforce and monitor the effectiveness of past reforms in the areas of apprenticeships and vocational training.

Beyond the labor market, policies for a sustained economic transformation include improvements in the regulatory environment, a reduction of administrative burden for firms and a simplification of the tax system. The planned public investment under the Next Generation EU represents an important opportunity to support the digital and green transitions and address some of France's long-standing structural challenges relating, in particular, to the need to enhance its potential output growth.