Christian Noyer: The Euro area – challenges and responses

Speech by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, at a breakfast for the Economic Club, New York, 18 April 2011.

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It is a great pleasure to be here today. It is also a privilege to address such a distinguished audience. I would like to take this opportunity to present my assessment of the situation in the euro area, particularly with respect to the difficulties we meet on sovereign debt.

Three views on the sovereign crisis in Europe

Broadly speaking, opinions and views expressed on the euro area by people outside the Eurozone, can be divided into three categories: hostility for, at least very few people, skepticism and support.

First, outright hostility. It is unfortunately true that, in some circles, there is a spontaneous and deeply ingrained opposition to European integration. Since the euro is the most accomplished part of the integration project, it is only natural that it crystallizes those oppositions. Somber predictions about the imminent demise of the euro came predominantly from those deeply anti – European commentators. While those views, like all opinions, should be treated with respect, there is no point in trying to refute arguments which, in great part, are irrational and mainly reflect wishful thinking.

Second, skepticism. It emanates mainly, but not only, from academic circles. Prestigious and well respected economists have been pointing to the fact that the Euro is not an optimum currency area. They also underlined that, absent sufficient labor mobility, there was a need for some form of fiscal federalism that current arrangements failed to fulfill by a large measure. Those arguments have been made and discussed for some time and deserve careful consideration. Obviously, recent turbulences and disruptions in the articulation of national fiscal policies have given them a new relevance. I will come back to this debate in a moment. At this stage, I will simply remind you of some responses that have been consistently formulated over the last decade. The benefits of the euro cannot be assessed exclusively through the lenses of the optimum currency theory. The Euro has brought to more than 400 million European citizens unprecedented stability. Price stability, obviously, with inflation averaging 1.97% over the last decade. And also, yes, financial stability. It is always useful to think of counterfactual when assessing a situation. Looking beyond current fiscal turbulences, let us think, for instance, how Europe would have absorbed the crisis with fifteen different currencies, fluctuating internal exchange rates, and, as a consequence, much higher volatility, uncertainty, risk premia and interest rates. This experiment speaks for itself.

In addition, numerous studies have shown that economic cycles are becoming more and more synchronized across the euro countries. After a spike in 2009, the standard deviation between national growth rates inside the Euro area has gone down to its lowest historical level ever. This convergence has eliminated one major asymmetry and is getting the eurozone closer to the canonical model of the optimum currency area.

The last observable reaction is support. It shows up in comments from a majority of observers and investors, especially in emerging economies: they praise the euro; they want it to succeed; but they sometimes wonder about our collective ability, in current circumstances, to do what is necessary, to make the right decisions or make them at the right time and to set in place the proper framework for the future. These are the concerns I want to address now.

Where and how did it start?

Most Euro area and EU countries entered the crisis with significantly deteriorated fiscal positions. We were very far away from the "structural balance objective" which was the basic pillar of our fiscal framework. So, all countries were severely hit, not so much by an increase in expenditures but essentially through a massive loss of revenues. The IMF has shown that, in all advanced countries, including the US and UK, those losses account for around two third of the deterioration in fiscal positions which have been observed during the crisis.

Fiscal deterioration was compounded, in some countries, by the size of blanket guarantees given to the banking sector. Those implicit liabilities only became apparent when difficulties materialized. As in the US and UK, fragilities in the banking sector stemmed from risks mostly taken in – or related to – the housing sector.

Let me note, in passing, that those problems unfortunately were not specific to the Euro area. Public debt jumped by around 30% of GDP in UK and in US. Structural deficits in those countries stand at similar or higher levels than those in most parts of the Euro area.

Overall, the crisis has put into light major deficiencies in the implementation of fiscal discipline and, more generally, in the economic governance of the Euro area. It is indeed demanding to operate a single currency with multiple fiscal and structural national policies.

Given the insufficient of market discipline, the founders of the Euro had seen the problem and put in place the Growth and Stability Pact. The principles were sound. The framework was adequate. The implementation has been extremely weak. Bluntly speaking, peer pressure failed to ensure consistent and rigorous respect of the principles which had been agreed upon. It was, and remains necessary to make a "quantum leap" in economic governance.

What did we do ?

The governments are now trying to address those deficiencies. Significant progress has been made over the past year.

At the national level, all Member States have embarked upon credible public finance consolidation plans that are already bearing fruit.

At the EU level, a new framework has been agreed upon. The first pillar is a strengthening of the SGP with a much stronger preventive arm. Surveillance over budgetary policies has been reinforced with a more effective prevention/correction of excessive deficits. Government debt levels are being better taken into account and sanctions will become more automatic. Ideally those European disciplines should be now completed by the adoption, in each member states, of strong national fiscal rules.

The second Pillar is a new process to monitor competitiveness and, in particular, unit production costs.

Lastly, member states have agreed on a new euro area framework for crisis management. Experience has shown the need to provide temporary financial support to EA Member States facing impaired access to market financing,

As you know, a new facility, the EFSF, was created in May 2010 for a three year period. It has been used to support and finance the Greek and Irish programs. Although nominally set at 440bn its effective lending capacity was in fact limited to 250bn, an amount which may have been insufficient to instill confidence in the markets. Last March, an agreement was reached to raise that capacity to an effective 440 bn.

Member states also agreed on a permanent crisis management framework due to be implemented in 2013 and mainly based on a European Stability Mechanism (ESM) with an effective lending capacity of EUR 500 bn. That mechanism will have the possibility of

exceptional interventions in sovereign debt primary markets. Identical and standardized Collective Action Clauses (CACs) will be included in all new euro area government securities, with maturity above one year, from July 2013. Their basis will be consistent with the CACs that are common in New York and English laws.

Significantly, all those mechanisms associate the IMF and the European Commission "in consultation" with the ECB to avoid relying only on peer pressure between members states and ensure proper conditionality.

As you know, the crisis has also led the Eurosytem to embark on a very limited program of bond purchases. It was our judgment that the transmission mechanism of monetary policy was severely impaired in some cases, as local bond markets were close to paralysis. That program has served us well. Monetary impact was instantly and fully sterilized.

Where do we stand?

Overall, those changes have been favorably received by the markets. Spreads and CDS on most sovereigns are been trending down since January. Nevertheless, the sense of crisis has not yet disappeared. Most recently, Portugal has asked for an IMF / EFSF program. The success of existing programs remains to be demonstrated. The very progressive elaboration of new framework has prevented outside analysts to see the big picture and measure the amplitude of the changes.

There is also a more diffuse concern about sustainability, which I would like to discuss.

Looking at aggregate numbers, it is very difficult to understand many of the concerns expressed on the euro area. The Euro area is the only major currency zone with its external accounts in balance, and which therefore does not depend on external finance. This is an essential element of robustness and, for outside investors, provides a strong guarantee of long term solvency. Its aggregate fiscal balance (with a 2010 deficit at 6,3% of GDP) is the most favorable of all advanced economies (US is at 10,5%, UK at 9,6% and Japan at 7,7%). The same holds true for public debt which stands at 92% of GDP similar to 93% in the US versus 200% in Japan.

But, of course, markets, and analysts do not look always at the euro area as a whole. Because fiscal policies remain national, they tend to assess separately the situation of public finances in each individual country. While most analysts would acknowledge the magnitude of the efforts undertaken, some tend to take a very pessimistic view about future outcomes. As I understand it, that pessimism can be articulated around two lines of argument. First, the amplitude of fiscal consolidation will negatively affect growth for a very long time making it impossible to service debt and leading unavoidably to some kind of restructuring. And second, this economic stagnation will trigger strong political reaction which, ultimately, would put the very existence of the euro area at risk. In short, the whole reasoning is based on the euro area, and more specifically, its periphery, being unable to return to normal growth anytime in the foreseeable future. This is a very dramatic assumption and it matters a lot because, as we all know, the dynamics of debt are extremely sensitive to forecasts about future growth. Small changes in projections can have a huge impact on sustainability. Some of the implicit assumptions underlying current negative judgments seem to me seriously misguided.

Let's look first at the short run. As you know, we have been recently surprised on the upside with the dynamics of growth in the Euro area. Consumer confidence is almost back to pre crisis levels, PMI are at an all time high and GDP growth will almost certainly be above potential, on average, for the year 2011. Those developments take place at a moment where drastic fiscal consolidation programs are implemented in all countries. Those analysts who predicted that fiscal tightening would stifle growth in the Euro area are currently being proven wrong. Positive confidence effects in the private sector are outweighing the negative impact

of public expenditure reduction. In our economic jargon, we seem to be living to day in a "Ricardian" world.

What about countries in the periphery? Spanish growth rate swung from –3.7% in 2009 to –0.1% in 2010, despite the fact that a major austerity plan was being implemented. Spanish exports are booming with an increase of 10% within the euro area in 2010 and 19% outside the euro area in 2010. This compares very favourably with performances of other countries both inside and outside the eurozone.

Turning to the long run, it is essential, when looking at the inner workings of the euro area to make a distinction between real and nominal evolutions. Real convergence is occurring between various parts of the zone and I think this process will continue and support growth in the future, contrary to over simplistic descriptions.

One overlooked fact is the very fast productivity catch up in the periphery of the euro area. Between 2000 and 2008, cumulative labor productivity growth in Greece, as measured by the output per employee, was 14,7%, and 10,2% in Ireland. Both significantly outpaced Germany (6,1%). This is exactly what you would expect in an integrated economic and monetary area and this process should continue in the future, provided that appropriate policies are implemented. Economic convergence will therefore boost growth and support the return to debt sustainability.

Now, looking at nominal evolutions, a very different picture emerges. During the same period nominal wages grew by a total of 42% in Ireland and 52% in Greece vs only 7,4 % in Germany. The nature of the challenge, therefore, is clear. There has to be a regime change in the way nominal wages and prices are set in some parts of the euro area. As Central Bankers, we have been making that argument for years. One benefit of the crisis has been that this message is now fully accepted by Governments and public opinions. Strong reforms are currently being pushed in labor markets legislation as well as wage determination in the public sector in many countries.

I'll end up with a few words about the banking sector. I have the privilege to be both a Central Banker and a supervisor. From that vantage point, I will make four remarks:

1. Revenues for the twelve biggest European banks have grown, in aggregate, by 8.6% in 2010 (as compared, to 2.5% for the main US banks). As a result, European banks' Core Tier 1 ratios stood at between 8.5% and 15.3% at the end of 2010 (corresponding numbers for US banks are between 8.4% and 13.3%). Our "universal banking model", based on a diversity of activities and sources of income is proving its resilience.
2. Obviously there is a circular causality between government debt and the banking sector. Spreads on public debt naturally act as floors for the funding costs of banks. And, conversely, doubts about banks solvency create expectations of public support and deterioration in public finances. This gives rise to multiple equilibria where sudden shifts in confidence can be self fulfilling and create difficulties which, previously, did not exist. This process has been at work in a number of cases in the Euro area during the last year.
3. The main purpose of the stress tests is to break that circularity. Our first european tests encompassed 81 banks vs only 19 for the US. The basic exercise was sound and taken as such by analysts when it was published. Somehow clumsily, however, a few banks were added at the last moment, with only limited investigation, and these are precisely the banks which proved problematic afterwards, which undermined the credibility of the whole exercise. That mistake won't be repeated.
4. A lot has been made of the fact that no sovereign stress was made on the banking book. And indeed, as regulators, we did not want to give any credibility to a scenario that we consider unacceptable. However, there was full, total, and transparent disclosure of exposures to sovereigns for each in individual bank. Everybody is free

to make their own assumptions and calculations. With knowledge of the exposure, it does not take a rocket scientist to figure out some scenarios. It turns out that such calculations would produce very reassuring numbers. But, for some reasons, they never were publically made by most analysts. Just as an illustration, the total exposure of French banks to sovereign debt in the southern part of Europe is 38% of total tier one (13% without Italy). I'll let you make your own conclusions. Even in an apocalyptic scenario, only a small fraction of French banks tier one ratio would be compromised. The same results apply, with some variations, to other countries.

Conclusion

Let me know conclude. Like all other major advanced economies, the euro area is facing big challenges in adjusting to the post-crisis environment. For all, those challenges relate to long term fiscal sustainability. They are neither bigger nor smaller for the euro area than for the US, UK or Japan. They may be more complicated to solve because, by nature, our governance is more complex and we face specific collective action problems. It may take us longer to deal with difficulties as they appear, and we are paying a price for this relative inertia. But problems are being tackled, reforms are being implemented and I am convinced that, at the end, the Euro area will emerge as a stronger and more robust entity than before the crisis. As for the European System of Central Banks, I can assure you that we stand ready to act as forcefully as necessary to ensure price stability and preserve the integrity of the euro, which is, today, our most precious common good.