Christian Noyer: After the global crisis, which models of growth?

Keynote 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 the CIGS (The Canon Institute for Global Studies) – EHESS (Ecoles des Hautes Etudes en Sciences Sociales) International Symposium "After the global crisis, which models of growth?", Tokyo, 3 October 2011.

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Let me begin by saying I am delighted to be here with you today. I am of course conscious that the world is experiencing major economic turbulence and that Japan has suffered this year a series of particularly cruel catastrophes. As you know, I have profound admiration for your country, and we French wish to show our solidarity with you in the face of these ordeals. I would like to warmly thank the organisers of this symposium – which should be fascinating – for giving me this opportunity to speak to you.

I thank the Canon Institute for Global Studies and its Chairman, my friend Governor Fukui. I also thank the France-Japan Foundation of the EHESS and its Director, Sebastien Lechevalier. In 2009, the Banque de France was one of the first institutional sponsors of this Foundation, whose objective of promoting greater intellectual and cultural exchange between Japan and France is highly commendable. Our two countries have much to learn from each other and a great deal to gain from deeper collaboration. I do therefore strongly welcome this initiative.

The last two months have brought important changes to the world economy. Growth perspectives in advanced economies have significantly worsened, markets are increasingly volatile, and confidence indices have fallen.

The continued downward revision of US growth performance has certainly played a role. But, most significantly, two almost simultaneous shocks have occurred: in the US, reaching an agreement to raise the debt ceiling has met with considerable difficulties; and, in Europe, it has been recognized that Greece, a euro and OECD country, would not be able to fully honor its signature, unless there is voluntary private sector involvement in its refinancing. In the eyes of the market, this has had significant implications for other peripheral European sovereigns.

Overall, doubts have been cast on the ability of major advanced countries to pay back their sovereign debt. In different ways, to differing degrees and with opposite consequences, the same question is now being asked on both sides of the Atlantic: what kind of risk is attached to sovereign debt? We used to think of public debt in major countries as a riskless asset. Not anymore, not to the same extent.

In that sense, a true regime change has occurred, with deep and long-lasting consequences, upon which I will try and reflect today. Much what I will say, of course, relates to Europe. But I will also adopt a more global perspective.

Over the last 70 years, financial markets have developed on a strong, albeit implicit, assumption. Public debt in advanced economies was considered risk free. On that basis, it was possible to build a whole architecture of asset prices, whose relative riskiness is determined according to the intrinsic characteristics of assets and investors' risk appetite. The important word here is "relative". To price financial assets, markets need a basis – a risk free rate. That basis has now been shaken.

Immediate consequences seem benign in the US. Markets have judged, and rightly so, in my view, that there is currently no alternative to US debt as the most liquid market and it remains the ultimate benchmark for assessing risk. So, if anything, the downgrade of US debt was followed by new inflows into Treasuries and a decrease in US interest rates across the yield curve. At the same time, however, a pervasive uncertainty has been created, which might be responsible for the strong decline in confidence and equity prices that has occurred over the last weeks. In Europe, of course, sovereign credit risk has had more immediate and dramatic consequences, with an abrupt increase in sovereign spreads for peripheral countries following the July 21st statement.

It remains difficult to foresee how, in the longer run, markets will assess debt sustainability in different countries and jurisdictions. That assessment depends on a complex process, where, together with economic fundamentals, subjective probabilities, self-fulfilling beliefs and other influences play a major role. The certainty that debt would be paid in full strongly anchored market perceptions in the past. Now that this certainty is gone, debt sustainability may well rest on a more fragile and volatile basis.

As we all know, debt sustainability depends on three variables: the primary surplus, the growth rate and the interest rate. The relationship between those three parameters and debt can be expressed through a simple equation, the famous "unpleasant arithmetic". Assessing sustainability seems therefore relatively straightforward. Many economists and market analysts on sovereign European debt simply assume low growth and high interest rates forever in peripheral countries – which enables them to conclude categorically that debt is not sustainable. A (slightly) more sophisticated and developed version of that story takes account of the impossibility, for Euro economies, to depreciate their exchange rates, therefore locking them into a low competitiveness and no growth equilibrium.

I see three major problems with those analyses.

First, the competitiveness story does not hold. Take the UK, for instance. Its effective real exchange rate has depreciated by 23% over the last four years. And its exports have grown by a healthy 15%, in nominal terms, over the first six months of 2011. But Italy, Spain and Greece have done even better, with exports growing respectively by 16%, 19% and 37% during that same period, and, of course, no exchange rate adjustment. Equating competitiveness with exchange rate depreciation is therefore overly simplistic. This does not mean that efforts to improve competitiveness in many parts of the euro area should not be strengthened. But it certainly shows this can be done, with great efficiency, by proper internal adjustment.

Second, both aggregate and country-based data do not point to widespread and inevitable unsustainability in peripheral Europe.

The euro area's aggregate budget deficit will stand around 4.1% in 2011, less than half that of the UK or the US. The same holds true for public debt, which amounts 85% in the euro area while it will soon cross the 100% mark in the US.

The euro area is also the only major currency union with its external accounts in balance, which is an essential element of robustness and a strong guarantee of long-term solvency.

Peripheral countries are also improving their fundamentals. The primary deficit of Spain for 2011 will be around 4.7%, half that of the US and the UK. Italy will be one of the very few advanced economies to have a primary surplus, around 0.5%. Both countries announced and adopted major fiscal consolidation and structural reform plans aimed at balancing their budget by 2013. Ireland provides the perfect example that a country with very high deficit and interest rates can reverse the trend if it makes the necessary efforts. The Irish deficit will fall from 32% in 2010 to around 10% in 2011, exceeding the requirements of the EU-IMF programme. At the same time, growth is back and will probably be around 2% this year.

The third issue is more subtle. It relates to solvency and liquidity. In times of trouble, sovereigns, like financial institutions can be either illiquid, or insolvent, or both. In many cases, the distinction is blurred. When uncertainty is high, sovereigns face liquidity shortages, and they can only issue new debt at constantly higher interest rates. This, in turn, creates doubts about their ultimate solvency, triggering a negative spiral. This process is clearly at work in peripheral Europe, especially Spain and Italy, since the beginning of August.

In short, sovereign solvency is partly endogenous. Good fundamentals are an absolute necessity, but not always a sufficient condition. Liquidity spirals, when allowed to develop, can lock a country, just like a financial institution, into a bad equilibrium.

What is therefore the appropriate policy reaction? We had a continuing debate on that question in 2009–2010 when dealing with financial institutions. We are faced with the same question now regarding sovereign risk.

The standard answer is twofold. First, get the fundamentals right. For European countries, it means reverting to a sustainable fiscal position which, in most cases, necessitates a significant primary surplus. Necessary efforts are greater now since doubts have been created about sovereigns' ability to meet their obligations. And second, when solvency is achieved, there is a need for a liquidity backstop to ensure that bad equilibria will not be allowed to develop.

Where that backstop is coming from is a key question in the current debate. In most jurisdictions, but crucially not in the euro area, unconventional monetary policies have led central banks to purchase significant amounts of Government debt: those purchases amount to 51% of the total debt issued since 2009 in the UK, 21% in the US and 7.6% in the euro area – where they were fully sterilized. Although this was not the primary purpose, this policy stance has contributed to giving markets an insurance, or even an assurance, against a potential dry-up in liquidity. In all countries where significant amounts of debt have been purchased by monetary authorities, long-term interest rates have been kept at very low levels, irrespective of their fiscal situation.

By contrast, purchases of sovereign debt by the Eurosystem have remained extremely limited and will stay so. Our objectives are very circumscribed: avoid disruptions in the monetary policy transmission mechanism. Any lasting liquidity backstop has to come from the governments. This is why we have been asking for more flexibility in the EFSF and very much welcome decisions taken in this regard on July 21st. Whether amounts are big enough is a matter of opinion. It would be unrealistic to expect an increase in the EFSF itself but I am personally open to any scheme that would allow existing commitments to be leveraged to provide greater intervention capacity.

At the moment, the kind of insurance that most monetary authorities provide may look cheap because inflation is projected to stay low in the foreseeable future. But this equilibrium could be unstable in a different inflation environment. While markets are currently rewarding those countries which liquefy public debt, they seem to be aware of some inflation "tail risks" and hedge themselves through gold and the CHF – whose prices have reached historical highs.

At this stage, therefore, the euro area is paying a double price. One for its mistakes and one for its virtues. The mistake, for governments, was to allow the piling up of debt through unsustainable fiscal policies over a decade, and then to create ex nihilo a doubt as to their ability to pay those debts. And we are also paying the price for our virtue and our refusal to liquefy our debt through massive monetization of our fiscal deficits.

Will our virtue be rewarded at the end? I believe so and, to explain why, I need to take a longer-term perspective. In the next decade, the world will be divided into two: on the one hand, advanced economies, with high absorption capacity, low savings and high debt with ratios between 85% and 100%; and, on the other, emerging economies, with high savings, low debt (around 30% GDP on average) and less absorption capacity. Our common prosperity will therefore depend on our ability to create stable channels and mechanisms of financial intermediation between those two parts of the world. That, in turn, will crucially depend on the existence of assets that can be considered safe stores of value. As I have said from the start, public debt may not be able to play that role to the same extent as before. The ultimate safe asset, therefore, will be the currency itself. Markets and lenders will trust those currencies that, whatever the circumstances, are managed with one overriding priority: preserving price stability and the intrinsic value of the currency unit. On this fundamental basis, we can look at the future of the euro with strong and realistic optimism. I see the recent decision by the Swiss central bank to peg the CHF to the euro as a confirmation of this statement.

A few words on the banking sector, and, of course, French banks. I would remark, first, that banks have been hit in all advanced economies by the downward revision of growth prospects. Since August, CDS premia on major banks and BOR-OIS spreads have risen in all regions, although to a larger extent in Europe, displaying everywhere a sharp rise of counterparty risk. By the same token, banks' share prices fell in all major economies, with French banks being particularly hit. This overreaction of share prices can be explained by a simple amplification mechanism: slower growth means lower profits, thus lower projected dividends. At the same time, banks are required to build additional capital buffers, which further constrain their pay-out ratio. So dividend prospects are doubly affected and that explains why, in the current period, share prices are reacting so strongly to negative news on growth. This global movement has been more pronounced in Europe, because of a third uncertainty, related to banks' exposures to peripheral sovereign risk.

In addition, French banks have suffered from two specific vulnerabilities, one real, one exaggerated. The real vulnerability is their dependence on dollar funding, due to the scale of their international activities, which they may have been too slow to address effectively. It is currently being dealt with through a combination of deleveraging and consolidation. In the meantime, and since this is a broader problem for European institutions, in order to ease the transition, the Eurosystem, together with other central banks across the world, has decided to conduct three US dollar liquidity-providing operations with a maturity of three months.

A more exaggerated concern about French banks is their exposure to peripheral countries' sovereign risk. Let me just point out some facts and figures: total exposure of major French banks to the sovereign risk of so-called "peripheral countries" amounts to 60€bn which is only a limited fraction of their core Tier One capital. In terms of liquidity, the Eurosystem refinancing policy provides for an unlimited provision and the total collateral of French banks amounts to 600$bn in eligible assets.

I would note that both so-called "vulnerabilities" are a consequence of the internationalization of banking activities. And there is a certain paradox in a situation where globalized banks, with diversified activities and balanced business models are perceived as riskier than more specialized institutions.

Let me now conclude. In these turbulent times, Europe has a special role and a special responsibility. We are at the epicenter of the crisis and very much aware of the necessity to take and implement the appropriate decisions. Like in 2009, however, the crisis itself is more global in nature. A new uncertainty has been created and the interaction between markets and governments has become more complex and more dangerous. We live in democracies and have to accept that political decisions follow their own process and obey their own constraints. In all our countries, rising public debt and the unstable state of public finances is creating enormous anxiety, which, in turn, makes it more difficult to reach the necessary decisions. There are, however, good reasons for optimism. On the supply side, our economies are robust and dynamic. Corporate balance sheets are very strong. Emerging economies are well placed to enjoy strong and sustainable growth in the years to come. Above all, the community of nations seems ready to face the extraordinary challenges we are confronted with. Coming back from the IMF-World Bank Annual Meetings, I am struck by the spirit of cohesion and the willingness to cooperate that has been displayed by all participants. As you well know, central banks themselves are constantly cooperating in monitoring the situation and acting when necessary, as they have done recently to provide dollar funding to international banks. This spirit of cohesion is our best asset in the current environment. We can all look forward to another step forward in international cooperation at the G20 Leaders' Summit, in Cannes, next November.