

Christian Noyer: Challenges and outlook for the global economy

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 press conference, Saint-Denis, Reunion, 14 November 2011.

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Secretary General of the Prefecture,
Elected representatives,
Consul General of China,
Representatives of civil and military authorities,
Ladies and gentlemen,

It is a great pleasure to be here today. And not only because it is 20 degrees warmer than Paris at the moment, or because I spent the weekend enraptured by the beauty of your island and the friendliness of its people.

I am particularly pleased to be here today because it is extremely important for me to have the opportunity to talk directly to local economic players throughout the French territory, listen to their views and explain our actions. Above all, in these complex times, such exchanges are tremendously valuable.

I would especially like to extend my regards and thanks to the Mayor of Saint-Denis for receiving us in this beautiful venue.

I will start by rapidly recalling the crisis to date and the solutions that have been implemented. In the past months we have witnessed a succession of serious and complex events. It is therefore logical that feelings of confusion and uncertainty have developed in society. I will thus attempt to provide some useful insights into the situation that we are currently facing. I would be delighted to listen to your comments or reply to your questions afterwards.

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The crisis: where do we stand?

Epicentre No.1: The United States between 2006 and 2008

In order to fully understand the current crisis, it is important to realise that it is in fact a new episode of the acute crisis that has been with us since 2006.

Why 2006? Because it was the year in which the US property market started to fall after several years of continued, strong growth. It is perhaps hard to imagine but the turnaround in this market and the problems we are currently experiencing are closely linked.

Indeed, this downturn greatly affected many low-income households in the United States, who had taken out residential adjustable-rate mortgage loans (the famous subprime loans). When the value of their property plummeted, monthly repayments rose sharply, meaning that households were unable to repay their mortgages. This generated losses, albeit very limited at the outset.

But how did these limited losses cause the most serious financial crisis since 1929? In fact, subprime loans were packaged into extremely complex financial products, along with other debt securities and sold to insurers and investors. These securities, known as “CDOs”, developed exponentially in the 1990s and 2000s, and came to represent colossal sums on the balance sheets of many financial institutions worldwide. These instruments were intended to disperse credit risk. But when the value of the underlying subprime loans

collapsed in 2006/2007, it became clear, on the one hand, that the risk had not disappeared and, on the other, that by increasingly dispersing this risk, it was everywhere.

This was the crux of the first episode of the crisis. Investors then realised that these products were opaque and toxic and they became distrustful. The collapse of a number of hedge funds in summer 2007 as a result of these products led to a freeze in interbank markets and banks stopped lending to each other. In September 2008, these dynamics and the attendant loss of confidence culminated in the folding of the major US investment bank Lehman Brothers. The seizing up of the interbank market and the magnitude of the shock for banks was even greater and had an immediate impact on the real economy. Lending to the economy declined, investments and international trade collapsed and all regions of the world went into recession at the end of 2008.

This is a brief recap of the first leg of the crisis. You can see that at the outset it was a real estate and financial crisis whose epicentre was in the United States.

Epicentre No.2: Since 2009, the euro area

But how did this first crisis transform into the euro area crisis that has been raging for the past two years? In two words, the answer is public debt.

Indeed, the financial crisis of 2008 had far-reaching consequences on the public finances of most countries: tax revenues fell due to declining activity; welfare spending rose due to higher unemployment; stimulus plans had to be implemented and, in many countries with the notable exception of France, the cost of rescuing the financial system was huge. Government deficits in numerous countries increased and their debt exploded. As an indication, the ratio of government debt to GDP of most industrialised countries rose by over 20 points between end-2007 and today, which is very significant.

If the fiscal positions of these countries had been sound before 2007, the situation would be very different today. But most countries had large deficits and high debt levels before the crisis. Creditors started to question the ability of some countries to meet their commitments. Doubts emerged as to the “sustainability” of their public debt, despite the fact that, for decades, markets had considered government bonds to be risk-free or the safest type of asset.

For the past two years, the epicentre of this second episode of the crisis has been in Europe because the first doubts about the sustainability of an OECD country’s public debt focused on a euro area country: Greece.

At end-2009, the newly-elected Greek government announced that the government deficit for that year was twice as high as expected, above 12%, and that public debt exceeded 100%. Creditors suddenly lost all confidence and Greece’s borrowing rates soared, making it impossible for it to access market financing. In fact, for years, Greece had made poor management choices: no structural reforms, no privatisation, it had raised wages much faster than productivity and, to cap it all, it had massaged its public debt figures. The cocktail was explosive and it did indeed explode.

Markets then became jittery about the debt of two other euro area countries: Ireland and Portugal. Nonetheless, a distinction should be made between these countries’ situations.

Ireland enjoyed very strong growth for ten years with exemplary fiscal management. But it made two mistakes: on the one hand, it allowed its banking sector to become too developed with huge exposure to US real estate assets and, on the other, it gave an almost blanket guarantee to this sector. In 2010, the country was hit by the US financial and real estate crisis that caused banks to fail and require massive State bail outs. Its fiscal deficit then exploded, triggering panic on the markets. But, it is clear that this crisis was due to more specific factors.

However, the case of Portugal is closer to that of Greece, even though it is much less critical. The Portuguese economy has constantly performed poorly for the past few years. Growth and productivity have been weak and fiscal policies very lax. It is therefore a crisis of confidence about the sustainability Portuguese sovereign debt that caused its borrowing rates to soar and denying it access to market financing as of last March.

Greece, Ireland and Portugal are the three countries that have benefited from EU and IMF rescue packages. I will return to this in greater detail in a minute.

The financing conditions of a number of other euro area countries have been extremely tight for the past few months, but they have not required bail-outs. This is particularly the case of Spain and Italy. Here too, certain economic or political weaknesses along with deteriorated public finances are stoking fears in financial markets, which – I should say in passing – have the unfortunate habit of lumping all players together and always expecting the worst.

I would like to stress one point: the current crisis is not a crisis of the euro but a sovereign debt crisis. Moreover, we can see that all the turmoil that has been affecting the economy for the past few years is ultimately due to indebtedness: first, US household indebtedness and then sovereign indebtedness.

Nevertheless, since end-2009, the crisis has revealed major shortcomings in the implementation of fiscal discipline and, more generally, in the economic governance of the euro area.

The founders of the single currency had put in place the Stability and Growth Pact because they knew that a monetary union could not work without a common fiscal discipline. Its principles were sound, aiming to achieve a long-term balanced budget. But its implementation was greatly lacking.

I believe that two major mistakes were made:

- First, countries – including France and Germany – weakened the Pact by failing to comply with the provisions of its preventive arm (they were not in balance over the cycle but permanently close to the 3% deficit ceiling), or those of the corrective arm (they never abided by the sanctions).
- Second, the euro area did not equip itself at the outset with an instrument for monitoring competitiveness. The basic premise is important and simple: when joining a monetary area whose goal is to achieve a rate of inflation of just below 2%, changes in its unit production costs must be in line with this central bank objective. In all the countries that did not abide by this calculation and this discipline, year after year, there was a loss of competitiveness.

The crux of the matter is that, as soon as countries were approved for euro area membership, they considered that they were protected simply because they belonged to a single currency area: as their fiscal or competitiveness gaps were no longer penalised by the markets that indiscriminately lent to all euro area Member States at the same rate. When doubts started to emerge, the markets reacted rapidly, violently and often excessively, although it must be said that real underlying problems existed.

How the euro area sovereign debt crisis has been dealt with to date

What have we done to tackle the urgent issues stemming from the crisis and to deal with the underlying problems?

Tackling the urgent issues

To tackle the urgent issues stemming from the crisis, it was first essential for the three countries that were experiencing major difficulties to be able to continue funding themselves:

the EU and the IFM stepped in to assist them. They did this via bilateral loans in the beginning, and then in the framework of a structure that borrowed on the markets backed by a guarantee from the euro area Member States: the European Financial Stability Facility (EFSF). This support was subject to strict conditionality to ensure that the sustainability of public finances was restored and the country in question regained its competitiveness. These countries therefore undertook to meet deficit reduction targets in order, ultimately, to be able to tap the markets directly for their funding needs. This support was always designed to be temporary and encourage sound fiscal policies.

Central banks also played a decisive role throughout the crisis. First, they cut their key interest rates sharply after the crisis of 2008 in order to guarantee price stability and boost lending and activity. Furthermore, they provided financial institutions with liquidity to limit credit crunches. Since 2008, the Eurosystem, for example, has conducted fixed-rate tenders with full allotment against an extended range of eligible collateral. Since 2010, it has run a programme to purchase government securities of countries in difficulty in order to support the market, ease pressure on interest rates and thus improve the efficiency of the transmission of its monetary policy to the real economy. In addition, cooperation between the world's major central banks was stepped up, in particular for the provision of foreign currency liquidity.

The rescue packages put in place for Portugal and Ireland are working well. Ireland in particular has considerably reduced its deficit, and implemented very extensive economic structural reforms approved by a broad political and social consensus. It is ahead on the execution of the programme and has even already returned to a path of growth.

In Greece, unfortunately, the situation is less rosy. For several months, it has appeared that Greece would not manage to meet its targets for reforms and deficit reduction. This has exacerbated market concerns.

To resolve this situation, the Heads of State or Government of the euro area and the IMF worked towards an agreement that was reached on 21 July 2011. This agreement allowed for major progress:

- First, it agreed to support a new rescue programme for Greece, better suited to its situation, with lower interest rates and extended maturities;
- Second, it included, on an exceptional basis and solely for Greece, a voluntary contribution of the private sector to write down the country's debt and enable it to recover;
- Lastly, it considerably bolstered the EFSF's scope of action.

It is important to realise that this constitutes major progress, in particular from the point of view of European integration. No one would have imagined that this would have been possible a few years ago. However, it was not enough to contain the crisis.

As of last August, against the backdrop of expectations of slower growth, financial market tensions increased again. A vicious circle developed between the risk of a Greek default, uncertainties surrounding the debt of other euro area countries and their banking sectors. In other words, as sovereign debt had previously been considered a risk-free asset, banks purchased massive amounts of government bonds. This was especially the case in Europe due to the interdependence of the economies and the free movement of capital. For instance, German and French banks have a relatively large exposure to Greek, Italian and Spanish debt. The fear of a credit default by these countries therefore constitutes a risk of very heavy losses for banks. Since this would ultimately affect the public finances of the States if it materialised, it in turn increases concerns about the fiscal soundness of these countries, creating a vicious circle. So you can see that much of this mechanism is not entirely rational. Only the Greek debt situation is truly critical, while all the other countries have solemnly undertaken to repay their debts in full and they are in a position to do so. Moreover, I have regularly given the exact facts and figures concerning our banks' exposures

and their ability to deal with extreme scenarios. But once this mechanism is set in train, it is hard to stop it.

A little over two weeks ago, a European summit offered even more far-reaching solutions to calm the crisis: the EFSF's capacity was doubled, banks' capital is to be bolstered more rapidly than planned and Greece's creditors have accepted a 50% debt writedowns (compared with the 21% agreed on 21 July).

I firmly believe that these are the right solutions. With this debt relief and the loans offered by the EFSF, Greece can achieve debt sustainability. I am sure that it will manage to do so if the agreements are fully implemented and if it meets its commitments in the areas of tax collection, structural reforms and privatisation. These efforts are obviously painful and require public support, but they are the only way for Greece to get back on its feet.

Dealing with the underlying problems

In addition to tackling the urgent issues stemming from the successive crises, it has been absolutely necessary for each country to implement all the efforts needed to restore them to a sound fiscal path. From my point of view, all countries have taken their responsibilities to do so. Their credibility is now at stake and they must be committed to bringing their public finances back into balance as soon as possible. Moreover, the euro area has considerably enhanced its fiscal discipline framework: national budgets have become subject to European Commission monitoring, sanctions are more automatic, and early warning mechanism more appropriate. A new framework for surveillance of macroeconomic imbalances and competitiveness developments has also been put in place.

I now wish to recall two points. First, excessive public debt is not solely a European problem. The sovereign credit rating of the United States was downgraded last summer and its fiscal policy framework does not appear to be much more simple or rapid than that of the euro area. Second, in aggregate terms, the euro area's government deficit is one of the "least bad" of developed countries. It is expected to stand at around 4.5% at end-2011 whereas those of the United States and the United Kingdom are double for example. Naturally, this is not a reason to slow down reforms, quite the opposite. But it shows that our situation is not as bleak as some market developments might suggest.

Measures taken by the G20 in response to the crisis

We have seen that there is a close link between the US episode that started in 2007 and the European episode. This clearly shows that the different regions of the world are facing common challenges and that the solutions must be shared. To this end, the G20 has grown in prominence since 2008, and has already made significant changes.

The French presidency of the G20 came to an end with the Cannes Summit in early November. As you may have noticed, the Greek situation grabbed the limelight meaning that the major advances made this year may not have received all the consideration they deserved. I would therefore like to finish my talk by recalling some of these advances:

- First, the G20, the FSB and the Basel Committee, continued their work on the reform of the international financial regulatory system underway since 2009, in particular regarding systemically important institutions;
- Second, the G20 finished its work on the "Framework for strong, sustainable and balanced growth". This involved strengthening economic cooperation between countries and better taking into account the potentially damaging effects of national policies on other countries. For example, countries running balance of payment deficits undertake to carry out reforms, while surplus countries commit to stimulating domestic demand.

- Third, the G20 also started work on reforming the international monetary system. This is naturally a long-term project, but there have been encouraging signs, in particular concerning the international role of emerging market currencies
- Lastly, G20 countries have fully understood the risk of excessive public debt. All the countries in this situation committed to reversing the trend.

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It is the combination of short- and long-term national, European and international solutions that will enable us to truly emerge from this crisis.

Major challenges lie ahead, but they are also opportunities to create a more stable economic environment for the future.

Thank you for your attention.