Christian Noyer: Europe – a financial crisis, not a monetary one

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 Paris Europlace Financial Forum, Singapore, 30 November 2011.

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The situation in Europe and the world has significantly worsened over the past few weeks. Market stress has intensified. Bond markets in the euro area are not functioning normally. Economies outside the euro area are feeling the effects of increased uncertainty, lower growth prospects and capital repatriation. In these conditions, it is important to clarify the mechanisms at work and identify the underlying causes. I will also discuss possible policy responses, from a Eurosystem perspective.

The true nature of the crisis

I will start with a paradox. Looking at fundamentals, the euro area today seems in a position of strength when compared to other developed economies. Growth has been stronger than in the UK and Japan since 2007. External accounts are in balance. Even the fiscal position is favorable. On aggregate, the euro area deficit (at 4% of GDP) is the smallest of all, less than half of that in the US, Japan or the UK. This remains true even for some peripheral countries. For instance, the Spanish fiscal deficit, at 6.1% of GDP, is much smaller than that in the US, the UK and Japan. Total gross public debt, at 67% of GDP, is amongst the lowest in the OECD.

Considering these figures, it is clear that Europe has the resources to face a manageable financing gap in some parts of the region. And yet, it is in turmoil. The answer to this paradox can be found by considering the true nature of the crisis. Most observers would simply see the fiscal imbalances in peripheral economies. These may have been the trigger. But we are now looking at a true financial crisis – that is a broad-based disruption in financial markets. To understand what is going on, it is necessary to take a step back.

Europe is the most financially integrated area in the world. There is full capital mobility inside the EU. Financial regulation is almost totally harmonized, financial infrastructures and payment systems are closely interconnected. Europe is truly a single financial market and, more importantly, a truly single financial system.

The single capital market has brought significant benefits to Europe. Capital has been flowing to peripheral countries, triggering investment and growth. Financial integration has supported and underpinned the broader process of trade and economic convergence.

At the same time, capital mobility has been used to postpone fiscal adjustment. Capital inflows have fueled credit and asset booms. Current account deficits have been financed through fragile sources of funding. The easy access to financing has created insensitivity to current account imbalances which, in turn, have weakened the incentives for preserving or improving competitiveness.

An integrated financial system may be efficient, but not necessarily robust. The more complex and interconnected it gets, the more vulnerable it is when exposed to small, and localized, shocks. These may worsen and compromise the stability and integrity of the whole. This is what is now happening in Europe, as it happened before with subprime mortgages in the US. In both cases, problems of limited size – the Greek public debt in the case of Europe – have had a disproportionate impact because amplification mechanisms have occurred inside the financial system.

In Europe, three separate dynamics have been at work.

First, between solvency and liquidity of sovereign debtors. In times of turmoil, 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 ever higher interest rates. This, in turn, creates doubts about their ultimate solvency, triggering a negative spiral. 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. This process has clearly been at work in peripheral Europe, especially Spain and Italy, since the beginning of August.

A second interaction occurs between sovereigns and banks. Both are perceived as closely linked by the market. Indeed, sovereign CDSs act as floors to bank CDSs. And, conversely, banks' creditworthiness depends on their exposure to sovereign risk. This circularity creates powerful feedback loops which may lead to absolute market freeze.

Finally, banks form a closely interconnected network. Interbank relationships are key to the smooth functioning of financial intermediation. They have been severely disrupted during the current turmoil. It is important to note – and accept – that counterparty risk between financial intermediaries depends as much on perception as on reality. It was enough for European banks to be perceived as vulnerable, even if that was unjustified, to experience tensions on funding. A case in point is the significant retrenchment by US money market mutual funds from European banks on the basis of their exposure to peripheral sovereign risk.

What we have seen in the last three weeks is the simultaneous interaction between these three dynamics: solvency and liquidity; banks and sovereigns; and inside the banking sector itself. All sovereigns have been impacted. This includes, most recently, all triple A countries, even Germany.

I draw three conclusions from this analysis

First, the essential weakness of Europe does not primarily lie in the fragility of any of its components. Europe's fragility comes from its difficulty to organize and manage, in times of crisis, the complex interactions occurring at the heart of its financial system.

Second, we are facing a financial crisis, not a monetary one. There are huge differences. Confidence in the currency remains as strong as ever. Gross capital inflows in the euro area remain unaffected. The euro exchange rate remains high by historical standards (6% in real terms above its average over the past decade).

Finally, interconnectedness, which creates contagion inside Europe, also works well beyond the euro area. Banking and market pressures have been transmitted globally. Asia may be 6,000 miles away from Europe, but, for the financial markets the distance is less than 30 seconds.

Origins and causes

How could the crisis have been allowed to develop? There have been lags in the decision-making process. Fiscal discipline has not been respected in the past. European rules have not been implemented. Also, some policy decisions have produced unintended consequences.

One example is private sector involvement (the so-called PSI) in sovereign debt resolution. On the face of it, it sounds totally appropriate. Economists like saying that, once debt has become unsustainable, it is better to reduce it immediately. Beyond simple economics, PSI is seen as necessary for eliminating moral hazard and ensuring market discipline. When investors have taken excessive risks, they should normally pay a price. Finally, PSI has a strong, and legitimate, political appeal: tax payers cannot be called to bear the consequences of the reckless behavior of borrowers and lenders.

However compelling, this line of reasoning misses an important point. The sovereign bond market is more than a means of financing governments. It is the pillar on which all financial systems ultimately rest. Over the past 70 years, financial markets have worked on the assumption that public debt in advanced economies was, indeed, risk-free. That basis has now been shaken, both by PSI in Europe and the debate on the debt ceiling in the US. We used to think of public debt in major countries as a riskless asset. Not anymore, or at least not to the same extent.

The immediate effects seem benign so far in the US, which remains the deepest and most liquid bond market in the world. In Europe, by contrast, there have been more dramatic consequences. Once credit risk has entered into sovereign bonds, a fundamental element of instability has been introduced. This is why, unfortunately, the strong statement made in the Communiqué of the Euro Area Heads of 21st July that Greece was a unique and exceptional case did not impact the market and was followed by an increase in sovereign spreads for all peripheral countries.

A second, more recent, decision may have contributed to intensifying the current turmoil. It was rightly decided by European regulators, under the auspices of the European Banking Authority, that banks should hold more capital to face increased uncertainty in the current environment. A deadline was set for them to achieve a 9% core tier 1 ratio, based on a commonly agreed definition of capital. Unfortunately, however, calibration for this exercise explicitly incorporated a mark to market assessment of each bank’s exposure to sovereign debt. Although this element of the calibration was deemed to have been done once and for all, just for the purpose of calculating an additional capital cushion above the objective of 9%, the market considered the risk that it might be repeated in other circumstances. This created a powerful disincentive to hold, let alone acquire, such debt, since banks felt they could be penalized in the future. Banks are major actors on the sovereign bond markets and it is certainly no coincidence that liquidity dried up and spreads went up in most markets in the days following that decision.

Policy responses

Cumulative and destabilizing dynamics need to be addressed by a conjunction of complementary actions.

First, it is essential to stabilize European bond markets. We have to recognize that the necessary degree of fiscal adjustment is heavily dependent on the level of market confidence. This has been well recognized by France with the recent EUR 18 billion consolidation package for this year and 2012, consisting notably of tax benefit reductions, VAT increases and an acceleration of the pension reform. But we also know that markets react positively, if only progressively, to credible fiscal consolidation and financial reform. Witness the success in Ireland where 10-year spreads have gone down from 14% in July to around 8% recently.

Second, we should try and delink bank and sovereign risk. In the future, this may call for more structural solutions, with deposit insurance and crisis resolution mechanisms firmly established at the euro area level.

In current, unstable circumstances, what role should the central bank play?

Monetary policy should certainly stick to its mandate and ensure price stability in the medium run. In Europe, with financial conditions tighter as a result of the explosion in sovereign spreads, increased uncertainty and loss of confidence, – as shown by the fall in most indicators – there are now more downside risks to price stability. It was therefore appropriate to lower our policy rates by 25bp, a decision reached unanimously by the Governing Council.

Second, we need to ensure that the banking system has access to liquidity –what is sometimes called the role of lender of last resort of the central bank. In this respect, the

Eurosystem has confirmed its policy of providing unlimited liquidity – at fixed rates – to the banking system until at least until the end of Q2 2012. Collateral policy has been adjusted to avoid the shocks and liquidity squeezes borne out of rating changes. Dollar funding, based on the existing swap with the Federal Reserve, has also been made easier.

Finally, in a period of intense market disruption, it is essential to ensure that the monetary policy transmission mechanism actually works. This may involve temporary and exceptional interventions on those market segments where dysfunctions are most apparent. This is the purpose of the Securities Markets Program (SMP), initiated in May 2010 by the Eurosystem. It is important to note that in our case, the objective was not to expand the monetary base. Central bank money created through these purchases has been sterilized.

There have been some criticisms against this bond buying program. But it is; in my view, totally justified by our primary mandate. Faced with a clear risk of completely disrupted financial markets, and with huge divergences in credit market interest rates, the ECB was in danger of not being able to implement a truly single monetary policy, nor to meet its primary mandate, i.e. maintaining price stability over the medium term in the whole of the euro area.

There have been calls for more. Both markets and some governments seem to consider that the ECB should take a more aggressive stance in buying public debt. Let me give you some perspective on the issue.

In some jurisdictions, unconventional monetary policies have led central banks to purchase significant amounts of government debt – these purchases amount to 58% of total debt issued since 2009 in the UK, 21% in the US and between 9 and 10% in the euro area (there was a monetary policy objective in all cases). Although this was not the primary purpose, this policy stance has contributed to providing markets with an insurance, or even an assurance, against a potential dry-up in liquidity. In 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. But this equilibrium could be unstable in a different inflation environment. Indeed, markets seem to be aware of some inflation “tail risks” and are hedging against these risks through gold and the CHF, whose prices have reached historical highs.

In the Euro Area, we consider that any lasting backstop has to come from governments. This is why we have been asking for a speedy implementation and greater flexibility in the EFSF and very much welcome decisions taken in this regard in July and in October.

At this stage, therefore, the euro area is paying a double price. One for its mistakes and one for its virtues. The mistakes, 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 willingness to pay those debts. And we are also paying the price for our virtue and our refusal to liquefy public debt through massive monetization of our fiscal deficits.

I believe that virtue will eventually be rewarded. In the next decade, 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.

Conclusion

History has taught us that financial crises can be extremely violent. The current turmoil in Europe is no exception. In the most intense phases, it is difficult to imagine that there is light at the end of the tunnel.

But history has also taught us that crises provide opportunities for reform and progress. We live in democracies and have to accept that political decisions follow their own process and obey their own constraints. But I am confident that the euro area will emerge from this period stronger and more cohesive.

There are, indeed, some reasons for optimism. On the supply side, our economies are robust and dynamic. Corporate balance sheets are very strong. Our banking system is robust and well supervised. Emerging economies are well placed to enjoy strong and sustainable growth in the years to come therefore contributing to sustained global demand. Above all, the community of nations seems ready to face the extraordinary challenges we are confronted with.