Christian Noyer: The euro area sovereign debt crisis

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 Bank of France / Toulouse School of Economics Conference "The euro area sovereign debt crisis", Paris, 19 December 2011.

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Ladies and Gentlemen,

It is a great pleasure for me to give the introductory address to this stimulating conference that the Banque de France is very pleased to organize jointly with Toulouse School of Economics. Obviously, finding a more topical subject would be difficult, now that euro area's sovereign debt markets are caught in the vortex of the financial turmoil that has been plaguing the world economy for the last four years. This topic is also the one we have chosen for our next Financial Stability Review, to be released next March, with a significant number of contributions stemming from today's presentations.

The current crisis is indeed extremely challenging. Many complex factors are currently interacting, making policy decision-making particularly difficult. In such a context, academics have a critical role to play to help us clarify the tradeoffs and available options, so that we are better able to make the right choices in real time.

This very fact that intellectual inputs from research are a precious resource in times of stress and multi-faceted uncertainty confirms me in my view that central banks' investment in economic research, be it in-house or through partnerships with academia, is a very valuable asset. Therefore, I also warmly welcome this conference as being one brilliant illustration of the benefits brought by our three years long partnership with Toulouse School of Economics (TSE). Note however that, while the organization of high-level academic conferences has been an important achievement within this partnership, it is not the only one. Indeed, many avenues of fruitful collaboration have developed. Two series of regular joint seminars, one on monetary economics, the other on financial stability, and several workshops have notably contributed to strengthen the links between Banque-de-France and TSE researchers and stimulate the scientific and policy debates. I would also like to take this opportunity to thank Jean Tirole for his personal involvement in the exchanges with Banque de France. Last but not least, let me also advertise the new Banque de France – TSE Senior and Junior Prizes in Monetary Economics and Finance which purpose is to distinguish outstanding contributions by academics. The first prizes will be awarded for the first time on 16 March 2012.

In the remaining of this address, I will first discuss the sovereign nature of the current crisis, its origins, implications and the associated challenges. Then, I will focus on the response of the Eurosystem to this crisis.

1. The euro-area sovereign debt crisis: some thoughts on its origins, its implications, and the challenges ahead

The origins of the euro-area sovereign debt crisis are twofold: the real cost of the overall financial crisis and the excesses of the pre-crisis period have jointly contributed to the gravity of the current situation. While this is not specific to the euro area, the consequences have turned out to be particularly harmful here. Indeed, by not internalizing the policy requirements associated with the participation in a monetary union, several euro-area countries entered the global financial crisis in a particularly vulnerable position.

One of these policy requirements is fiscal discipline. Within the Stability and Growth Pact, fiscal discipline was associated with pre-agreed quantitative ceilings for the deficit and debt-to-GDP ratios. In practice, many euro-area countries did not take advantage of expansionary periods to reduce the probability of reaching these limits in recessionary phases.

Unfortunately, an exceptionally hard recession, by all historical standards, hit the euro area in 2009, as a consequence of the financial turmoil initiated in the US in 2007–2008. The tax revenue went down and the large fiscal stimulus packages that were then required to contain the real consequences of the crisis and to avoid major disruptions in the financing of the economy also resulted in swift increases in public debts across the board. The fact that both public and private indebtedness had followed an unsustainable pace of growth over the previous decade then makes area-wide adjustments both necessary and painful.

Among the factors that contributed to the excess of the pre-crisis period stands in my view the misleading belief that sophisticated financial engineering was able to achieve close-to-perfect risk diversification and market completeness led in fact to excessive risk-taking by banks. This is in sharp contrast with the current situation, in which investors have doubts about even the risk-freeness of sovereign bonds of developed economies.

Restoring market confidence is a difficult and potentially lengthy task. That said, all actions that are consistent with the commitment of governments to address national fiscal imbalances and structural impediments to real growth are likely to accelerate this process. Besides, it is clear that nominal long-term anchors are also of the essence to reduce uncertainty and facilitate such reforms. The primary mandate and the best possible contribution of the Eurosystem is precisely to ensure price stability in the medium run. Then, to the extent that dysfunctional financial-markets are likely to jeopardize our ability to maintain stable prices in the medium run, the Eurosystem must intervene. This analysis has motivated our decisions in the past and will continue to motivate future ones. This brings me to the second part of my talk today.

2. Measures taken by the Eurosystem to fight against the financial crisis

Our analysis of the recent situation suggests that the weak outlook for economic activity in the euro area is weighing downward on costs, wages and prices. Accordingly, the Governing council decided twice to lower the key ECB interest rate by 25 basis points, in its early November and early December Meetings.

Changes in the ECB rates ultimately affect inflation through changes in bank lending rates, monetary and financial conditions and aggregate demand. Under normal financial-market conditions, monetary-policy transmission mechanisms work properly and non-standard measures are unnecessary. But when transmission mechanisms are impaired, standard policy is likely to be less effective. In such exceptional circumstances, extraordinary, or non-standard, measures must be implemented. It is in that spirit that the Eurosystem has constantly and reactively updated its set of non-standard measures, keeping pace with the crisis' developments. On December 8, we have announced extensive measures to contain the refinancing risks of Euro area banks. The Eurosystem has announced in particular two longer-term refinancing operations with a maturity of 36 months which will be conducted as fixed rate tender procedures with full allotment as well as the extension of the collateral it considers eligible to borrow its liquidity. We also have reduced the rate of reserve requirements from 2% to 1%, which is also contributing to stem collateral constraints of parts of the euro area banking system.

I would like to recall again that, in the euro area, banks are the main channel for mobilizing domestic savings and financing investment. This explains why ECB's non-standard measures have primarily aimed at enhancing access of the banking sector to liquidity and at facilitating the functioning of the euro-area money market.

Given the topic of the current conference, I would like to take the opportunity to elaborate on one of these non-standard measures, namely the *Securities Market Programme*, or SMP. Sovereign yields are central in the transmission of monetary policy, in particular because government bonds provide a floor to the private-sector funding costs. This is the reason why we launched the SMP.

I insist that, through the implementation of all its non-conventional measures – including the SMP – the Eurosystem has fully played its expected role as a lender of last resort (LLR), by which I mean that we have and we will intervene to stem liquidity crises that threaten the stability of the banking system.

Having said that, it is clear that engaging in large-scale asset purchases of sovereign bonds is well beyond what should be expected of a central bank's role as a LLR. Moreover, large-scale asset purchases are not without risks. While they may help to alleviate upward pressures on long-term interest rates in the short run, they could also affect price and financial stability in the medium-run, by endangering the value of the central-bank money. Such risks do not necessarily materialize, but when they do, the repercussions are dramatic.

Altogether, considering the different tools are potentially at the disposal of policy-makers, it is crucial to gauge the short- to long-run benefits, limits and risks associated with each of them. I do not think that confidence would really benefit from measures that are known to carry non-negligible long-run risks, even if some short-term relief is expected from them.

As a way of conclusion, let me shortly consider the progress that has already been made to solve this crisis and list some of the remaining challenges ahead.

First, it seems important to welcome the significance of the fiscal stabilization programs many euro-area governments have committed to. As mentioned earlier, this is a necessary step to restore confidence in a sustainable way. Although this is a difficult task, the timely delivery of the promised reforms is necessary.

Second, beyond individual policy actions, the recent progress obtained in the design of a common fiscal governance in the euro area is of the essence. Indeed, many important decisions have been taken in that direction: The creation of the EFSF and the ESM or the agreement on fiscal rules and surveillance mechanisms during the Brussels EU Summit on December the 8th and 9th are historical steps in the right direction. Obviously, most of these newly established institutions, rules and processes would have been unthinkable four years ago. This makes me really optimistic about our prospects for restoring stability and growth in the euro area.

Thus, significant progress has been achieved. However, the future may still add to the extraordinary challenges we are now confronted with. I rely on the academic community to help the policymakers in the decisive decisions they will have to take.

Thank you for your attention. I wish you all a fruitful and stimulating conference.