# Christian Noyer: The situation in the euro area

Introduction 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 Luncheon, New York City, 23 April 2012.

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Ladies and gentlemen,

It is a great pleasure for me to host this luncheon together with Lawrence Leibowitz. I would like to thank Paris Europlace for organizing this very interesting Forum and the NYSE for welcoming us here, at the very heart of the global financial world.

I would like to focus my short address on the situation in the euro area where the important steps already taken to exit the crisis now need to be further enhanced.

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## 1. The important steps to exit the crisis already taken by the euro area are beginning to bear fruit.

Indeed, when you compare the situation of the euro area in the first quarter of this year with that in the second half of 2011, the contrast is striking:

- Conditions in bank funding markets are much better. For instance, euro area banks have already issued about 70 billion euro in senior unsecured debt so far this year, which is well in excess of what they did in the whole of the second half of last year.
- The money markets are in much better shape as well: EURIBOR-OIS spreads have narrowed substantially, signalling a lowering of risk premia; the US money market funds seem to be re-opening access for euro area banks.
- Tensions on sovereign debt markets have also eased: 10-year Italian bond rates have shed around 200bps since early December; Spanish rates have also decreased significantly in spite of recent renewed tensions.
- Although at a low level, overall economic activity is stabilizing, as is bank lending.

All these elements indicate a trend reversal. How has this come about?

All of the players have proved their commitment and ability to restore stability. National authorities, especially in the most troubled countries, have taken far-reaching measures both to consolidate their public finances and to enhance long-term growth. The new Greek program has been launched. At the European level, a strong new fiscal compact has been agreed upon, as well as the rapid implementation of a powerful financial stability instrument. Banks are meeting their new capital requirements in an orderly way. And – I saved the best till last! – the Eurosystem has taken measures that have been absolutely decisive for this whole process to take place.

Unquestionably, the steps already taken by the euro area to exit the crisis have been numerous and important. But recent market developments have reminded us that there is still a tremendous need for further demonstration of the determination of all the players in the European crisis to rise to the challenges facing us.

I will mention three of these challenges.

## 2. But challenges remain to be addressed.

### *2.1. The challenge for each individual euro country: achieving strong fiscal consolidation while ensuring long-term growth*

The first challenge is the seeming dilemma between fiscal consolidation and long-term growth. One thing is very clear: this crisis is fundamentally a sovereign debt crisis; hence the priority in order to exit it once and for all must be a return to a sustainable fiscal path.

In fact, an impressive effort has already been made. The Portuguese deficit shrank from around 10% in 2009 to around 6% last year. The Italian deficit has been reined in from 5.4% in 2009 to 3.9% in 2011, and Italy actually ran a primary surplus of 1% last year, which is very rare among developed economies. The French deficit has been cut from 7.5% in 2009 to 5.3% in 2011. If we look at the aggregate picture for the euro area, we see that it is the economic zone that has tackled fiscal consolidation with the greatest intensity and the best results. According to the IMF (*January 2012 fiscal monitor*), after peaking at 6.5% of GDP in 2009, the public deficit in the euro area started to decline in 2010 and stood at around 4% by the end of 2011 (down by 40%). Over the same period, the US deficit was reduced from 13% to 9.5% (down by 27%) and the UK deficit from 10.4% to 8.6% (down by 17%). These figures show not only that the absolute level of the euro area's deficit is half what it is elsewhere, but also that the pace of fiscal consolidation is actually faster.

While these efforts are absolutely crucial, there are concerns that too abrupt an adjustment in public finances will be detrimental to growth and, ultimately, to fiscal consolidation itself. In the current circumstances facing Europe, I believe these concerns are misplaced. We have to look at the counterfactuals: delaying consolidation would expose our economies to even greater risks. At current debt levels, economic agents are very "Ricardian" and would react to fiscal permissiveness by delaying their own private expenditure. Financial markets would continue to impose very punitive interest rates on our countries to compensate for the uncertainty in the fiscal outlook. Overall, the confidence and financial benefits of fiscal consolidation far outweigh its negative effects on effective demand in the short run.

In addition, everyone knows that there are ways to boost growth strongly and durably even in times of fiscal consolidation: through structural reforms. Here as well, the progress already made in many countries is impressive. In recent history, European economies have never reformed so extensively in such a brief period of time. I could cite many examples: the labour market reform in Spain and now in Italy, the pension reforms in Italy and France, privatisations, public wage decreases in Ireland, etc. Some positive effects from these measures are immediate, but naturally, most of the impact on competitiveness and growth will take time to materialize. In any case, such reforms are a necessary foundation for dynamic and sustainable growth in the future and they must be vigorously pursued. There is no doubt that the euro area as a whole will benefit from these national reforms that represent a significant asset for us in the global economy.

### *2.2. The challenge for the banking system: continuing to ensure that the economy is properly financed while strengthening the financial sector*

The dilemma here is easy to understand: on the one hand, it is absolutely necessary to strengthen banks' balance sheets to enable them to better absorb shocks, protect public finances and re-establish normal market functioning. On the other, a disorderly deleveraging would create enormous problems and add credit constraints to the many headwinds currently facing our economies.

The euro area is currently making sure that these two objectives – although sometimes difficult to reconcile – are achieved.

Banks are meeting their new capital requirements. The capital plans submitted to the European Banking Authority (EBA) indicate an intention to exceed the benchmarks set by more than 20%. French banks already comply with the Basel 2.5 regulations. At the same time, bank lending seems to be stabilizing, although at a relatively low level. Banks are starting to assess their financial situation more positively and in many cases their willingness to grant loans is increasing.

***This would not have been possible without the strong support of the Eurosystem.***

As you know, two exceptional three-year liquidity-providing operations have been decided on and successfully implemented over the last two months. For the second operation, we decided to have an expanded collateral pool, so that smaller banks – which tend to lend to smaller businesses that are crucial for the European economic activity – could benefit more. The LTROs were specifically designed to help the banking system overcome the dilemma it is facing. The idea was to remove the funding pressures, thereby allowing a smoother deleveraging process; while at the same time preventing a major credit crunch that could compromise the maintenance of price stability in the euro area.

At this stage, positive effects from these operations have already materialized. It is clear that banks were facing major funding uncertainties in 2012 and 2013: these funding pressures have now been removed. This could in turn contribute to the issuance of new shares and hence to the meeting of the capital requirements without forcing excessive deleveraging. A reduction in counterparty risk is visible through lower BOR-OIS spreads and banks' CDS spreads have significantly narrowed as well. It is too early to assess the extent to which these measures will "trickle down" to the financing of the real economy, but the fact that more banks participated in the second operation (800 compared to around 500) indicates that the money is now closer to small and medium-sized enterprises than it was before.

### *2.3 The challenge for the EU institutions: enforcing economic union*

The weakness of European economic union in the context of monetary union contributed to the development of the current crisis and, if we are to emerge from it stronger, real improvement is required in this area.

European governments have fully understood this issue and have made concrete and significant progress towards a more integrated economic union.

On the one hand, Europe has considerably enhanced its fiscal discipline framework. The legislative package (the so-called "Six Pack") entered into force in December and considerably reinforces the Stability and Growth Pact: the surveillance powers of the European Commission over national budgets have been enhanced, sanctions have become quasi-automatic, the criteria for public debt and public spending are being more closely scrutinised and a new framework for the surveillance of macroeconomic imbalances and competitiveness developments has been put in place.

In addition, 25 European Heads of State or government signed the Treaty on Stability, Coordination and Governance which establishes a comprehensive new "fiscal compact". It includes in particular a requirement for national budgets to be in balance or in surplus, a criterion that will be met if the annual structural government deficit does not exceed 0.5% of GDP. This rule must be incorporated into the Member States' national legal systems, preferably at the constitutional level.

On the other hand, Europe has equipped itself with an instrument to combat crises.

At the last European Council meetings, it was decided to accelerate the creation of the permanent European Stability Mechanism (ESM) to July 2012, and to make it more powerful. An important step in this direction has been provided by the agreement to accelerate the payment of the paid-in capital for the ESM, starting with the payment of two tranches in 2012 and to increase the lending capacity of the ESM to 1tn dollar.

All in all, these changes constitute the most comprehensive reinforcement of economic governance in the EU and the euro area since the launch of Economic Monetary Union almost 20 years ago.

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The euro area has already demonstrated its determination and ability to take decisive steps to exit the crisis. Many more remain to be taken, and all of the players – the banks, governments, European institutions – need to continue to face up to their responsibilities.

The Eurosystem is providing the European economy with key elements of stability. First and foremost, we are providing price stability and will continue to take all necessary measures to fulfil this mandate. Moreover, our recent exceptional and temporary measures should be seen as a window of opportunity for banks to strengthen their balance sheets and for governments to step up their efforts in a less troubled financial environment.

Thank you for your attention.