Christian Noyer: Remaining challenges facing the euro area

Speech with Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, at the Foreign Correspondents Club of Japan, Tokyo, 10 October 2012.

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Ladies and gentlemen,

I would like to start by thanking the Foreign Correspondents Club of Japan for this invitation. I am delighted to be here with you today to discuss, here in Tokyo before an audience from different backgrounds, the situation in the euro area.

For the past few years the euro area has been going through a major crisis. This crisis has multiple causes that call into question the institutional foundations of monetary union.

I strongly believe that the different roots of this crisis have now been thoroughly analysed and are being effectively addressed. The main challenge facing the euro area is to pursue the efforts underway to return to balanced budgets, regain competitiveness and growth and strengthen Economic and Monetary Union.

1. What is the situation in the euro area?

In early 2012 the outlook seemed encouraging. Confidence appeared to be steadily returning, the decisions taken, in particular the very long-term refinancing operations – had calmed the markets. Nevertheless, pressures quickly mounted again, reflecting especially the difficulties experienced by Greece and Spain. It became clear that the situation was still precarious, and that the solutions hitherto adopted in the euro area had to be enhanced in order to be truly lasting.

Today there are a number of positive signs: bond market activity is reasonably buoyant, yields of peripheral countries have declined slightly and stock markets have picked up. However, two major weaknesses persist:

– Financial markets are highly fragmented within the euro area and sovereign yield spreads remain substantial;

– Growth is weak and, here too, there are major disparities within the euro area. In the second quarter, growth stood at -0.2% for the area, after stagnating in the first quarter. Germany posted the highest growth, at 0.3%, and Portugal the weakest, at –1.2%. We are still expecting growth to recover very gradually next year.

Before discussing how to address these problems, we have to correctly analyse the causes.

In my opinion, three mutually reinforcing causes gave rise to the euro area crisis.

1. The main origin of the crisis lies in the lack of fiscal discipline on the part of most Member States. While these countries had had to make considerable consolidation efforts to fulfil the convergence criteria and to be allowed to join the euro, almost all of them became more lax as soon as they entered. In the first ten years of EMU, they ran up deficits and debts, including during times of growth. As a result in 2008, when the crisis started, these countries had no more fiscal room and their public finances deteriorated substantially.

   Member States’ individual discipline has therefore been too weak, and collective discipline, which was nonetheless provided for in the Stability and Growth Pact, was not applied in practice. I would like to recall the spirit of this Pact. It was designed to be the fiscal pillar of monetary union. It was based on a peer-review mechanism. But, on the one hand, it was deliberately misinterpreted: whereas countries were required to maintain a fiscal balance over the cycle, without breaching the 3% of GDP reference value for the annual public deficit, they interpreted this to mean: "we can constantly run a 3% deficit". And, on the other hand, the Pact was not respected, as sanctions were not imposed on Member States that breached these rules (including France and Germany around 2002).

2. The second cause of this crisis lies in the competitiveness gaps that had widened for a long time before the crisis. The economic rationale is easy to understand: when joining a currency area whose goal is to achieve an inflation rate of just below 2%, changes in unit production costs must be in line with this central bank objective, modulo the productivity gains. In all countries that did not abide by this calculation and this discipline, year after year, there was a loss of competitiveness that ultimately proved very significant.

   As regards these budgetary slippages and competitiveness losses, I hasten to add that markets did not play their role. As soon as the euro was adopted, they ceased to differentiate between countries and sovereign yield spreads narrowed, even aligning themselves at the lowest levels, i.e. those of Germany and France.

   For the first decade of EMU, the single currency appeared to play a buffer role that in addition to protecting countries against monetary instability – which the euro successfully did and was its raison d'être – also protected them against the economic reality. Member States were labouring under the illusion that they could, without ever suffering the consequences, allow themselves to flout the rules for budgetary discipline or make no efforts to remain competitive. The crisis came as a very severe wake-up call.

3. The third cause of this crisis, interlinked with the other two, is institutional: monetary union was not built on sufficiently robust economic, fiscal, financial and political institutions. The fiscal discipline mechanisms were insufficient, there was no mechanism for the surveillance of macroeconomic imbalances, nor was there a crisis management mechanism; financial union worked when times were good: banks held the bonds of other Member States, but it very rapidly fragmented when the crisis erupted, due to the lack of institutional soundness.

2. The causes of the crisis are being addressed

I will now explain how the euro area is dealing with the three fundamental causes of the crisis it is facing.

First, the efforts already made on the fiscal front by euro area countries are already bearing fruit: the primary position of the euro area should be close to balance by the end of 2012, which is a remarkable achievement compared to the other major economic areas (Japan, the United States and the United Kingdom will all run deficits of around 9%, 6% and 5% respectively). At the current juncture, this is clearly an asset for us and an element of confidence both for the markets and economic agents, and needs to be further enhanced.

In addition to these efforts at the national level, a stronger framework for common discipline has been put in place, which represents a major step forward towards a more integrated economic union.

The legislative package (known as the "six-pack") which came into force last December considerably reinforces the Stability and Growth Pact: the surveillance powers of the European Commission regarding national budgets have been enhanced, sanctions have become quasi-automatic and the public debt and public spending criteria are being more closely monitored. In addition, the Treaty on Stability, Coordination and Governance puts in place a new "fiscal compact", notably including the requirement that the annual structural government deficit does not exceed 0.5% of GDP.

At current debt levels, economic agents would respond to loose fiscal policy by delaying their own private spending. The financial markets would continue to impose very punitive interest rates on our countries to compensate for the uncertainty surrounding the fiscal outlook. Overall, the confidence generated and the financial benefits of fiscal consolidation far outweigh the negative effects on effective demand in the short run. It is crucial that all of the efforts in this area are pursued with determination.

Now turning to competitiveness, here too the progress already made in terms of structural reforms and the adjustment of unit production costs in many countries is very encouraging. Never in the recent past have the European economies been reformed so much in such a short space of time. I could cite many examples: the reform of the labour market in Spain and Italy, or the pension reforms in Italy and France. These reforms constitute the necessary foundation for dynamic and sustainable growth in the future and they must be vigorously pursued. Furthermore, the new Stability Pact includes a surveillance mechanism for macroeconomic imbalances, which has been missing up till now.

Lastly, the institutions that underpin the euro area are in the process of being strengthened extremely rapidly as a result of the crisis.

- I have already mentioned the substantially reinforced fiscal and macroeconomic discipline framework: it needs to be recognised that this is a very important step given the transfers of sovereignty that it represents – we are moving towards a stronger economic union;
- The European Stability Mechanism, whose implementation has been bolstered by the go-ahead given by Germany's constitutional court and which held its first Board meeting, has a firepower of EUR 500 billion of new money to directly buy government bonds, provide collateral or lend funds. It will also be able to directly lend money to banks in difficulty without increasing the debt of their home countries as soon as the single supervisory mechanism will be in place. It is a powerful crisis resolution tool that Europe has equipped itself with; added to already disbursed bilateral and EFSF loans and to the existing EU facility, the total firepower will near 1000 billion of USD.
- The work on the establishment of the banking union is moving forward rapidly too.

  The Commission's report that was submitted a few weeks ago sets out a clear framework: all banks in the euro area will quickly become subject to a single supervisory mechanism under the authority of the ECB. Day-to-day supervision will be performed by the national supervisors, in accordance with the principle of decentralisation that has already proved its effectiveness in the implementation of the single monetary policy within the Eurosystem. The principle underlying this single supervisory mechanism is that the severity of the crisis in the euro area has largely been due to the vicious circle that developed between banking and sovereign risk. To break this link, we need to have a genuine institutionalised banking union that ensures not only the same supervision throughout the euro area, but also identical rules, an integrated bank crisis resolution mechanism and a common deposit guarantee scheme. We are moving towards the banking and financial union that was missing from monetary union.

3. The Eurosystem is providing valuable support during this period of necessary reforms

It is clear that the ultimate responsibility for exiting the crisis lies with governments, at national level – implementing reforms, consolidating public finances and restoring competitiveness – and at the collective level – agreeing on and implementing a more coherent and comprehensive institutional framework around monetary union. These reforms are obviously – and fortunately – the fruit of a democratic process and can only be that. But the corollary to this is that these necessary reforms cannot be immediate: they take time, first to be implemented and then to yield their effects. And the time of the markets is not that of democracy, as you know. Doubts and delays create nervousness, volatility and worry in financial markets, which often leads to sharp rises in interest rates for countries deemed to be vulnerable.

The Eurosystem has decided to take firm action when it considers that these interest rates do not reflect a genuine credit risk differential, but rather unfounded fears about the reversibility of the euro. Because at that point, the effectiveness of the single monetary policy is clearly jeopardised: the key interest rates that we set no longer feed through to the real economy in the same way in all countries via the bank lending channel – which is a crucial channel in the euro area given the predominance of intermediated financing. In order to fulfil our mandate of maintaining price stability, our monetary policy impulses need to be transmitted homogeneously across the whole area. This is why we decided to create a new instrument: Outright Monetary Transactions. The idea is to have a credible backstop to counter unjustified increases in sovereign yields. This backstop must naturally be accompanied by strict conditionality to guarantee that the country concerned makes effective progress towards a more robust economic situation.

By means of this new tool, as with all of the other tools that we have deployed since the start of the crisis – in particular the measures to support bank liquidity – the Eurosystem is endeavouring to relieve the pressure from the markets which may undermine the ability of countries to implement the reforms embarked on, and which may eventually jeopardise price stability. We shall continue to take all of the necessary action to fulfil our mandate and contribute, within this framework, to the success of this tricky but necessary period of transition towards a more coherent, stable and dynamic economic and monetary union.

Thank you for your attention. I shall be pleased to answer your questions.