Christian Noyer: "Noyer heralds new era for eurozone and for France" – Interview in *Euroweek*

Interview with Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, in Euroweek "France in the Capital Markets", 25 February 2013.

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EUROWEEK: You were frequently quoted in 2012 as saying that the eurozone was moving in the right direction. Do you feel vindicated by the recent strength of the euro and the performance of the eurozone's financial markets?

Noyer: Things have clearly improved, but this should not come as a surprise. It's clear that markets lagged a bit before taking stock of what has happened, but looking back, enormous progress has already been made on all levels. This is true in terms of policies aimed at the restoration of sound public finances in many, if not all, eurozone countries as well as in the field of structural reforms.

For example, we have seen very extensive progress in areas like pension reforms in France and Italy, banking reform in Spain and labour market reforms across much of southern Europe and France.

We have also seen great progress in terms of surveillance – not just surveillance of fiscal policies, which is a must in the context of the European monetary union, but also surveillance of competitiveness which is the basis for structural reforms. This is essential if we are to avoid distortions in the convergence of competitiveness and therefore prevent a re-emergence of the problem of growth moving towards certain parts of the eurozone to the detriment of others.

In structural terms a decisive move in this direction was the agreement on banking union which will break the negative feedback loop between banks and sovereigns and will ensure the efficiency of the single monetary policy. Last but not least there was the new concept developed by the ECB saying it was determined to do whatever it took to ensure the stability of the euro. The concept of the OMT has the merit of making it difficult for the market to fight the central bank once it has expressed a determination to do whatever it takes to achieve a certain goal.

On the other hand, the OMT is also credible because of the conditionality. It's not a case of simply endlessly signing cheque after cheque. It is framed within the context policies which are geared towards sustainability.

Finally, of course there is the permanent backstop of the ESM. So I think that when we look at all these decisions they amount to a very comprehensive package which addresses all the doubts and questions which have been raised since the start of the sovereign debt crisis. Therefore it is quite natural that 2012 is considered by market participants to have been a landmark in the creation of a new era for the eurozone.

EUROWEEK: You have often expressed frustration that markets aren't ready enough to acknowledge the longer term sustainability of monetary union. Are views changing, especially beyond the eurozone itself?

Noyer: Although it is of course clearly understood in Europe, it is starting to become relatively well understood in the US and in Asia. It is taking more time outside Europe to develop this comprehensive view, because markets in the US and Asia don't have as much information at their disposal about Europe. But given how globalised markets now are, the fact that they have been so positive in recent weeks is to me a clear sign that it has started to be understood relatively well all around the globe.

EUROWEEK: You've been speaking with your eurozone hat on, rather than specifically about France. Some of the data that has come out recently about European growth in general and French growth in particular have been very depressing, haven't they? Is there a concern that the so-called *modèle Français* is defunct?

Noyer: It is absolutely true that the figures have been disappointing in 2012. But what has to be taken into account is that France has been facing the same very strong headwinds that have been blowing across certain parts of Europe. Apart from Germany, the major markets for French exports are the southern European countries and the UK, all of which have been in recession in 2012.

The consequence was that the French economy was more or less stagnant. At a time when so many other parts of Europe were stagnant or in recession, this should not come as a surprise.

Additionally, French consumption, which had been very resilient during the crisis, was weakened by the fact that to restore credibility in the consolidation of public finances the government decided to implement a number of tax increases. These inevitably have had an impact on consumers' behaviour.

I do not believe that this will necessarily last, because the savings ratio in France is high compared to the average elsewhere in Europe. We can therefore expect the savings ratio to decrease somewhat, leading to a more sustained recovery in consumption.

That is hopefully one positive factor for the future. Another is that France is definitely moving towards reversing the trends in terms of competitiveness. The country is now demonstrating that there is a clear understanding of the need to pay close attention to firms' production costs, which is illustrated by the government's so-called Competiveness Pact. It is also illustrated through a number of structural reforms that have started to be introduced to increase the flexibility of the economy and make job creation more resilient.

From that standpoint the first move which is very significant is the so-called National Pact between business and unions which will be vetted by law. This is a complete reversal of the previous trend. So in a sense, yes, the *modèle Français* is adapting.

But I also think the model is retaining some features which are strong cultural characteristics. It relies on positive demographic trends, high educational standards and the quality of infrastructure. So it is not true to say that the French economic model has been characterised exclusively by the excessive inflexibility of its welfare system.

I would add finally that France has started taking measures to correct the excessive costs in the welfare system while not by changing radically the way it is constructed. Instead, we will probably move more towards what the Scandinavian countries have been able to do by introducing pension reforms to contain the costs of the system for corporates and containing healthcare expenditures. The Nordic countries have proved that you can have an efficient welfare system without damaging competitiveness.

EUROWEEK: But countries like Portugal are seeing their exports surging, underpinned by lower unit labour costs, while France's exports continue to fall. Does it concern you that the IMF has openly suggested that France is in danger if being overtaken by southern Europe?

Noyer: My understanding of what is behind the IMF's comment is the idea that these countries are addressing their competitiveness problems in a very strong manner, knowing that their problems were much more severe than those we had in France. Their relative productivity was lower and they also had relatively inflexible labour markets, which they are now reforming, notably in Spain and Italy.

So the IMF has simply observed that France can't afford to stand still when Germany began to reform some years ago, and given that the southern European countries are also moving to address the problems of cost competitiveness and rigidities. This is clearly why the economic reforms announced in France are so important. I'm delighted that the government has made this such a high priority.

EUROWEEK: Let's move on to France's relationship with the financial markets and with the developments in its banking system. Are you concerned about what the ratings agencies have been saying about France? Or are ratings agencies irrelevant these days? They don't seem to have had much of an impact on France's borrowing costs.

Noyer: No. I don't worry about ratings agencies. The crisis led to a weakening in public finances in most countries, so in relative terms there have been few changes in their ratings. No agency is denying that France still has one of the strongest risk profiles in Europe.

The second reason why I don't worry is that worldwide authorities such as the G20 and the FASB have said very clearly that they want market players to rely less on credit ratings agencies and to make their own judgments. This can be done by banks' internal models or other types of analysis by investment managers which are more sophisticated than they used to be a few years ago. For all those reasons I don't think the agencies are as influential as they used to be.

The agencies themselves have always claimed that they are just one of the resources available in the market. They have always insisted quite rightly that they are not the final arbitrators of investment decisions.

EUROWEEK: What about the French banking system? Are you comfortable that the French banks are adequately prepared for Basel III?

Noyer: I have always considered each of the five major groups within the French banking system to be basically resilient. The universal banking model is playing an important role in that respect because it creates a large base of diversified revenues which means that when one business line of the banks has been hit by a shock they can rely on the variety of their other revenues and preserve their earning capacity.

But this being said, with the benefit of hindsight, it's clear that like many others the French banks weren't sufficiently resilient to withstand major external shocks and tail risks during the crisis.

So the French banking sector had to increase its capital base and reduce its leverage. I have to say that in my view the French banks have done so quite successfully and rapidly. Between the end of 2011 and June 2012 they increased their capital base by €20bn through retained profits or fresh fundraising in the market or from their shareholders.

They have also managed to achieve a very well controlled process of deleveraging by reducing their exposure to non-core businesses, in general at good prices. So their overall balance sheet situation has been substantially improved and they are now in the process of meeting in full the requirements of Basel III with core tier one ratios of 9% before the end of 2013. This is several years ahead of the schedule that was originally stipulated.

By the way, I always felt that the time frame determined by the supervisors in Basel for compliance by the beginning of 2019 was always a little bit theoretical, because markets were likely to ask for more rapid implementation, which is what the French banks have done.

So when I compare the French banking system with other major banking systems, be it in North America or in Europe, I have the clear conviction that the French banks are on track and are among the best performers in terms of their capital ratios.

EUROWEEK: Has this deleveraging process been at all damaging to the economy, as some people say it has been in the UK and in southern Europe, by reducing their lending to the corporate sector? Or is the universal banking system such that this is much less of a threat in France than elsewhere?

Noyer: The deleveraging of the French banks has been partly done through the reduction of their exposure to sovereign debt markets globally. The remainder has been in areas such as project and trade finance.

The French banks haven't exited from these businesses altogether, because they have very strong franchises in these areas which are a good source of revenue. But they have managed to liquidate a number of operations that were weighing down their balance sheets. That has helped them to reduce their financing needs.

They did not reduce their leverage through imposing some kind of credit crunch – absolutely not.

Actually, the change in the volume of bank lending in France has been less rapid than in almost all other eurozone countries – or almost all other European countries, including the UK.

I don't believe there has been any constraint on the supply of credit to the economy. If there has been a decline in lending volumes this has been a reflection of reduced demand, rather than any decline in supply.

Possibly in the future there may be a relative decline in the importance of bank lending, because we have worked a lot on developing simple and transparent alternative financing instruments such as securitisation.

These may attract more attention from institutional investors and would therefore be a way of providing more credit to the economy without putting as much pressure as there may have been in the past on the balance sheets of the banks. This will be positive as long as we can avoid the defaults we saw at the beginning of the crisis, which were created by vehicles that were opaque and complex and impossible for investors to understand.

EUROWEEK: At the same time, presumably French banks should not be discouraged from using the skills of their derivatives technicians, which are recognised throughout the world?

Noyer: I agree completely. That is why I have been reticent about the idea of separating investment banking and retail operations. I don't think that is an appropriate concept.

We live in a world where medium-sized and large corporates require access to bank lending for a large number of banking activities but also for market operations. Exporters, for example, also use the markets to hedge their risks – so they're re-shaping the risk on their balance sheet by changing the structure of their liabilities or their assets if they have claims arising from trade.

For all these activities and risks, giving corporates access to banks which are able to respond to their entire commercial and investment banking needs is crucial for the development of the economy.

On the other hand, what we don't want to see is banks embarking on proprietary trading which is totally disconnected from their banking activities. The ideal approach is to have a clear separation between what we in France call "purely speculative activities" – in America they would call it "prop trading" – and what is useful for the financing of the economy.

Admittedly, it is not always simple to know exactly where the line should be drawn between these two purposes. But if the guidelines are clear enough it should be up to the supervisors in each country to make sure that this line is respected, and if need be to oblige banks to reorganize their activities. This is the philosophy which was the basis of the Liikanen Report and hopefully it will prevail.

EUROWEEK: And if things do go wrong is it fair to have a bail-in regime where debt investors bear their share of the losses?

Noyer: Bail-in is an important concept. We discovered during the crisis that if all stakeholders are not eventually obliged to take part in the cost of restructuring a bank if necessary, the consequence might be that the taxpayer has to foot the bill, which is not fair , although it can be necessary in extreme circumstances.

The other consequence is that banks are forced into fire sales of assets, which means the prices they command are very low and their losses are maximised. The result is either that the bank is pushed towards bankruptcy if the state allows it, or has to be supported using taxpayers' money and possibly having them bearing the losses, which as I said before is not right.

So the concept of bail-in after all the equity holders and the subordinated debt holders have been wiped out, could involve the transformation of senior debt into equity or semi-equity in a going concern bank. In such a case, it is a very good and important concept.

To my mind, bail-in should be part of the extra powers given to the supervisor. That is the only way we can reassure investors that it will be used only when it is absolutely needed to avoid a bankruptcy. That means that ultimately it is in the interests of senior bondholders to know that they won't be penalised just because it's beneficial for other stakeholders, but because it can't be avoided. This is why it is essential that this power should be in the hands of the supervisor.

But bail-in needs to apply to the whole of the senior debt. I'm not completely convinced that there is merit in having specific bail-inable instruments like CoCos. This is because either it makes the basis of the bail-in very restricted and may not be sufficient in many instances so that in the end you may need recourse to a second layer. Or, if it is a big amount, it can be extremely costly because of the specific risk, and therefore it may be better in that event to move directly to equity.

In any case, the fact that bail-in is now on the table and can be used by the supervisor will probably be one of the reasons why the banks will be tempted to increase their capital base regularly over time, to demonstrate to the buyers of senior debt that they are sufficiently protected. It will also be a strong incentive for banks to limit and control their risks and clearly communicate to the market how they do so.

EUROWEEK: Has all this done enough to break the pernicious and highly damaging loop between sovereign and bank risk that was so central to the crisis? Or is that loop one that is simply impossible to break?

Noyer: I think we have reduced that risk. The work is not totally finished. We need to continue in the direction we have taken. But to my mind there were three decisive moves that have addressed the problem of this feedback loop. One was the action that was taken on the consolidation of public finances, because if you have stronger government finances then of course the risk for banks is reduced.

The second was moving decisively on the banks' capital bases, because clearly if you have stronger banks then the risk for governments is lower.

And finally, the decision to move to a banking union starts with supervision and then allows us to advance to the second and third steps which will have to be a resolution scheme and a resolution authority and finally a euro area deposit guarantee scheme.

There is also the possibility in the euro area to ask for refinancing by the ESM. Those developments are key for providing a comprehensive response. We still have some work to do to finalise the consolidation of public finances and establish them on a stronger footing. But clearly we are well advanced in the process of doing so, and the same is true of the banks' capital base, although we may have to finish that with the SIFIs' capital surcharge as from next year or thereafter, and with banking union which is in the process of being negotiated.

EUROWEEK: You've made some very strong comments about London. But what role does Paris see itself playing as a financial centre in the European context?

Noyer: First, it's clear that London is and will remain a major financial hub which brings a lot of advantages to the global economy, given its skills base and the capacity of its infrastructure.

The comment I made was not a suggestion that Paris should replace London but simply that I do not believe in the trend of financial services concentrating more and more in London. This is something that should not be acceptable from a financial stability perspective by the euro area authorities.

Why? Because, in the event of any problems, the central bank needs to be able to provide liquidity without any time lag where and if it is needed, and in a strictly controlled way. To do so, central banks need to exercise very close oversight not only on the banks themselves but all the major financial players and infrastructure providers.

So I think it's normal that within a given monetary area the bulk of banking and financial activities should take place within the area itself and not overseas. Clearly there are many US dollar operations that take place outside the US, but the bulk is still concentrated in the US, and the same is true of activities in pound sterling, Japanese yen, Canadian dollar. The same must apply in the eurozone because it is a complex area and its activities should therefore be shared between Paris, Frankfurt and other financial centres within the zone.

To answer your question about the specificities of Paris, we have several assets to play an important role. First, the Paris marketplace has a very strong position in equity markets within the euro area. Second, in the fixed income sector, Paris is by far the most important centre in two areas – the market for short term paper, where it has a share of about 36% of the euro market, and the corporate bond market, where its share is about the same.

Finally, we have in Paris the world's second largest asset management industry after New York. We may not have the entire panoply of banking strengths, but we have a number of very strong niches which will continue to make Paris a strong hub, which can and should continue to play an important role in the European financial services sector.

EUROWEEK: At the same time, would you like to see the big French banks continue to be active on the global stage, where their experience has been mixed? They didn't do very well in southern Europe, did they?

Noyer: There was a time when there was a feeling in the market that we were going to move towards a return to more national banking system, which meant that international diversification was basically a weakness.

Things have changed quite a lot and I don't think anyone would argue that the move by BNP Paribas to acquire Fortis during the crisis was not a clever one.

The French banks weren't alone in believing that because we were supposed to have a single market in Europe, it was natural for banks to expand to neighbouring countries – just as it is natural for banks originally set up in Scotland to expand to England. So it was natural for French banks to see the eurozone and future euro area members in central and eastern Europe as their backyard.

Yes, we had the Greek problem, which was painful and costly for Crédit Agricole. But this was really an extreme case and hopefully we'll never see similar accidents again in our banking industry.

As we move out of the financial crisis, I believe that having activities in several countries across the eurozone will soon re-establish itself as a normal diversified business model that is regarded as a strength rather than a weakness.