Christian Noyer: The euro area perspectives

Keynote 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 International Financial Forum, Paris, 10 July 2013.

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Ladies and Gentlemen,

I am very pleased to have this opportunity to speak to such a distinguished audience and I thank Paris Europlace for the invitation. As Arnaud de Bresson just mentioned it, I take this opportunity to express, again, my strong support to the ongoing development of financial activities in off shore RMB out of Paris. In that regard, let me also commend the work undertaken by Paris Europlace to federate and coordinate the variety of initiatives that we have seen develop over the recent months.

We are lucky, here in Paris, to benefit from the presence and the dynamism of the major Chinese banks, which are among the main international banks. This is an asset for Paris. Similarly, the main French banks are active on the Chinese markets, out of Hong Kong and out of mainland China. This is another major asset for Paris as a financial center. Both will benefit Chinese corporates in France, and French corporates in the Chinese markets. Both these assets will guarantee that liquidity in RMB does and will flow smoothly from China to Paris. Furthermore, Paris ambitions to serve as a hub for the development of yuan denominated business throughout the euro area. Paris has the potential, the expertise and the infrastructures to do so.

To introduce your two-days Forum on “Growth and Investment Opportunities in Europe”, I wish to first give you an overview of the current economic and financial situation in the euro area and then discuss the major changes currently underway that are considerably strengthening our monetary union.

1. Overview of the current economic and financial situation in the euro area

Before I start this overview, I would like to quote a famous sentence by Jean Monnet, one of the founding fathers of Europe: “what matters is neither to be optimistic nor pessimistic, what matters is to be determined”. In other words, what the euro area needs is neither euro-bashing nor celebration, but awareness and action.

As you all know, overall growth in the euro area has been very weak for a few years. The most recent figure is a 0.3% contraction in GDP in the first quarter of 2013, following a decline of 0.6% in the fourth quarter of 2012. Output has thus declined for six consecutive quarters, with labour market conditions remaining very weak. The euro area economies were badly affected by the crisis (first financial, then economic, then sovereign debt), and the fiscal adjustment that became necessary to overcome it has had a negative impact on growth as well.

ECB projections see a gradual recovery taking shape later this year. A number of elements support this view:

- Our accommodative monetary policy stance – which will remain so for as long as necessary – should contribute to underpinning this recovery;
- Recent developments in economic sentiment survey data have shown some improvement from their low levels;
- Looking ahead to later in the year and to 2014, euro area export growth should benefit from a recovery in global demand, while domestic demand should be

supported by our accommodative monetary policy stance and by the recent real income gains due to lower oil prices and lower overall inflation.

- Furthermore, the significant improvements in financial markets seen since last summer boost confidence and generate wealth effects and should work their way through to the real economy, as should the progress made in fiscal consolidation.

Nevertheless, the Governing Council continues to see downside risks surrounding the economic outlook for the euro area. They include the possibility of weaker-than-expected domestic and global demand and the slow or insufficient implementation of structural reforms in euro area countries.

Overall, the June 2013 Eurosystem staff macroeconomic projections for the euro area foresee annual real GDP declining by 0.6% in 2013 and increasing by 1.1% in 2014 thanks to three main drivers: export growth, accommodative monetary policy and low inflation.

2. How can we boost growth further in the euro area?

A strong fiscal stimulus obviously appears unfeasible, given the necessity to rebalance public finances. I want to stress two things here:

- The euro area has very rapidly and efficiently set to work to cure its fiscal weaknesses and can today boast some of the best results among the major developed economic regions: its public deficit has been reduced from 6.3% of GDP in 2009 to approximately 3% today; by the end of 2013, the euro area should show a positive primary balance;
- While the commitment to progressively achieve sustainable levels of public debt and deficit has to be achieved; the measures need to be designed in such a way as to limit the negative side-effects on growth. For instance, efforts need to be focused on non-productive spending.

In fact, there is only one way to durably raise the growth potential of our economies, and that is by structural reforms that enhance competitiveness. It is clear that the euro area is well equipped to confront the challenges of the 21st century. With 370 million consumers and high purchasing power, it remains the biggest market in the world. It is also the most economically integrated area, with highly qualified manpower and very good infrastructures. Too often, however, euro area countries are prevented from reaping the benefits of their position by the rigidities that have accumulated over time, during the periods of easy growth. Now, the international environment is more challenging: new and powerful competitors have emerged and comparative advantages are shifting. There is no alternative to adjustment.

In this field too, the euro area has made considerable progress over recent years, especially in the countries that had a particularly large competitiveness gap vis-à-vis the rest of the zone and which, as a result, fell deeper into the crisis than their neighbours:

- We have seen a significant improvement in cost competitiveness as measured by unit labour costs (ULC). Between 2008 and 2012, in the three programme countries (Greece, Portugal and Ireland) cumulated ULC growth stood about 12 percentage points below the euro area average.
- The current account balances clearly show a strong correction. In the three programme countries, the current account balances as a percentage of GDP improved by more than 9 percentage points between 2008 and 2012. In Spain, the current account deficit improved by more than 7 percentage points over the same period.

  Most of the adjustment has been driven by a contraction in domestic demand. However, in Ireland, Spain and Portugal export performance has been very strong compared with the pre-crisis period.

In total, the euro area generated a trade surplus of more than 1% of its GDP in 2012 compared with around zero in previous years. We expect this surplus to continue growing in the coming years.

The speed and depth of the reforms underway in euro area economies is unprecedented. They have undertaken reforms in the areas most important for competitiveness, growth and the sustainability of public finances such as labour markets, products markets, social security, pension systems, etc. These reforms are a prerequisite for dynamic and sustainable growth in the future and they must be vigorously pursued.

In addition to this very clear determination at the different national levels to reduce deficits and introduce the necessary reforms, Europe has equipped itself with a new disciplinary framework. The Heads of State signed a new fiscal compact over a year ago that fixes very strict rules and gives very extensive powers to the European Commission to assess the compliance of Member States. This new compact goes hand in hand with the introduction of rules for monitoring macroeconomic imbalances.

It is important to understand what these institutional advances represent: in effect, they represent a new Treaty creating very strong commitments for the States via rules that are far better calibrated and far more binding than those in place when European monetary union began.

3. Monetary Union is to be enhanced with a banking union

As well as being a year that saw a considerable strengthening of fiscal and macroeconomic discipline in Europe, 2012 also saw significant progress towards a banking union.

Why has a banking union suddenly become such an indispensable and urgent project? Simply because we are now certain that many of the problems we have experienced could have been avoided with a banking union. A banking union is necessary for the smooth functioning of a monetary union for the following three reasons:

- It breaks the link between banks and sovereigns by bringing banking supervision and crisis management to the federal level. With the banking union, banks will be considered as euro area institutions over and above their nationality; it will ensure that credit conditions in the euro area will not depend on *where* you are but on *who* you are, which is what should be expected of an efficient financial market.
- It allows re-integration of the European banking system. A supra-national supervisor is in fact better placed to assess the risks of cross-border activities and therefore to protect and encourage such activities; it is not subject to national biases that can lead to the temptation of economic introversion. It is therefore more credible and strengthens stability and confidence in the area;
- Moreover, it restores the full efficacy of monetary policy. If our monetary policy impulses are not transmitted uniformly to all of the area's countries because of the bank-sovereign link, it undermines the very foundation of Europe's monetary union; remember that three quarters of the financing of the euro area's economy consists of bank loans. By breaking this link, a banking union would restore the federal dimension of monetary policy.

Today the first pillar of the banking union is being constructed: the Single Supervisory Mechanism. We are currently working on legal issues, on identifying systemically important banks within the euro area, on the supervisory model, on the future data reporting and, of course, on the asset quality review that will be undertaken before we take on the responsibility of supervision. The governance structure we have adopted will guarantee that, while the Governing Council will keep the decision power, there will be no conflict of interest between monetary policy and banking supervision. On the contrary, more consistent supervision across the euro area should allow for the early detection of potential risks and imbalances and, ultimately, improve the transmission of monetary policy.

This is a fundamental first step and its rapid implementation will be a major success for the euro area.

But, alone, it cannot achieve the objectives of a banking union. That is why we must rapidly construct its two other pillars: a supranational bank resolution authority and a unified deposit insurance scheme. In this respect, the recent progress made by the Eurogroup both on the future ESM direct recapitalisation instrument and on a common position on the Bank recovery and resolution directive is very positive and reaffirms the determination of European leaders to finalise these decisive steps towards a genuine banking union as soon as possible.

The banking union will deliver a higher level of structural coherence to the euro area's financial system, which has already been considerably strengthened since 2008: banks' capital levels have been substantially consolidated, certain activities have been streamlined and the most stressed banks have been restructured. Recent numbers show major advances for European banks in their efforts to strengthen their capital base, in line with Basel III requirements and, in particular for big international banks, quite comparable to capital strengthening in US banks (when differences in accounting standards are neutralised). The banks have reimbursed half of the liquidity injected via the two LTRO programmes.

4. The Eurosystem

From the very first signs of the crisis (remember the Eurosystem injected 90 billion euros in August 2007 to counter the impact of the first freeze in the financial markets), the Eurosystem has provided constant support to bank funding (and thereby underpinning credit to the economy). We have been able to use our collateral framework – with a wide range of counterparties accepted – to relieve the liquidity constraints faced by banks. The maximum maturity of our operations has increased from three months before the crisis to three years. Through these measures, we have addressed the liquidity pressures on banks and avoided a genuine credit crunch.

At last week's meeting, we decided to take a further step towards forward guidance on our rate policy by saying that we expect the key ECB interest rates to remain at present or lower levels for an extended period of time. All in all, both our standard and non-standard monetary policies have prevented the materialisation of deflation risk. The programme we launched a year ago – Outright Monetary Transactions – succeeded in countering speculation about a euro area break-up. Its basic functioning is as follows: if a given State suffers unwarranted tensions on its debt, we could decide to intervene as far as is necessary, provided that State commits to an agreed recovery programme.

Undoubtedly, the announcement of the creation of the OMTs had a very strong impact: banks and firms regained access to capital markets; the spreads between the yields on Spanish and German 10-year bonds fell from more than 6pp in July 2012 to just under 3pp in May 2013, while the premium on Italian 10-year bond halved. This new monetary policy instrument has therefore fostered a considerable improvement in financial conditions in the euro area and represents a solid shield against further speculative attacks. The ECB's Governing Council has stressed that monetary policy will remain accommodative for as long as necessary. In the period ahead, we will monitor very closely all incoming information on economic and monetary developments and assess any impact on the outlook for price stability.

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The euro area is getting stronger: it is undergoing major reforms, building new institutions and setting up powerful crisis management instruments. These major and in many respects historical advances will lay the foundations for the future of our monetary union.

The effects on financial markets are already very visible: tensions have abated and signs of defragmentation are starting to appear (TARGET balances for instance have declined by almost 300 billion€ or 25% from their peak). We must now pursue the efforts already initiated and do our utmost to ensure that these improvements feed through to the real economy so that economic growth can return and unemployment can reverse its rising trend.

Thank you.