Christian Noyer: The financial crisis – how are we doing?

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 Global Interdependence Center Conference "Capital Markets in the Post-Crisis Environment" Part V, organised together with the Bank of Finland, Helsinki, 6 June 2011.

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It is a great pleasure for me to be here today in Helsinki. It is also a privilege to address such a distinguished audience.

But as you all know, next Board of ECB Governors will be held in a few days and I am therefore to respect a silent period. The remarks that follow are general and do not prejudge the decision of the Board.

I would like to take the opportunity I have been offered of giving you my assessment of how we are doing three years after the start of the crisis. For reasons you certainly understand, I would like to focus more on the situation in Europe and the euro area.

Economic prospects are encouraging

Recent macroeconomic developments point to a successful exit from the crisis. Recovery is now widespread, as most countries across the world experience pre-crisis growth rates. After a strong rebound, world trade is back on track to its pre-crisis trend. Financial conditions are favorable, with short and long-term interest rates at low levels and scarcely any signs of credit rationing.

In this supportive international environment, the euro area experienced a brilliant first quarter of 2011, emphasizing the robustness of the recovery. GDP increased by 0.8% over the quarter but as fast as 1.5% in Germany and 1.0% in France. All euro area countries, except Portugal, enjoyed positive growth rates. These developments no longer reflect solely the economic policy stimulus and the inventory cycle; they testify to a broad-based recovery, with a self-sustained private sector dynamics. One remarkable development of this first quarter is that French and German growth has been mainly driven by private domestic demand and, in particular, business investment. In France, it grew at a 1.9% quarterly rate, posting a fourth consecutive quarter of strong growth.

The pace of recovery may slow in the coming quarters. Business climate indices, such as the Purchasing Managers Index, the Economic Sentiment Indicator or Germany's IFO, have peaked at high levels. Beyond these observations, the crisis may have left scars on our economies. Potential growth may have been affected. The balance sheet repair process, involving both public and private agents, may also weigh on growth in the medium term.

Still, prospects are encouraging. The OECD, which recently issued its latest forecasts, has just raised its growth forecast for the euro area to 2.0% in 2011 and 2012.

All in all, we have strong reasons to believe that we successfully exited the economic crisis. There are increasing signs that the recovery is now well on track. While there is still a high degree of uncertainty, recent economic data confirm the positive underlying momentum of economic activity in the euro area.

The sovereign crisis in Europe

While economic prospects have improved, we still face challenges. The most important one is certainly "the sovereign crisis" in the euro area. Broadly speaking, opinions and views

expressed on this by people outside the euro area can be divided into three categories: hostility, skepticism and support.

First, outright hostility: gloomy predictions about the imminent demise of the euro came predominantly from deeply anti-European commentators. While these views, like all opinions, should be treated with respect, there is no point in trying to refute arguments that are largely irrational and mainly reflect wishful thinking.

Second, skepticism: it comes mainly, but not only, from academic circles. Prestigious and well-respected economists have been pointing to the fact that the euro is not an optimum currency area and that some form of fiscal federalism is missing to compensate for insufficient labour mobility. Let me simply recall a few facts. The benefits of the euro cannot be assessed exclusively through the lens of the optimum currency area theory. The euro has brought to more than 300 million European citizens unprecedented stability: price stability, of course, with inflation averaging 1.97% over the past decade, but also financial stability. It is always useful to think of counterfactual (?) when assessing a situation. Looking beyond current fiscal turbulences, let us think, for instance, of how euro area member countries would have absorbed the crisis with fifteen different currencies, fluctuating internal exchange rates, and, consequently, much higher volatility, uncertainty, risk premia and interest rates. This experiment speaks for itself. Let me add, also, that despite the perception of slow motion from European authorities, we share a great sense of urgency and solidarity. There is no benign neglect nor resignation/despair.

The last type of reaction is support. It shows up in comments from a majority of observers and investors, especially in emerging economies: they praise the euro; they want it to succeed; but they sometimes question our collective ability, in current circumstances, to do what is necessary, to make the right decisions or make them at the right time and to set in place the proper framework for the future. These are the concerns I would now like to address.

Where and how did it start?

Most euro area and EU countries entered the crisis with significantly deteriorated fiscal positions, very far from the “structural balance objective”, which is the core of our fiscal framework and also the commitment made by Member States that adopted the euro. With the crisis, fiscal imbalances increased, not so much because of a rise in expenditure, but essentially through a massive loss in revenue. The IMF has shown that, in all advanced countries, including the United States and the United Kingdom, these losses accounted for around two thirds of the deterioration in fiscal positions observed during the crisis. Fiscal deterioration was compounded, in some countries, by the size of implicit blanket guarantees, which materialized as the crisis unfolded through public money injections in the financial sector.

Unfortunately, these problems were not specific to the euro area. Public debt jumped by around 30% of GDP in the United Kingdom and in the United Kingdom. Structural deficits in these countries stand at similar or higher levels than those in most parts of the euro area. This is also true for Japan.

Overall, the crisis has brought to light major deficiencies in the implementation of fiscal discipline and, more generally, in the economic governance of the euro area. The founders of the euro had put in place the Growth and Stability Pact. The principles were sound. The framework was adequate. The implementation has been extremely weak. Bluntly speaking, peer pressure failed to ensure consistent and rigorous compliance with the principles which had been agreed upon. It was, and remains necessary to make a “quantum leap” in economic governance.

What have we done?

Governments are addressing these deficiencies. Significant progress has been made over the past year. At the national level, all Member States have embarked upon credible public finance consolidation plans that are already bearing fruit.

At the EU level, a new framework has been agreed upon, built around three pillars. The first pillar is much stronger prevention: surveillance of budgetary policies has been reinforced; government debt levels are better taken into account; and sanctions will become more automatic. Ideally, this should be completed by the adoption, in each Member State, of strong national fiscal rules. The second pillar is a new process for monitoring competitiveness and, in particular, unit production costs. The last pillar is the new framework for crisis management agreed upon by euro area Member States, to provide temporary financial support to euro area Member States facing impaired access to market financing.

At the same time, Europe has equipped itself with financial fire power. A new, temporary facility, the EFSF, was set up in May 2010 for a three year period. In March this year, its capacity was raised to an effective EUR 440 billion. Member States also agreed on a permanent framework to start in 2013 and mainly based on a European Stability Mechanism (ESM) with an effective lending capacity of EUR 500 billion. This mechanism will make it possible to conduct exceptional interventions in sovereign debt primary markets. Identical and standardized Collective Action Clauses (CACs) will be included in all new euro area government securities, with maturities above one year, from July 2013.

Significantly, all of these mechanisms involve the IMF and the European Commission, "in consultation" with the ECB, to avoid having to rely only on peer pressure between Members States and to ensure proper conditionality.

As you know, the crisis has also led the Eurosytem to embark on a very limited programme of bond purchases, with a view to restoring the monetary policy transmission mechanism where it had been impaired. This programme has served us well. The monetary impact has been systematically and fully sterilized.

Where do we stand?

Overall, these changes have been favorably received by the markets. Nevertheless, the sense of crisis has not yet disappeared. Most recently, a joint IMF / EU EUR 78 billion programme has been approved for Portugal.

In order to alleviate the persistent sense of crisis, existing programmes must be delivered on. In this respect, their conditionality is of the utmost importance. Countries under a joint programme have committed themselves to conducting structural reforms, whose benefits and positive impact cannot immediately be assessed. These programmes pave the way for stronger and more sustainable growth in the near future.

To be absolutely clear, there is no doubt that countries under assistance have to deliver fully on their austerity programme. Solutions akin to debt restructuring are not an option. It would push these countries into a disastrous scenario, associated with a sustained loss of access to any kind of financing.

Programmes can and do work. If you look at Eastern European countries that received conditional financial assistance from the EU and the IMF two or three years ago, you will conclude that these programmes proved to be highly useful and successful. Hence, the assessment has to be cautious, before being definitive. In short, in just one year, since May 2010, the EU has embarked on a radical overhaul of its economic governance, while managing the sovereign crisis. This is a great achievement, especially considering the multiplicity of actors involved and the creativity of the response, which also had to take account of public opinion.

Positive developments

Looking at aggregate numbers, it is very difficult to understand many of the concerns expressed on the euro area. The euro area is the only major currency area with its external accounts in balance, and which therefore does not depend on external finance. This is an essential element of robustness. For outside investors, it provides a strong guarantee of long term solvency. Its aggregate fiscal balance (with a deficit of 6.3% of GDP in 2010) is the most favorable of all advanced economies (10.5% for the United States, 9.6% for the United Kingdom and 7.7% for Japan). The same holds true for public debt, which stands at 92% of GDP, close to that of the United States (93%), and much lower than that of Japan (200%).

Looking at national fiscal situations, most analysts would acknowledge the magnitude of the efforts undertaken. Yet, some tend to take a very pessimistic view about future outcomes. In short, their argument is that the euro area, and more specifically, its periphery, will be unable to return to normal growth anytime in the foreseeable future. This is a very dramatic assumption and it matters a lot because, as we all know, debt dynamics are extremely sensitive to forecasts about future growth.

Some of the implicit assumptions underlying current negative judgments seem to me to be seriously misguided.

Recall what I pointed out at the start of my talk. We have recently been pleasantly surprised by growth dynamics in the euro area. Consumer confidence is almost back to pre-crisis levels; PMIs are at an all time high and GDP growth will almost certainly be above potential, on average, for the year 2011. These developments take place at a time when drastic fiscal consolidation programmes are being implemented in all countries. Positive confidence effects in the private sector are outweighing the negative impact of reductions in public expenditure. What about countries in the periphery? The Spanish growth rate swung from –3.7% in 2009 to –0.1% in 2010, despite the fact that a major austerity plan was being implemented. Spanish exports are booming, with an increase of 10% within the euro area and 19% outside the euro area in 2010. This compares very favourably with performances of other countries both inside and outside the euro area.

Let me also remind you that real convergence is at play in the euro area. This process will continue and support growth in the future, contrary to over simplistic descriptions. One overlooked fact is the very fast productivity catch-up in the periphery of the euro area. Between 2000 and 2008, Greece and Ireland posted cumulative labor productivity growth rates, as measured by the output per employee, of 14.7% and 10.2% respectively. Both significantly outpaced that of Germany (6.1%). This is exactly what you would expect in an integrated economic and monetary area and this process should continue in the future, provided that appropriate policies are implemented. Economic convergence will therefore boost growth and support the return to debt sustainability.

It is true that, looking at nominal developments, a different picture emerges. During the same period, nominal wages grew by a total of 42% in Ireland and 52% in Greece, compared with only 7.4% in Germany. There has to be a regime change in the way in which nominal wages and prices are set in some parts of the euro area. As central bankers, we have been putting forward this argument for years. Strong reforms are now being pushed in labor market legislation as well as in wage determination in the public sector in many countries.

What about banks?

I would like to end with a few words about the banking sector.

Revenues for the twelve biggest European banks grew, in aggregate terms, by 8.6% in 2010 (as compared to 2.5% for the main US banks). As a result, European banks' Core Tier 1 ratios stood at between 8.5% and 15.3% at the end of 2010 (corresponding numbers for US

banks were between 8.4% and 13.3%). Our "universal banking model", based on a diversity of activities and sources of income has proven its resilience.

Obviously, there is a circular causality between government debt and the banking sector. Spreads on public debt naturally act as floors for the funding costs of banks. And, conversely, doubts about banks' solvency create expectations of public support and lead to a deterioration in public finances. This gives rise to multiple equilibria where sudden shifts in confidence can be self-fulfilling.

In this context, the main purpose of stress testing is to break that circularity. Our first European tests included 81 banks, compared with only 19 for the United States. The basic exercise was sound and taken as such by analysts when it was published. Somehow clumsily, however, a few banks were added at the last moment, with only limited investigation, and these are precisely the banks which proved problematic afterwards and which undermined the credibility of the whole exercise. This mistake will not be repeated and the coverage for the new stress tests has been carefully examined.

A lot has been made of the fact that no sovereign stress was made on the banking book. And indeed, as regulators, we did not want to give any credibility to a scenario that we consider unacceptable. However, there will be, like last time, full, total, and transparent disclosure of exposures to sovereigns for each individual bank. Everybody will therefore be free to make their own assumptions and calculations. With knowledge of the exposure, it does not take a rocket scientist to figure out some scenarios. It turns out that, during the last exercise, such calculations would produce very reassuring numbers. But, for some reason, they were never made public by most analysts. Just as an illustration, the total exposure of French banks to sovereign debt in Southern Europe is 38% of total Tier 1 (13% without Italy). I will let you draw your own conclusions. Even in an apocalyptic scenario, only a small fraction of French banks' Tier 1 ratio would be compromised. The same results apply, with some variations, to other countries.

Conclusion

Let me now conclude. Like all other major advanced economies, the euro area is facing big challenges in adjusting to the post-crisis environment. For all, these challenges relate to long-term fiscal sustainability. They are neither bigger nor smaller for the euro area than for the United States, the United Kingdom or Japan. They may be more complicated to solve because, by nature, our governance is more complex and we face specific collective action problems. It may take us longer to deal with difficulties as they appear, and we are paying a price for this relative inertia. But problems are being tackled, reforms are being implemented and I am convinced that, in the end, the euro area will emerge as a stronger and more robust entity than before the crisis. As for the European System of Central Banks, I can assure you that we stand ready to act as forcefully as necessary to ensure price stability and preserve the integrity of the euro, which is, today, our most precious common good.