Christian Noyer: Euro area's situation – analysis, challenges and solutions

Lunch-debate 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 Montreal conference: "Demographic shifts – threats or opportunities?", Montreal, 11 June 2012.

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Prime Minister,

Governor,

Mr Chairman,

Ladies and Gentlemen,

It is a great pleasure and honour to participate in this lunch-debate with you today. I would especially like to thank the International Economic Forum of the Americas and its Chairman for organising this Montreal Conference, which for the past 18 years has been a major international economic event.

I would also like to take this opportunity to share my analysis of the euro area's situation, the challenges we face and the solutions available to us.

Before doing so, I think that it would be useful to say a few words about the international economic situation.

At the global level, growth is expected to slow down slightly in 2012 compared with 2011, notably due to a moderation in growth in Europe and a little bit also in emerging countries, in particular China. The United States is recovering relatively rapidly, but faces a number of challenges, especially with regard to its fiscal situation and the housing market.

Overall, – and this is one of the things that the crisis has clearly highlighted since 2008 – the world's economic areas are closely interlinked and problems end up being shared. Consequently, some solutions can only be applied at the international level. This is why the G20 has grown in significance since 2008.

We need to make further progress in international cooperation, in particular to identify the sources of global financial imbalances and reduce them via the "framework for strong, sustainable and balanced growth" and to improve international financial regulation. As regards the latter, we must always bear in mind our twofold objective: enhancing financial stability while ensuring the financing of the economy.

I would now like to turn to the situation in the euro area.

As you know, in 2011, the sovereign debt crisis in the euro area was particularly ferocious, spilling over to countries with sound economic fundamentals.

The first three months of 2012 had shown a few signs of improvement, in particular thanks to the Eurosystem initiatives and positive political impulses: pressure on sovereign debt eased slightly, and bank financing and money markets recovered somewhat.

But since April, sovereign debt and banking systems have come under renewed pressure. The two main driving factors behind this deterioration are the fiscal problems and difficulties in the banking sector in Spain – but the plan adopted over the weekend should respond effectively – and, above all, the major political uncertainty in Greece.

Therefore, there is a tremendous amount of work to do on a number of fronts if Europe is to find a durable solution to the crisis.

The challenge for most individual euro area countries is obviously to achieve strong fiscal consolidation while ensuring long-term growth. Clearly for me, there is no contradiction between these two objectives. On the contrary, they are complementary.

The efforts already made on the fiscal front by the euro area are already bearing fruit: not only is the absolute level of the euro area's deficit half that of elsewhere, but also the pace of fiscal consolidation is actually much greater. It is clearly an asset for us today and an element of confidence both for the markets and economic agents, which needs to be further enhanced. But, by the same token, countries need to create the conditions for a strong and sustainable growth through strong structural reforms. Here as well, the progress already made in many countries is important but more needs to be done, notably with regard to the labour and goods and services markets.

Beyond these national efforts, I believe that what the euro area really needs today is to make progress towards a more coherent and integrated economic and financial union. Indeed, the crisis has clearly brought to the fore a number of weaknesses in the functioning of the euro area and has thus fuelled concerns.

First, the fiscal discipline mechanism through peer pressure as established by the Stability and Growth Pact proved to be weak. Second, the euro area did not equip itself at the outset with an instrument for monitoring competitiveness.

Third, the euro area had not put in place a resolution mechanism before the beginning of the crisis.

I believe that important decisions have been taken on these three points, which should bring significant improvements if they are fully implemented:

– 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 and competitiveness imbalances 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" including a requirement for national structural deficit not to exceed 0.5% of GDP. These new rules must now be fully implemented by each country.

– Besides, Europe has equipped itself with an instrument to combat crises. At the last European Council meetings, it was decided to bring forward the creation of the permanent European Stability Mechanism (ESM) to July 2012, and to make it more powerful, increasing the lending capacity of the ESM to USD 1 trillion. It is absolutely necessary that this strong tool becomes fully operational as soon as possible.

I believe that there is another very important reason why the euro area has been so badly hit by the crisis; it is because we are a very highly integrated economic area but do not have the appropriate institutional mechanisms for this integration. In particular, this explains the contagion effects and the negative feedback loops between banks and States, which have made matters much worse in the area.

Obviously, a good and coherent functioning of the banking sector is absolutely vital for an overall solution to the euro area crisis. This conviction is based on two fundamental observations:

– ***Appropriate financing*** is essential for our economies to achieve strong and sustainable growth. In Europe, the banking system is the main source of financing, and hence its strength is of crucial importance. However, financial markets naturally also play a key role and they should focus on serving the economy.

– Secondly, ***financial stability*** is critical not just for creating the right conditions for the appropriate financing of the economy. It is also an extremely valuable asset in fostering confidence, which has been severely lacking in recent years and is another key condition for growth. It is also a vital condition for the effectiveness of monetary policy as it allows the normal functioning of transmission mechanisms. In addition, given the feedback loop between banks and sovereigns and the potential impact of a financial crisis on a country's fiscal position, financial stability makes a major contribution to fiscal stability.

A smooth functioning of the banking sector is therefore clearly an essential element in the resolution of Europe's problems. As a central banker and supervisor, I see three major tools which can help to ensure appropriate financing of the economy and financial stability – both of which are essential financial conditions for sustainable growth.

1. Financial regulation and supervision must be tailored to the two objectives of strengthening the financial sector while ensuring an appropriate financing of the economy. Of course, after the 2008 financial crisis, the most urgent priority was to re-establish financial stability and bolster resilience to financial shocks. But in the implementation process of the new Basel 3 rules, we need to pay the utmost attention to their potential consequences for the financing of the economy, especially in view of the much shorter agenda. In particular, the new liquidity rules need to be adjusted. In addition, much more progress is now needed in the area of "shadow banking".

2. Since the beginning of the crisis, the ***Eurosystem*** has constantly provided all possible support within the scope of its mandate to help the banking system overcome its difficulties. For instance, the idea of the two LTROs was to remove funding pressures in order to allow a smoother adaptation to the new rules and difficult environment. Simultaneously, this aimed to prevent a major credit crunch that would compromise both the financing of the economy and the maintenance of price stability in the area. We will continue to pursue these goals, with no concessions to our primary mandate and our independence.

3. Beyond this action of the Eurosystem entrenched in the Treaty, the euro area needs a new and concrete ***leap towards stronger financial integration***. It is true that we have made enormous progress for more regulation and created new tools, but the different episodes of the crisis have demonstrated that a monetary union can be stronger if it relies on a financial system whose health is not ultimately dependent on national mechanisms:

– the homogeneous health of the financial system is key for the proper transmission of a single euro area monetary policy;

– as long as the euro area's financial health is vulnerable to problems in one country, negative feedback loops between sovereign and banking risks can materialise – this is precisely what happened in the euro area;

– in a monetary union, capital is free to move very quickly from one country to another, thereby augmenting the potential incidence of "bank runs" if no supranational deposit guarantee mechanism is in place.

Therefore, we have to build a truly federal authority in the Euro zone, a structure combining the US FDIC's functions with the ones of the US Federal Reserve System would be a major advantage for the future of the euro area. It should have three main powers:

– banking supervision (possibly the same kind of structure as the Eurosystem with one "head" and decentralised implementation);

– deposit guarantee, with massive firepower, provided that it could collect a tax on every euro area bank and could borrow on the markets with a supranational guarantee;

– banking resolution (crisis management).

Of course, such a leap will require numerous steps and the elimination of a large number of substantial obstacles. But what it requires most is an unfailing political will from all euro area members to progress towards a stronger and more coherent economic and monetary union. After all, the greatest advances in the European project have always come in reaction to crises. And we should remember the prediction of Jean Monnet: "Europe was born out of crises and will be the solution to these crises."