Christian Noyer: The euro area is moving in the right direction

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 Paris Europlace Financial Forum, Tokyo, 3 December 2012.

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Mr Governor,

Ladies and gentlemen,

It is a real pleasure to be with you today and I want to thank the whole Paris Europlace team for its excellent organization of this event in Japan.

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I would like to start by taking stock of the current situation:

- Economic activity in the euro area is weak. Real GDP contracted by 0.1% in the third quarter after a 0.2% contraction in the second quarter. This weak trend is expected to continue over the coming months. It is a difficult period which has notably resulted in very high unemployment across the whole area. But it needs to be understood that this weak activity is in large part due to the necessary process of balance sheet adjustment in the financial and non-financial sectors. This process is underway, it has already yielded significant results and is a prerequisite for the strong and lasting recovery to come.
- The euro area's financial situation has improved over the past few months. i) Long-term sovereign bond yields have fallen sharply for several countries – in Spain for example, the 10-year yield has shed around 200 basis points since July – and have remained at very low levels for the "core" countries (slightly above 2% for France for instance);
- ii) We are seeing US money market funds coming back to invest in the euro area; iii) We are seeing more unsecured issues and issues of corporate bonds.

These are all positive signs – among others – that point to a gradual return of confidence in the euro area.

I think I can say that the fundamental causes of the euro area crisis have now been fully taken on board by all of the players, so that everyone has a clear and fair view of their own responsibilities. Three causes for the crisis can be identified:

- A lack of fiscal discipline;
- A loss of competitiveness;
- Incomplete European integration.

I would like to show you that the euro area is now moving decisively in the right direction to address each of these causes.

Governments are consolidating their public finances and competitiveness and European integration is moving forward.

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. The public deficit of the euro area has shrunk from 6.3% in 2009 to 4.1% in 2011. 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 much stronger framework for common discipline has been put in place, which represents a major step forward towards a more integrated economic union. 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, in Spain (labour market and financial sector reforms), Italy (pension and services market reforms) and in France, where an important pension reform was made in 2010 and where structural reforms on the labour market and on the goods and services market are in preparation.

These structural reforms constitute the necessary foundation for dynamic and sustainable growth in the future and they must be vigorously pursued. Furthermore, at the European level, the new Stability Pact includes a surveillance mechanism for macroeconomic imbalances, which had 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 just 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 has a firepower of EUR 700 billion 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. It is a powerful crisis resolution tool that Europe has equipped itself with;
- 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 union that was missing from monetary union.

Given these elements, 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 lead to sharp rises in interest rates for countries deemed to be vulnerable.

Since the onset of the crisis and these episodes of extreme and, in part, unjustified tensions, the Eurosystem has acted with firmness, creativity and determination in order to restore confidence and stability.

The monetary policy conducted by the Eurosystem is contributing to restoring confidence, a key element for the success of the adjustment process.

A reminder of the policies implemented by the ECB and their underpinning.

You will remember that the first response to the financial turmoil in the summer of 2007 came from the Eurosystem, which injected liquidity of over EUR 90 billion into the European interbank system which was on the verge of seizing up completely. Since then, the Eurosystem has provided concrete and often crucial responses to the different manifestations of the euro area crisis. To do so, it has redesigned its policy measures both from a qualitative point of view – by creating new instruments – and a quantitative point of view (the size of its balance sheet has trebled since the start of the crisis).

As regards instruments, we have used both:

- The “standard” instrument par excellence: interest rates. The ECB’s monetary policy has been very accommodative for several years, with key interest rates currently at historically low levels and negative real interest rates in large parts of the euro area.
- A broad range of “non-standard” instruments that can be grouped into two categories: i) liquidity-providing instruments (with the fixed rate full allotment policy, the expansion of eligible collateral, and the extension of maturities up to three years with the VLTROs) and ii) instruments making it possible to intervene directly on the most dysfunctional market segments (the CBPP and SMP).

This diversification and broadening of the Eurosystem’s interventions has naturally raised questions about the ultimate goals pursued, the methods used and the possible risks incurred. In this critical period, we were convinced of the need to build a solid, robust and clearly defined foundation for our actions. In particular:

- We have always acted and will continue to act within the framework of the mandate assigned to us by the Treaty: our priority objective is to maintain price stability, defined as an inflation rate below, but close to 2% over the medium term. Fears concerning the possible inflationary effects of our policies are therefore completely unfounded.
- Moreover, we have always acted, and will continue to act, totally independently from the political authorities. It has always been perfectly clear that the responses to the real roots of the crisis can only be provided by the governments themselves and that monetary policy can never durably mitigate political shortcomings. Thus fears regarding the financing of euro area States are also groundless.

Focus on OMTs

I would like to conclude by presenting in greater detail the most recent ECB measure, known as Outright Monetary Transactions (OMTs).

To understand the logic and power of this instrument, we need to make a brief excursion into monetary policy theory (before lunch… sorry! But it’s not that complicated).

As you know, central bank monetary policy impulses are transmitted to the real economy via several different channels. In the euro area, with bank loans accounting for three quarters of the economy’s total financing, the “credit channel” is by far the most significant vector. In normal times, if the ECB lowers its key rates, the banks’ financing costs decrease, allowing them to pass these lower costs on to the lending rates they offer to customers, companies or households.

However, we noticed that this channel was no longer functioning correctly in the euro area. In fact, we noticed that a drop in key rates was feeding through to lower lending rates in certain parts of the euro area, but not everywhere. This means a fundamental aspect of our monetary policy and of its efficacy – i.e. its singleness – was impaired. As a result, major differences in bank lending rates appeared across euro area countries, which could not be explained by disparities by the fundamentals of the countries concerned. For example, two hotels with the same activities and financial characteristics and located on each side of the Austro-Italian border are obliged to borrow at substantially different rates. This is not because of a real difference in the credit risk. In reality, this rate differential stems from the fact that certain segments of the financial markets had developed fears regarding a possible break-up of the euro area. They were adding to the rates they were offering certain countries a risk premium to cover a "re-denomination" of bonds into the local currency.

In this context, we felt it was vitally important to defuse these unfounded fears that were not only fragmenting the euro area's financial markets, but also, in the longer term, threatening to undermine the effectiveness of our monetary policy. That is why we created the OMT which will consist of an ex ante unlimited intervention on the secondary market to acquire sovereign bonds for which we consider the risk premium applied by the markets is unjustifiably high. The OMT will therefore represent a massive and effective backstop to the unjustifiable increase in sovereign yields and will allow us to counter the fragmentation of the euro area's markets and restore the proper transmission of our monetary policy. The use of this instrument will be subject to very strict conditions: States must have previously negotiated a programme with the ESM and must respect their commitments regarding fiscal consolidation, financial reforms and competitiveness. This should enable a return of confidence and stability, not just in the short and medium term thanks to our action, but also on a longer term basis.

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Today, the euro area is advancing with determination in the right direction. The Eurosystem's monetary policy is a source of immediate confidence and stability. Its governments are making fiscal, structural, financial and institutional reforms that will ensure the future stability and growth of the euro area.

Our determination is total and our efforts must be continued relentlessly.

I thank you for your attention.