Christian Noyer: The euro area is getting stronger

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, "Post-crisis growth and investment opportunities in Europe", New York, 22 April 2013.

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Mr Chairman,

Ladies and Gentlemen,

I am very pleased to have this opportunity to speak to you here in New York.

I'd like to offer you some views about the euro area from both a short- and long-term perspective.

I'll start with Cyprus. This was certainly a traumatic episode. Obviously, the decision process was not optimal. And the adjustment effort requested from the country, while absolutely necessary, was totally unexpected by the population. As a result, many observers have interpreted the Cyprus crisis as a sign of fragility and uncertainty about the euro.

In fact, it's quite the opposite. Imagine if the situation in Cyprus had occurred nine months ago. Most likely it would have resulted in a new wave of turbulence in euro sovereign markets, with interest rate increases and strong capital flows out of the periphery. This was not the case. There was no contagion, and no spill-over effects from Cyprus to other euro area countries. During the first quarter of 2013, when the Cyprus crisis developed, long-term interest rates in Greece, Portugal and Ireland actually declined by around 270, 120 and 130 bps, respectively. In the case of Spain, yields decreased by 70 bps, while in Italy, they decreased by 30 bps.

This is the first time in three years that a major crisis in one euro area country has not affected others. This sends an important message. The euro area is more robust today than it was a year ago. While challenges remain, the actions taken have increased our resilience to internal and external shocks.

Before I move on to other areas of progress, I would like to say a few more words on Cyprus. First, the financial support provided by the euro area countries and the IMF was very substantial, up to EUR 10, 000 for every Cypriot citizen. This should put to rest the claims that the country was unfairly treated and discriminated against. Second, the commitment to protect insured depositors has been maintained in the euro area and, in fact, is strengthened as a result of recent events. Last but not least: Cyprus is a unique case. This was an extreme situation of moral hazard with big depositors looking for abnormal yields in the domestic banking system. And it justified an exceptional treatment. Cyprus is neither a precedent nor a template for future crisis management. It is also important to state that such a banking model has no place in the euro area. And such a situation would not have existed had the banking union been in place.

This brings me to some broader issues and the progress made in restoring the euro area's robustness and integrity.

Nine months ago we had reached a degree of market fragmentation that was threatening the integrity of the euro area. Spreads on peripheral sovereigns were at an all-time high; private capital flows from core to periphery countries had all dried up, financial conditions were increasingly diverging. The same borrower was faced with very different conditions across countries.

As everybody knows, the introduction of the OMT, following President Draghi's remarks in July 2012, marked a major change. The measures taken have restored confidence, eliminated the tail risks of convertibility and reversed the dynamics of market fragmentation. The process of repair of financial intermediation is making significant progress. In recent weeks, non-euro area investors have returned to debt and equity markets in stressed countries. Deposits flows have also reversed from core to periphery where repatriation by domestic households has been significant. Target 2 balances, which measure the degree to which financial intermediation compensates for insufficient private capital flows, have receded by 20% since last summer.

The second transformational change has been the Banking Union. Never in its history, has the EU been able to agree upon and implement a major reform so quickly. A year ago, the issue was not even on the table. Then, last June, leaders made a decisive step. Through days and night of hard work and negotiations, a detailed agreement was finally reached in December.

It is hard to overstate the benefits that banking union will bring. It will break the link between sovereigns and their banks. It will stop those negative feedback loops that have such perverse effects in times of stress. 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.

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.

Today the first pillar of the banking union is being constructed: the Single Supervisory Mechanism. This is a fundamental first step and its rapid implementation is a major success for the euro area.

But alone it cannot achieve all the objectives of a banking union. That is why we must rapidly construct its two other pillars: a supranational bank resolution authority (the European Commission is due to deliver a draft text on this topic before the summer) and a unified deposit insurance system.

Naturally, in the current situation, there are some dark spots. One major concern is the stagnation of bank credit, which especially affects SMEs. Overall, the improvement in banks' funding situation, has not led to increased lending to the non-financial private sector, which has declined in recent months. Admittedly, part of this weakness is due to low demand factors. And here also, some fragmentation can be observed. Among countries: credit distribution is more active in Germany or France than in Italy or Spain. And among borrowers: big corporates can issue at very favourable rates while at the same time, too many SMEs are deprived of necessary financing. This divergence is a source of concern, especially since, in our economies, SMEs play a dominant role in fostering innovation and employment.

This situation may not reflect a weakness specific to the euro area. In all advanced economies, banks are engaged in a process of balance sheet repair and deleveraging. 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 neutralized). To put it simply, in the euro area, banks are responsible for 80% of total financial intermediation, twice as much as in the US. Consequently, the impact is much stronger on the real economy.

What can central banks do? Our actions are guided by the following elements. Inflation is firmly under control. Policy rates are very low. In practice, most central banks today are operating close to the zero lower bound. Therefore, their actions are focused, in all advanced economies, on making sure that the impact of their decisions is felt in all parts of the economy. In other words, they aim to ensure that the monetary policy transmission mechanism is working.

Let us now turn to fiscal policy. In all advanced countries, and primarily in the US, the fiscal stance is being hotly debated. As we all know since Musgrave has introduced his famous distinction, fiscal policy has three dimensions: stabilization, allocation and distribution. In a post crisis environment, governments are struggling to find the right mix.

Today, what constitutes a "growth-friendly" fiscal policy? Discussion has sometimes focused on the stabilization aspect, and more specifically, on one important, but limited feature: the so-called "fiscal multipliers" which are set out to measure the impact of a change in the fiscal balance on GDP. This narrow standpoint focuses on the negative impacts of fiscal consolidation, especially when the output gap is significantly negative, as is now the case. However, we need to take a broader perspective and take into account the effects of fiscal policy on consumer and investment confidence as well as on the efficient allocation of resources. Where could the gains come from? To answer this question, it is important to consider the interactions between the fiscal stance and debt markets. Surely, a growth-friendly strategy is one that minimizes the risks of major financial disruptions in the future, that does not impede the smooth functioning of financial intermediation and that does not block the transmission of monetary policy. In several countries of the euro area, sovereign spreads are still at penalizing levels. In so-called "core" countries, including France, the situation is different with historically low interest rates. While, in some cases, this reflects the consolidation achieved in fiscal accounts, there are also other temporary factors at work. Low interest rates are the product of low growth expectations in the short run; and they also result from exceptionally accommodative global monetary and liquidity conditions. This environment offers a unique window of opportunity to consolidate and bring public debt to a more appropriate level.

Ultimately, growth in the euro area will depend on the ability to undertake the necessary structural reforms and enhance competitiveness. The euro area, like all advanced economies is facing a double challenge. First, it must absorb the consequences of the crisis, resorb financial imbalances, eliminate excessive indebtedness and restore the normal functioning of capital markets. And second, it must adjust to the deep changes taking place in the world economy. Looking past current difficulties, 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.

Already, the crisis has produced significant reforms in many countries, with the downsizing of the public sector, changes in labour regulation and more competition in goods markets. We have seen a significant improvement in cost competitiveness as measured by unit labor costs (ULC): between 2008 and 2012, in the three program countries (Greece, Portugal and Ireland) cumulated ULC growth stood about 12 percentage points below the euro area average, thanks either to wage cuts, to productivity gains, or to both. The current account balances as well clearly show a strong correction. In the three program countries the current account balances in percent 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. Part 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 in the coming years.

In France, successive governments have reformed pension regimes, introduced measures to reduce labour costs (the competitiveness pact) and increased flexibility in the labour market. These are first steps in an ongoing effort to restore competitiveness and rebuild an export base. These measures must be pursued and amplified.

Let me conclude. The last three years have been the most difficult for Europe since the creation of the European Union. It is certainly too soon to say that the crisis is over. Current trends, however, are positive and the euro area looks today much stronger than it did a year ago. Current projections point to a return to positive growth in the second half of 2013 and in 2014. There are numerous signs that efforts undertaken in the last two years are bearing fruit. Significant changes have been made to euro area governance, both by strengthening fiscal frameworks and improving crisis management mechanisms. Much remains to be done. But if we keep on the right track, we will emerge from the crisis better equipped to take advantage of the opportunities offered by our common currency.