

Christian Noyer: Current policy debate challenges – a euro area perspective

Welcome address 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 4th Bank of France-Deutsche Bundesbank Macroeconomics and Finance Conference, Paris, 24 May 2013.

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Ladies and Gentlemen, dear colleagues,

It is a great pleasure for me to speak in front of such a distinguished audience. As you might know, this is the fourth time that the Banque de France and the Deutsche Bundesbank have jointly organised a conference of this type. It is held every other year, alternately in Germany and in France. The fact that these two institutions sponsor an event of this nature sends a clear signal to the community of researchers: it illustrates the importance of research for the conduct of monetary policy. This is especially relevant at the current juncture as our understanding of the interactions between financial markets and the real economy remains incomplete. The work of outstanding quality presented during this conference could help influence the design and the conduct of monetary policy.

The programme of this conference is very rich. It covers topical subjects that are of the utmost importance from the point of view of current policy debate. Let me take as an example the topic covered this morning: unconventional monetary policy, which have been my bread and butter as a member of the ECB Governing Council for the already six years.

After the Lehman collapse, central banks implemented far-reaching unconventional monetary policy measures, first by setting up liquidity facilities and then, for some of them, by undertaking large-scale asset purchase programmes. Measuring the propagation of these policies on our economy is a challenge. Unconventional policies are typically announced in order to respond to specific economic and financial conditions. They are endogenous. And disentangling their effects from those induced by other economic and financial factors can be very difficult.

Empirical studies of the effects non-conventional policies, including pioneering studies by Anne Vissing-Jorgensen, have proceeded through so called “event studies”. This approach consists of measuring the response of asset prices the day when a given measure is announced. The “identification” problem is solved in the sense that reactions by interest rates and asset prices on the day when a central bank announced a new non-conventional measure are indeed very likely to be caused by the announcement. This literature has for instance showed that the effects of the so called Large Scale Asset Purchase programs of the Federal Reserve. “QE1”, launched in 2009, and “QE3”, launched in 2012, had larger effects on US long-term interest rates than the 2010 “QE2” program. Another insightful result from this literature, which is presented this morning by Simon Gilchrist, is the differential effects of these policies on credit risk. LSAP programmes have reduced the non-financial sector’s default risk, but they had a very limited impact, if any, on the default risk specific to the financial sector.

Taking a euro area perspective, these results are interesting in at least two respects. First, the level of US interest rates are an essential feature of the world economy and the economic and financial environment of the euro area. Second, the experience of other major central banks is a natural benchmark for the design and the monitoring of our own policies, on which I would like to share with you a few thoughts.

The predominant objective of our first wave of unconventional measures, which we have labelled the “fixed rate full allotment” supply of liquidity, was to ensure that liquidity shortages do not escalate into defaults, especially in the financial sector. This has mainly consisted in ensuring the correct provision of liquidity to the banking sector against the backdrop of a major confidence crisis.

Yet, by the end of 2010 the crisis had taken on a new form. The fiscal constraint became binding in a number of periphery countries. Investors started to price in sovereign credit risks. By 2011, it appeared clear that investors were also factoring in the risk of a euro area break-up. This, in turn, entailed an increased degree of market fragmentation within the euro area, with borrowers facing different credit conditions depending on their country of origin.

Our Outright Monetary Transactions (OMT) programme was specifically designed to reaffirm the irreversibility of the euro. The OMT allowed investors to discard a specific form of systemic risk. In addition, financial fragmentation, which exacerbates heterogeneity across countries and which may exist in part for fundamentally justified reasons, poses an obstacle to the smooth transmission of the ECB' monetary policy stance across the euro area. Like the other unconventional measures implemented by the Eurosystem, the OMT programme contributes to overcome this obstacle. The OMT has very significantly reduced spreads across euro area countries and we observe a partial reversal of Target 2 balances.

There are however evidence that a certain degree of financial fragmentation persists. In particular, our very accommodative monetary policy stance is not fully transmitted to the financial conditions of small and medium size enterprises at the periphery. In this sense, the current degree of financial fragmentation within the euro area remains an obstacle to the smooth transmission of our monetary policy. Hence we are currently considering the introduction of additional unconventional monetary policy instruments that would further reduce financial fragmentation.

This leads me to a couple of remarks on the institutional design of the European Monetary Union. Inspired by the hard lessons of history, the founders of EMU were especially concerned that governments might weaken the union through either debt monetisation or via a sovereign default that would cause financial instability in the area. These concerns were more than legitimate and led to the now famous Maastricht criteria. But one channel was not envisioned at the time: the possibility that a major financial shock could jeopardise fiscal sustainability, through large-scale bail-out programmes. In the case of the euro area, characterised by a high degree of financial integration, ignoring this risk exposed us to major disruptions. This analysis echoes Maurice Obstfeld's keynote address and I believe that our response to these risks is fully in line with his recommendations.

Indeed, we have learned a great deal from the past five years and have made progress at an unprecedented pace. EMU is now firmly on the road to a banking union. To a large extent, this is the very institutional mechanism that was lacking in the first place. Our OMTs have limited the scale of financial fragmentation and have greatly reduced the risk that increasing spreads might end in sovereign defaults. But the euro area needs an institutional framework capable of preventing the recurrence of such crises, essentially by decoupling financial risk from sovereign risk. The banking union thus consists of three major pillars: a Single Supervisory Mechanism, a supranational resolution mechanism, and a unified system of deposit insurance. For now, the first pillar of the banking union is the most advanced, but the other two are also in the pipeline and need to be pursued.

Let me now conclude. Euro area macroeconomic governance is now stronger than it was before the outbreak of the crisis since it has been put on a sounder institutional footing. Our institutional architecture is about to be completed, which will help to prevent the resurgence of a new sovereign debt crisis. Our unconventional policies were able to address market fragmentation and the ensuing financial disruption, hence facilitating the proper transmission of our monetary stance throughout the euro area.

Huge intellectual efforts are constantly needed to improve and adapt our policies to changing environments. The current crisis is a stark reminder of this, not just for policy makers but also for economists and academics. This is the very reason why the Bundesbank President, Jens Weidmann and I have high expectations for this two-day conference.

Ladies and Gentlemen, dear colleagues, thank you for your attention.