Christian Noyer: Does Europe face the prospect of a lost decade?

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 International Economic Forum of the Americas, Conference of Montreal, Montreal, 9 June 2014.

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It is always a privilege to speak alongside Larry. But it is also a challenge. I will make the most of it by referring often to salient remarks made by Larry in recent months. I will address three questions: is the euro crisis over? Does Europe face the prospect of a lost decade? What short-term policy challenges are we facing today?

I/ – Is the euro crisis over?

Less than two years ago, the euro area was fighting for its existence. Euro pessimists were questioning its ability to survive. Not anymore. Analysts may be questioning Europe's ability to grow. But the challenges that we are facing are different. They are macroeconomic, not existential or systemic.

Thanks, mainly, to the Eurosystem's actions, financial conditions are normalising. Spreads in peripheral countries have been dramatically reduced. Soon, budgets will be reasonably balanced and there will be no more fiscal drag on the economy. Households and corporates have strong balance sheets. Recent forecasts put German growth at more than 2%, Italy in positive territory, and the outlook for France has improved markedly. Growth of business activity in the euro area in April was the highest in the past three years.

But the crisis has left an important legacy:

- Money and financial markets remain excessively segmented. The monetary transmission mechanism is severely impaired and credit conditions are still very different across countries and sectors.
- Deleveraging in the banking sector still acts as an impediment to recovery and growth. Bank credit remains flat in the euro area as a whole, and SMEs' financing is a major concern, especially in stressed countries, where the percentage of financially constrained but viable borrowers is estimated at 25% vs 1% in "core" countries.

We are very aware that balance sheet repair is a prerequisite for credit to resume and for monetary policy to be efficient. So, we are addressing the problem as a priority.

1. We are building a safer and more robust system of financial intermediation. A major step has been the creation of a banking union that, as you all know, will delink bank and sovereign risks and ensure a harmonised and tough financial supervision. It is easy to underestimate this achievement. The idea was adopted less than two years ago. The Single Supervisory Mechanism is now up and running. There is no example in contemporary European history when so much has been achieved in so little time.
2. We have launched a tough and comprehensive AQR and subsequent stress tests that should be completed by the end of this year. For the first time, these exercises will be conducted in a fully integrated way – under the aegis of the SSM – with full accountability of the results. Completion should mark a turning point where there will be no more doubts about the sustainability of our banks and credit should resume at a normal pace.
3. In the longer run, a major policy challenge for the euro area is to "reinvent" a new and robust financial integration model. We need sound cross-border capital flows,

because we do not want the Eurosystem to intermediate permanently between borrowers and lenders from different countries. Developing a safe securitisation process should be a priority, despite the major technical difficulties.

II/ – Is Europe facing the prospect of a lost decade?

Questions about long-term growth are not limited to Europe. What we hear about our continent reflects a more general concern: the possibility of "secular stagnation" in advanced economies. Larry has launched this crucial debate. I don't know whether he was thinking specifically about Europe, but, of course, this question is very relevant for us.

Secular stagnation rests on the assumption that the natural interest rate is negative. This may happen for two reasons:

- *In the short run*, we may have a downward shock on demand and an increase in savings resulting from the deleveraging process. I have just explained how we are currently addressing this issue.
- *In the longer run*, ageing and slower innovation may push up saving rates and bring down the return on capital. Therefore, the ultimate response to the risk of secular stagnation is to improve the return on investment, thus pushing the natural interest rate back into positive territory. Again, this is not only a European problem. But we do have difficulties in this regard. Structural reforms are not easy.

Many, however, are currently being implemented. Italy is abolishing its provinces, generating savings that will allow for a reduction in taxes and liberalising its labour market. France is on the same track and has reduced taxes on its labour costs as well as improving labour market flexibility.

III/- short-term policy challenges and responses

The main challenge, of course, is low and declining inflation, with inflation expectations in the euro area drifting downward at short to medium-term horizons. This prevents adjustments in relative prices, – an important mechanism to eliminate gaps in competitiveness – and increases the risk of outright deflation, should a negative shock occur in the future.

Strangely, in the euro area, growth and inflation are moving in opposite directions. As growth accelerates, inflation keeps going down. This "disconnect" in the Philips curve is puzzling. We must look, then, at the broader picture. Euro area economies have attracted strong capital inflows over the recent months, with two opposite effects on financial conditions: first, easing through lower long-term interest rates. And, second, an appreciation of the euro exchange rate.

It's not clear whether the overall effect is positive. While nominal conditions are more accommodating in euro area than in the US, real indicators point to a more restrictive stance. We may see a perverse feedback loop develop, with low inflation, increasing real rates, capital inflows and exchange rate appreciation mutually fuelling each other. The financial economy may be heading towards a bad equilibrium that would threaten the real economic recovery.

The situation called for an appropriate policy response and, as you know, the Governing Council has agreed last Thursday on a strong package of four significant measures:

First the refinancing and deposit rates have both been reduced – bringing the deposit rate into negative territory for the first time. This should encourage financial intermediaries to actively put their cash balances at work both on credit and asset markets.

Those cash balances themselves will be significantly boosted as:

Second, the ordinary regime of unlimited liquidity provision has been extended to the end of 2016.

Third, the Eurosystem will conduct a new set of targeted longer-term refinancing operations. This exceptional liquidity will be provided at long maturity (up to four years) and a guaranteed fixed rate, a clear sign that monetary accommodation should persist for a very long time.

Finally, the Eurosystem is actively preparing to buy asset based securities that will help channel monetary accommodation and ease financial conditions to private non-financial borrowers, especially SMEs.