Christian Noyer: Challenging times for finance and banking in Europe

Keynote 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 Paris Europlace International Financial Forum, Paris, 8 July 2014.

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Ladies and gentlemen, dear Arnaud,

I am pleased to be able to give this keynote address today for our Paris Europlace International Financial Forum, before the round tables begin. These are challenging times for economic policy-makers, central bankers and professionals working in the field of finance and banking in Europe

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? And I will finally say a few words about recent changes in our communication strategy.

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.

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. France, although at too slow a pace, is reducing taxes on labour and has somewhat improved labour market flexibility.

Adjustments efforts conducted by several countries, especially in Southern Europe, are starting to pay off. Competitiveness gaps between Northern and Southern Member States have been reduced, notably through real wages decreases in countries like Spain or Portugal, which are exporting more and more. This builds the way for a healthy growth in peripheral countries, which are experiencing a trade surplus of 2% of their GDP on average, and a moderate public deficit, taken down to 3%.

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 month 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. 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.

IV. New communication strategy

As you know, two important decisions were made at the last Governing Council: the frequency of monetary policy meetings will change to a six-week cycle; and starting in January 2015, the ECB intends to publish accounts of its monetary policy discussions.

Why these decisions and why now? The starting point is that monetary policy is becoming more complex. This is true for all major central banks. Monetary policy does not only consist anymore in moving interest rates, but also comprises many other non-conventional measures. This makes it more difficult for markets and economic agents to understand the economic rationale behind these complicated sets of decisions. Still it remains crucial for central banks to be able to influence expectations. Indeed, one form of non conventional policy, namely, forward guidance, depends entirely on managing expectations about future interest rates.

There are, therefore, important challenges in implementing monetary policy in the post-crisis environment. The response is to place more emphasis on enhanced communication.

As you know, the Eurosystem has always put a priority on transparency. We were the first to systematically organise press conferences after our policy meetings. However, we need to go further and ensure that markets understand the reasoning behind the Governing Council's decisions. To that purpose, we should give a sense of the discussion and the main arguments. In the jargon, the aim is to clarify the Central bank's "reaction function" and allow financial markets and the public to form reasonable expectations about the future policy. This in turn gives us the capacity to influence interest rates at longer maturities and steer broader financial and economic conditions.

It is too early to tell exactly how those "accounts" will take shape. The Governing Council and the Executive Board of the ECB will be testing different possibilities. Many issues have to be considered. We need to preserve the collegiality of the Governing Council's deliberations, and the ability of each and every member to freely express and exchange views, in order to let them be influenced by the course of discussions. This is essential for the effectiveness of our collegiate decision-making. Like any committee, the Governing Council benefits from the diversity of views and perspectives that are brought to the table. As you all know, members sit and express their views in a personal capacity; they must consider the situation of the euro area as a whole and are forbidden by the Treaty to take any instruction from any Government. We need to take proper account of the specific institutional setting of the euro area and the unique communication challenges in a multi-country monetary union.

Once the decision is taken to publish accounts, it is natural to change the frequency of monetary policy meetings to six-week. This will give space for producing the accounts and yet not create confusion with regards to following meeting and any action that might be taken.

Conclusion

While many uncertainties remain, actions taken during the last two months show that the Eurosystem is flexible, responsive, and, as we have said many times, ready to take any actions that may prove necessary should downside risks further materialise.