Christian Noyer: Economic and financial crisis – the post-G20 outlook

Speech by Mr Christian Noyer, Governor of the Bank of France, at a luncheon organised by the Hong Kong General Chamber of Commerce, Hong Kong, 11 June 2009.

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Ladies and Gentlemen,

It is a great pleasure for me to speak to you today. At a time when the regulation of the financial and banking sectors is being discussed in-depth, this meeting is a unique opportunity for exchanging our ideas and thoughts on the most topical issues.

I would like to raise three questions that seem absolutely essential today, a couple of weeks after the G20 summit and the Spring meetings of the IMF. These three questions are the following:

- What is the economic and financial outlook?
- What type of financial regulatory framework are we moving towards?
- How can we strengthen financial stability at the international level?

What is the economic and financial outlook?

After the recession that has been affecting the world economy since September 2008, the first signs of a recovery are being examined very closely. While in the first quarter output data confirmed a further decline at a similar or stronger pace than by end-2008, survey indicators point to deceleration of the slowdown in the second quarter, which justifies cautious optimism. Indeed, I see several reasons for hoping that "the worst is behind us".

The strength, the scope and the synchronisation of the crisis were exceptional and the risks that continue to weigh on the world economy should not be underestimated. The first wave of the crisis consisted in the drying-up of liquidity on financial markets, a collapse in confidence and world trade. Although this first wave has not subsided, a second wave could hit the world economy. On the one hand, the feedback effects between the financial sector and the real economy would curb the availability of loans. On the other hand, the rise in unemployment, which lags the contraction in activity, may affect household consumption.

However, the factors that lend support to a recovery are also significant. They stem not only from a natural rebalancing of the economy but also from an exceptional fiscal and monetary stimulus.

Firstly, disinflation, which has been more rapid than expected, boosts households' purchasing power and should partly offset the deterioration in the labour market. [In the euro area, disinflation could result in a 3.5-point year-on-year increase in purchasing power in 2009; the rise in unemployment could reach two points.]

Secondly, the automatic stabilisers have a strong effect in the euro area, thanks to unemployment benefits and a broad tax base. They are, by construction, temporary, appropriate and targeted, which guarantees their countercyclical impact.

Thirdly, large-scale stimulus packages have been adopted and shall be implemented in 2009 and 2010. In the euro area, they are equivalent to 1.7% of GDP and are expected, according to the IMF, to contribute to raising growth by 0.9 point in 2009 and 0.3 point in 2010.

Fourthly, governments' very strong commitment to guaranteeing the solvency of banks should prevent risks of a credit crunch. In France, the two structures set up, *the Société de financement de l'économie française* (SFEF) and the Société de prises de participation de l'Etat (SPPE), give the government considerable room for manoeuvre to recapitalise the banking sector and ensure its financing, and thereby that of the economy.

Last, but not least, the 325-basis-point decline in the ECB's refinancing rate since July 2008 is unprecedented, both in terms of size and speed. In an environment characterised by fixed rates, the effects of this decrease shall spread progressively, but rates on new loans are already falling, in line with the cuts in policy rates. In addition, the ECB has embarked on a quantitative easing policy aimed at banks, which, by contrast with the United States, provide 80% of the financing of the economy. Since October 2008, the ECB has been providing unlimited liquidity and has eased collateral rules for its refinancing operation. At its May meeting, the Governing council has decided to extend the maturity of its provision of liquidity up to one year and to purchase euro-denominated covered bonds issued in the euro area. As a result, the 1-year interbank market has converged to the level of the US 1-year market rate.

What type of financial regulation framework are we moving towards?

The current crisis has highlighted certain failures in financial regulation and this is why, beyond the immediate measures I have just described, an ambitious agenda to reform financial regulation has been launched. This overhaul is crucial for laying the foundations of a more stable financial system. It should not be implemented in a hasty manner if we want to avoid hurting the recovery from the crisis.

The G20 has laid down clear principles to guide the overhaul of financial regulation. They mainly cover three areas: the strengthening of prudential standards, the redefinition of the scope of regulation and the revision of accounting standards.

Before bringing up these three dimensions, I would like to point out that the G20 Action Plan imposes a requirement for all stakeholders concerned with financial stability: how to better assess the risks facing the financial system as a whole? On this point, you will agree with me that systemic risk is THE risk that we need to take better account of. We have not been able to identify it, control it, or capture it in prudential terms. In many respects, systemic risk is the result of liquidity risk, leverage, compounded by financial innovation and high transformation risks. These factors are not easy to measure at the level of individual banks. They are even less so at the level of the financial system as a whole. This is nevertheless the challenge we have to face today.

Let me come back to the G20 action plan. This plan first recognises the need to strengthen prudential regulation in three areas. Capital requirements need to be strengthened and made more counter-cyclical by introducing a system of capital buffers. The quality of capital should be enhanced and its definition harmonised. We also may need to add to the range of instruments currently available a simple mechanism to measure leverage in order to complement the information provided by the solvency ratio.

Another lesson that the G20 has learned from the crisis is that the current scope of regulation and supervision is inappropriate as it is too narrow. The current framework is based on the implicit idea that banks alone – because they collect deposits – are the source of risks for the system as a whole. This used to be the case. Yet, it is no longer true at all. It is now evident that all systemically important institutions and markets need to be regulated. In concrete terms, the G20 is widening the scope of regulation to include rating agencies, hedge funds and derivatives markets. The general principle is to abandon a silo approach to regulation, which was structured around institutions' legal character (e.g. banks, insurance companies, etc.), and to move over to a type of regulation based on the roles performed by different players in the stability of the system (liquidity provision, deposit-taking, market making, etc).

Lastly, the G20 has set out a road map to improve accounting standards. Agreement on this point is not as broad as on the previous ones. The members of the G20 have sometimes divergent views about the role of accounting rules. In particular, one of the controversial points relates to mark-to-market and the scope of application of fair value accounting. Nonetheless, I observe that the G20, by asking that the accounting standard setters take greater account of financial stability constraints, implicitly acknowledges that the impact of accounting choices on the latter are not neutral. In any event, the countries agreed on three objectives: reducing the complexity of accounting standards, increasing the harmonisation of standards internationally and introducing a more forward-looking system of provisioning.

The discussions at the G20 summit find a strong echo in Europe. In fact, it is no exaggeration to say that the Europeans are a driving force in the international projects I have just described.

In regional terms, the report by the high level group chaired by Jacques de Larosière is a cornerstone for the new financial regulation and supervision that will emerge in Europe after the crisis. These recommendations appear highly relevant to me. They reconcile efficiency and pragmatism. Whether it concerns developing a European system of financial supervision or setting up a Systemic Risk Council under the auspices of the ECB and the ESCB, these ideas are truly conducive to greatly strengthening the surveillance of risks both at individual institution level and for the European financial system as a whole.

The reforms that I have just described should make it possible for the incentives of financial system players to be compatible with the stability of this system. The crisis has highlighted two types if not of incompatibility, at least of divergence that need to be corrected.

First, within the financial industry itself. Financial innovation and developments in the business models of financial intermediaries have weakened credit discipline in favour of a strict return-oriented discipline. Regulators are working on correcting the regulatory sources of these incentives, which are dangerous for financial stability. I am thinking notably of the work aimed at reducing regulatory arbitrage and at countering the short-termism encouraged by certain prudential and accounting provisions.

Second, we need to reconverge the incentives of private- and public-sector players. Their divergence is a natural phenomenon in periods of economic and financial boom. In these periods, regulators and supervisors find it harder to limit risk-taking when the risks to financial stability are unclear and competition is fierce. Maximising profit and competition considerations stand in the way of prudence and the prevention of financial imbalances. Countering these forces requires in particular the implementation of an independent macro-prudential policy. This is one of the main thrusts of the reforms proposed by Jacques de Larosière.

How can we strengthen financial stability at the international level?

The overall reform agenda that I have just outlined would not be complete without a component concerning the strengthening of the international financial architecture. Let me conclude my speech on this point. This strengthening currently has two very visible faces: the IMF and the Financial Stability Board.

The IMF has once again become one of the key actors in the new international architecture. It is tasked, together with the Financial Stability Board, with monitoring the implementation of the G20 agreements on financial regulation. It also has a central role to play in the multilateral surveillance of financial risks: since late April, it has been conducting early warning exercises on financial and macroeconomic risks jointly with the Financial Stability Board; it will also extend its analysis of the resilience of domestic financial sectors as part of the Financial System Assessment Programs (FSAP) to include all systemically important countries. Indeed, one of the notable outcomes of the G20 is that all the member countries undertook to accept this assessment by their peers, including, for the first time, the United States. This broadening of the Fund's role is being supported by a trebling of its resources, which will increase its lending capacity to USD 750 billion. In addition, the instruments at its disposal were reviewed, with notably the creation of a new credit line facility aimed at countries with a proven track record and designed to avoid the stigma that up to now has too often been associated with the IMF's interventions.

The Financial Stability Board is the other face of the new international financial architecture. As you know, this is the new name of the former Financial Stability Forum. In fact, it's much more than a change of name. The Forum is becoming a fully-fledged international body. It is gaining in firepower thanks to a reinforced and permanent administrative structure. It is also gaining greatly in legitimacy thanks to the broadening of its membership to all G20 countries. Moreover, it is acquiring new powers through its position as the supervisor of international standard setters. Lastly, it is strengthening its key role in the supervision of financial stability through its full participation in the exercise to identify vulnerabilities being developed by the IMF.

Let me stop here. Thank you ladies and gentlemen.