Christian Noyer: G20 roadmap – how finance can help rebalance the world economy

Introductory 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 Financial Forum, Paris, 6 July 2010.

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Before I start let me thank the organizers for inviting me to this conference: they have managed to put together an outstanding program and it is a great pleasure for me to exchange views with the other participants in this round table.

I was asked to introduce the discussion on "G20 Roadmap: How Finance Can Help Rebalance the World Economy". The title of this session contains some of the most important concepts on the current policy agenda: "*finance*", "*rebalancing the world economy*" and "*the G20 Roadmap*". Let me take them in turn.

"*Finance*", first. Since 2008, the world is going through the deepest financial crisis since the second World War, and hence never before has the word finance been so crucial in the policy agenda. This financial crisis has had very high real costs: real output, industrial production, trade flows, to name just a few key variables, have contracted markedly during the crisis. In addition, the fiscal positions and the public debt of many countries have also deteriorated markedly in the past two years. Yet, it is important to recall that these real and fiscal problems largely stem from the *financial* issues that plagued our economies in the past decade. Indeed the financial sector, with the help of financial innovation and loose regulation fostered unsustainable growth and asset price bubbles, and if trade linkages have contributed to spread the crisis across countries, financial integration has fostered the contagion. So, yes finance matters and is the heart of the real economy.

"*Rebalancing the world economy*", next. In the years leading to the crisis, the global economy was growing at unprecedented speed: above 5% per annum in 2006 and 2007, far above the average recorded in the decade from 1992 to 2001, at 3.1%. Yet, this growth was unbalanced, both internally and across countries, such that it was, as it turned out, unsustainable. In fact, the global policy agenda in the mid- to late 2000s was dominated by the issue of global imbalances: current account positions widened to unprecedented amounts (at least by modern standards), reflecting strong saving-investment gaps: to many observers, household saving was strikingly low in the United States, while emerging Asia was characterized by a "global saving glut", in the words of Chairman Bernanke. These global imbalances have adjusted markedly in the wake of the financial crisis, but this rebalancing has been mostly cyclical and the issue remains.

Let me now turn to the third important keyword of this session, *the G20 Road map*.

With the intensification of the crisis, it has become obvious that the G20 was the right, – because the most legitimate – forum to prepare the policy response. And the G20 fulfilled the most optimistic anticipations as it reacted promptly and strongly to the crisis. Beyond this, the G20 has also agreed on an ambitious policy agenda, aiming for the long run. The G20 Roadmap does not only aim at one particular aspect of the global economy; it is very encompassing. One aspect of it is macrorebalancing, another is on financial regulation and global financial safety nets. The G20 agenda is focused on crisis prevention by coordination in order to avoid, or at least dampen overheating and boom/bust cycles.

How are these issues related? First I will briefly tackle the important question of the link between the financial crisis and global imbalances. Second, I will go through the main implications of this link and outline the key features of the policy agenda of the G20. In this second part I will mostly focus on the so-called *"G20 Framework for a Strong, Sustainable*

and Balanced Growth" and on financial safety nets. In the last section I will focus on financial regulation issues more specifically.

Why and how do the financial crisis and global imbalances interact?

An overwhelming body of research has established the clear relation between global imbalances and financial issues, some of which were behind the financial crisis. Indeed, global imbalances were not just the result of cyclical factors, such as business cycle fluctuations, changes in oil and other commodity prices, etc. They were also, and to a large extent, the result of deeper, structural factors, as illustrated by the link between global imbalances and asymmetries in financial development. Ricardo Caballero focuses for instance on the notion of asset shortage: as safe financial assets were not readily available in some regions of the world (emerging Asia noticeably), net savings in these regions were channeled to the United States, which, in lowering financial constraints, amplified the current account deficit of this country. One may actually wonder whether this also partly contributed to the development of a financial bubble in the United States. The key idea I would like to take from this literature is that finance most certainly played a key role in the emergence of global imbalances.

How and why may the G20 Roadmap help financial soundness and global rebalancing

As the global economy is recovering from the crisis, the G20 roadmap aims first at ensuring the transition to a strong, sustainable and balanced growth. By "strong", we mean that growth should converge to the growth rate of potential output over the medium term whereas that potential is enhanced by the implementation of more effective structural policies. "Sustainable" growth should be consistent with public finance sustainability, price and financial stability, along with social and environmental policy goals. Finally, "balanced" growth implies a growth that is broadly based across all G20 countries and all regions in the world, and as I said earlier, that should not generate persistent and destabilizing internal or external imbalances. "Balanced" growth also implies to facilitate the catching up of developing countries (and the taking off of the poorest). Drawing the lessons from the crisis, growth cannot be strong without being sustainable and cannot be sustainable if it is not balanced.

The so-called "Framework for Strong, Sustainable and Balanced Growth" is the key mechanism by which G20 countries work together to achieve these objectives. With support from the IMF, G20 countries are going through a mutual assessment process by sharing their policy frameworks, programs and projections and assessing their consistency with the common objectives. This process will lead the G20 to recommend policy options to its members. Policy options obviously depend on national circumstances. Countries facing serious fiscal challenges need in particular to accelerate the pace of fiscal consolidation, while countries that have the capacity should expand domestic sources of growth and help cushion a decline in demand from other countries. Reforms of social safety nets will be essential in both cases and structural reforms of the product and labor markets will be key to foster stronger growth in the medium and long run. Policy options may also entail exchange rate adjustments consistent with smooth rebalancing.

In search of global financial safety nets

There is another side to rebalancing where finance matters.

Starting with the Asian crisis of 1997–1998 and up until the global shortage of liquidity that took place in 2008, many emerging countries have experienced sudden stops of capital inflows on a recurrent basis. The international financial architecture as it was before the crisis lacked appropriate tools to deal with volatility in global capital flows and to prevent crisis contagion. This was an incentive for emerging countries to self-insure against global liquidity

shocks by accumulating international reserves or protect themselves through capital flows control, both distortive types of protection.

Reserve accumulation is costly to emerging economies as they have to restrain consumption and forego profitable investment opportunities in order to buy the low-yield assets that usually constitute reserves. It also has global consequences. For those emerging market economies that ran a current account surplus to accumulate reserves, the process has contributed to current account imbalances. This is why finance has an important role to play to help these economies effectively deal with capital volatility. A lot has already been done by G20 countries and international institutions since the beginning of the crisis. Central banks of large advanced countries have set up swap arrangements with some emerging countries. The International Monetary Fund has created a precautionary lending facility: the Flexible Credit Line. A general SDR allocation of USD 250 bn has been agreed in the London summit of April 2009 and out in place.

However, there is still scope for improvement and further work is currently being done to improve global financial safety nets. In their meeting in Busan earlier this month, Finance Ministers and Central Bank Governors of the G20 have "acknowledged a need for national, regional and multilateral efforts to deal with capital volatility". A Financial Safety Net Experts Group has been set up to work on the issue.

The reform of financial regulation

The financial crisis as taught us some very hard lessons. While there are many causes to the crisis, it is clear that it forces us to reconsider the way we regulate and supervise the financial system. That is what we have been doing since the November 2008 G20 meeting.

We entered this crisis with many unregulated entities playing a major role in the financial system. There were, therefore, huge "black holes", including what has been called a "shadow banking system" where most of the excesses of securitisation took place. The G20 has fostered coordinated efforts by industrialized and emerging countries alike to bring most important financial actors under the umbrella of supervision, with rating agencies and hedge funds receiving a larger degree of attention. Beyond these actors, the G20 and the Financial Stability Board (FSB) in particular have been instrumental in efforts aimed at enlarging the ***scope of financial regulation*** to make sure that the systemic importance and interconnectedness of institutions, markets, instruments no longer escape our vigilance. Naturally, the necessary reform of OTC derivatives markets has gained traction and the G20 has set a very clear roadmap on these matters. Efforts aimed at integrating these markets into regulated and supervised market infrastructures are indeed an essential policy response to risks accumulated in these markets.

However, the crisis has not just shown us that we should expand the scope of regulation and supervision. In fact, two clear trends have emerged and are greatly affecting the very ***nature*** of regulation. The first observable trend is that we must complement micro-supervision with macrofinancial supervision: this macroprudential approach has in fact developed in many countries. The second trend is that regulation needs to become more global in response to the globalization of finance. In that respect, the commitment by all G20 jurisdictions to implement Basel II by 2011 and to finalize this year a new package aimed at strengthening bank capital and liquidity standards is a great achievement.

We are confident that making tangible progress on each of these fronts is an essential response from policy makers to the roots of the global financial crisis. To some extent, the ultimate aim of financial regulation has to do with financing the real economy. Sound regulation should enable the stable provision of financial services to economic agents as they strive to finance their productive investments and consumption, which constitute the fuel for growth. Banks are central to the financing of economic activity because they perform maturity and liquidity transformation as well as a credit risk screening function. This is

especially true in continental Europe, where they are responsible for more than 80% of financial intermediation. This is why the current focus on enhancing banking regulation is right and progress on key reforms to strengthen bank capital and liquidity standards remains a top priority. The recent reform package of the Basel Committee will lead to a much more robust and resilient banking system in the future, with both a stronger capital and liquidity base than before the crisis. The challenge, now, is to calibrate and phase in the new framework in a way that does not impede the recovery and does not contradict our macroeconomic objectives. The macroeconomic assessment of the reforms underway will help us strike the optimal balance.

We must also reduce procyclicality. Some of the procyclicality can be trimmed through prudential regulation but I strongly believe that our first line of defense against procyclicality should be the accounting framework. I therefore support the current focus on reducing the scope of the mark-to-market approach and moving from an incurred loss model to a forward-looking model for provisioning.

Conclusions

To conclude, the main challenge ahead of us is to find the right balance between all these measures and the short-run effects of the rebalancing. If the rebalancing process happens too fast, it might weaken the recovery; but if reforms are delayed too much, the longer-run growth prospects will be affected negatively. One very important issue to focus on while analyzing this trade-off is that policy decisions need to be perfectly coordinated across countries. The crisis has demonstrated that it was necessary, and that it was possible. I am confident that the G20 Roadmap is the right approach to this coordination problem. We will, under the French leadership of the 2011 G20, pay due attention to the smooth implementation of this process.