Christian Noyer: The G20's current challenges – combining new regulations and economic growth

Introductory remarks by Mr Christian Noyer, Governor of the Bank of France, at the Paris EUROPLACE Conference "The G20's current challenges: combining new regulations and economic growth", Paris, 5–6 July 2011.

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Ladies and Gentlemen,

It is my great pleasure to take part in this Paris-Europlace conference and I warmly thank the organizers for their kind invitation. I am very glad to introduce this roundtable dedicated to a major challenge, regulators and policy makers are facing at the current juncture, that is ensuring a smooth combination between new regulations and economic growth.

The crisis has taught us that market economies may be intrinsically unstable. And the costs of this instability are considerable. Whether we look at unemployment, or public debts, it will take many years to deal with the legacy of those few months where the global financial system was on the verge of collapse. Long term consequences still need to be assessed, and, as you know, there are questions about whether the crisis has – or not – permanently affected the growth potential of advanced economies.

Therefore, curbing the tendency of our economies to alternate phases of booms and busts and reducing the procyclicality of our financial systems, are legitimate public policy priorities. Indeed, with a strong impulse from the G20 and the French Presidency, we have embarked into an ambitious financial reform agenda whose explicit objective is to prevent any recurrence of such intense episodes of financial turbulence and instability.

On the other hand, growth cannot occur without efficient and developed financial systems to allocate savings, redistribute risks, and provide liquidity to the economy. There is ample evidence that financially repressed economies are penalized in terms of investment and economic growth.

The challenge, therefore, is to find the right balance, as suggested by the title of our session. Looking at our achievements to date, my sense is that we are definitely moving in the right direction. But, of course, this is still work in progress: regulators and policymakers are constantly looking for additional evidence and insights on how to best reconcile stability and efficiency in the developments of our financial systems.

The thrust of our efforts has been to increase the robustness of financial institutions and infrastructures. It is not in our power to eliminate financial shocks and volatility. It is our duty to make sure that they can be absorbed without undue consequences for the institutions themselves and the whole economy. Building up appropriate cushions was therefore a priority and a necessity to protect tax payers from the consequences of future turbulences.

First and foremost, a robust system needs strongly capitalized banks. Basel 3 will make essential contributions in this regard, by increasing both the quantity and quality of banks' capital.

Second, progress is being made to reduce the vulnerabilities intrinsic to the derivatives markets. We, regulators, tend to think that clearing and settling those derivatives through CCCPs will considerably reduce aggregate counterparty risk, limit the contagion channels, hence strengthening the whole financial system's robustness. I am fully aware that there are doubts, in some parts of the financial community, on the opportunity of such an evolution. There are fears it will lead to greater standardization of derivative products and less flexible markets overall. This is clearly a case, where the optimum trade-off between efficiency and stability is different according to the market and regulator's point of view. But, of course, regulators' views are naturally finding their way into legislation, especially on this issue, as you know, in the United States.

More generally, when any new financial regulations are designed, two polar views were expressed.

One view is that regulatory reforms will take a significant toll on the economy. The argument is because they would raise, in this case, the cost of funding for the economy. It is feared that financial institutions will then pass this cost on to the private sector through an increase in lending rates or worse abandon certain financing segments. This would in turn have a negative effect on output growth.

The other polar view is that a more stringent regulation will not have any negative impact on growth because it would essentially reduce the frequency of crisis, hence improving the long term performance of the economy.

Both views are well-informed and of interest. They come from fairly different constituencies and have very different underpinnings. Having studied carefully all the arguments made during the last months, let me give you my personal sense, at this stage, on the good regulatory equilibrium.

First, some consequences of the new regulations are difficult to predict and should be carefully observed. Quantifying precisely the effect of the reforms on the economy is not an easy task. The phasing-in period of Basel 3 has been specifically designed to be consistent with the economic recovery and, more generally, to minimize potential adverse consequences on banks and the macro-economy.

Second, we all know also that any regulation may have unintended consequences. One of those, of course, is to create incentives for regulatory arbitrage. It is therefore crucial that the reforms be applied fully and consistently across jurisdictions. It is also important to make sure that a significant part of financial intermediation does not shift to the unregulated (shadow) financing sector, as this would not help reduce the likelihood of disruptive financial crises.

Finally, increasing robustness is a necessary but not sufficient condition to get safer financial systems. Another important element is to ensure that risk remains at acceptable levels and carefully managed. This is, so to speak, one specificity of our approach in this country. We believe in strong and efficient supervision. We don't think that bigger cushions are a substitute for competent supervisors. We are strong supporters, in our jargon, of the "Pillar 2" approach, whereby the supervisor is in charge, at any single moment, to check the adequacy of capital buffers with the effective level of risk in the system. Needless to say, we also strongly support the development of macro prudential tools allowing authorities to detect and prevent systemic risks. Given that all economic cycles are not simultaneous, to be fully efficient, those tools should be set and implemented at each jurisdiction's level and not a regional one, in order to take into account national cycles and the level of risks of individual economies.

Overall, I can assure you we are very keen to monitor in real time the economic impact of financial regulation. For the first time, economic and systemic assessments have been made of the new projected Basel 3 framework. We will continue to update them permanently. A good example of our constant vigilance relates to projected liquidity ratios, where the systemic impact and implications for monetary policies are being thoroughly reviewed at this time.

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To conclude, let me emphasize that policy makers are fully aware of possible macro consequences of regulatory reforms and will be eager to limit the economic costs. Beyond broad effects on growth, it is also clear that the new regulations should neither derail financial systems nor favor some particular business models over others.

Yet, there was, and still is, a need to move from a financial world of excessive risk taking and heavy regulatory arbitrage to a new system of better quality capital and increased risk capture. An implementation of the Basel III package endorsed by the G20 will provide the appropriate foundations for such a system, provided that phase-in arrangements are respected and implementation is coordinated globally.

Thank you for your attention.