# Christian Noyer: The end of the financial dictatorship?

Introduction by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, to Session 5 “The end of the financial dictatorship?”, Aix-en-Provence Economic Forum, Aix-en-Provence, 6 July 2013.

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## 1. Firstly, is finance really a dictatorship?

This question isn’t new: already Petronius, in Roman times, at the start of our modern era, asked: “What use are laws when money is king?”

The question seems rhetorical, and you can sense in its resignation that the Latin writer (who, incidentally, was born in the nearby city of Marseille) was already worried about the difficulties of establishing the primacy of politics over finance.

i) It is true that the world of finance does have considerable powers:

- The power to create and support economic development. In its most traditional forms, this is finance’s most crucial role – and power: it is an essential cog in the wheel of economic activity, allocating capital, supplying credit and enabling the management of risk. More than just “the sinews of war”, it can be seen as the lifeblood flowing through our veins.
- But also a highly destructive power: it was the unchecked sophistication of finance and the excesses this caused that lay behind the 2007-2008 financial crisis, a crisis that subsequently transformed into an economic, social and political crisis. Limited losses on subprime loans ultimately led to the destruction of millions of jobs throughout the world, and the links between finance and the real economy were cruelly laid bare.

ii) But finance can certainly not be considered “all powerful”: in my opinion, the world of finance only has the political power that State governments choose to give it.

- Granted, the difficulties some countries were facing, notably in the euro area, were exacerbated by financial market pressures – think back to the attacks on Italian debt in the summer of 2011. But if the markets were able to exert this pressure, it was because those countries had, in a sense, put themselves at their mercy by demanding that they finance their ever-expanding public deficits, even during periods of growth.
- In nearly all the crises faced by the euro area since 2009, it is true that market reactions were often brutal and even extreme. But these reactions were frequently based on legitimate fears: for example the sustainability of Greek debt, weaknesses in the institutions of monetary union and divergences in competitiveness between euro area Member States. Again, it was by failing to make the necessary efforts (to ensure budget discipline, preserve competitiveness or finalise the institutions of a European financial union, for example) that these countries put themselves in a position to be rushed or even pressured by the markets and bear the consequences of their overreaction.

Governments should not use finance as an alibi or as a scapegoat. On the contrary, they should assert their ascendancy over it through strict financial management.

## 2. Finance should not dominate the economy, it should serve it.

i) Reasserting the importance of regulation and supervision:

- The period from the 1990s to the start of the 2000s is sometimes called "The Great Moderation" because inflation remained stable at moderate levels and growth appeared solid and sustainable. In reality, however, the period saw frequent build-ups of financial excesses. These excesses led to the crisis, and they were firmly rooted in the dogma of self-regulation – a dogma which was itself fostered by the belief that financial markets were somehow sacred and inherently "efficient", capable of setting "real" prices.
- The crisis completely discredited this theory. From the first sparks of turmoil, the lack of transparency in certain segments of the market – notably CDOs – significantly exacerbated the loss of confidence. Financial institutions had insufficient capital cushions to absorb the shocks, leading to bankruptcies and forcing the government to bail them out, a process that was extremely costly for public finances, but also very damaging to financial sector accountability, as at times it meant bank losses were "socialised" whereas previously their profits had been "privatised". This is the problem of moral hazard, a subject which will no doubt come up over the course of this session.
- The facts therefore served as a stark reminder that self-regulation just doesn't work, primarily because of the imperfections in certain financial markets, which are neither transparent nor efficient (like the CDS market for example) and can generate potentially huge negative externalities. Thus, regulation and supervision were once again elevated to their rightful role after the crisis – a role they should never have lost. By way of an aside, I note that the crisis was triggered in the United States by unregulated entities (conduits) or banks that weren't applying Basel 2 requirements (investment banks which theoretically were regulated by the SEC). By contrast, French banks for example, where supervision was at times branded "intrusive", managed on the whole to get through the different phases of the crisis relatively unscathed.

ii) What rules should apply to finance?

- Once a consensus had been reached over the need to reinforce financial regulation and supervision, the next question was naturally: what kind of regulation?
- The principle that guided the regulators, notably on the Basel Committee, was that finance should once again be made useful to the economy: that it should serve the economy rather than govern it.
- More specifically, the new regulations were guided by five main objectives:
  - i) To increase the resilience of the banking sector (solvency and liquidity ratios);
  - ii) To prevent excessive leverage and maturity transformation (leverage and net stable funding ratios);
  - iii) To reduce market risk and increase market transparency (reform of over-the-counter derivatives, Basel 2.5 on market risk);
  - iv) To limit systemic risks (macroprudential rules, identification of and specific rules for systemic institutions, rules for bank resolution);
  - iv) To fight "casino finance" (rules on the separation of certain speculative banking activities).
- Throughout the preparation of the new regulations, the idea was never to suffocate banks with overly restrictive rules. The regulators tried to calibrate the rules in a balanced manner, and took into account the reality of the situations these banks face – and the risk that, rather than limiting dangerous banking activities, the rules might in fact drive banks to shift them into unregulated entities. France, in particular,

worked hard to make sure that the “pendulum theory” did not mean regulation was set at a level that would prevent banks from continuing to finance the economy. I’m thinking of two examples in particular: the improvement of the liquidity coverage ratio (LCR) at the start of the year and the balanced choices made by both French and German political authorities on the separation of banking activities.

- Furthermore, the idea was never to place a ban on financial innovation. You are probably familiar with the words of former Fed Chairman Paul Volcker: that the only useful thing banks have invented is the ATM. I don’t completely agree with this statement (and, in all likelihood, neither does the man behind it, it was a joke). As with other industries, I believe that innovation and competitiveness should be encouraged in finance. Since the first commodity derivatives markets were created in Chicago, market innovation has more often than not proved useful to the real economy, notably enabling companies in the real sector to better manage their risks. However, given that excesses in finance have more potential than in any other sector to damage the broader economy, financial innovation needs to be closely controlled.
- To conclude, a great deal has already been achieved since 2009 to tighten control of the financial industry, and ensure that it fulfils its vital role in serving the economy without destabilising it. But there is still a lot of work underway that needs to be completed. I’m thinking in particular of work in those sectors where regulators have less influence than over banks: shadow banking, hedge funds, tax havens or rather regulatory havens. I am sure that the discussions in this session will help to give us some ideas.