

## **Christian Noyer: The macroeconomy and financial systems in normal times and in times of stress**

Speech by Mr Christian Noyer, Governor of the Bank of France, at a conference, jointly organised by the Bank of France and the Deutsche Bundesbank, Chantilly, 9 June 2009.

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### **Introduction**

Ladies and Gentlemen, Dear Colleagues

It is my great pleasure to address such a distinguished audience to day.

As you may know, this is the second time the Banque de France and the Deutsche Bundesbank have jointly organised such a conference. It is held every two years, alternating between Germany and France. The fact that an event of this nature is co-sponsored by the two institutions sends a strong signal to the research community. It also clearly illustrates the importance of research in today's monetary policy making, given the interplay, which is not always fully understood, between financial markets and the real economy. The top quality work that has been done in this conference will be of great help for policy making.

### **Normal times and times of stress**

Over the recent months, thanks to the joint actions of governments and central banks, markets have shown gradual signs of improvement. Yet, the functioning of the markets has not been fully restored. At the current juncture, one key challenge is to restore confidence in a context where players are still confronted with numerous sources of uncertainty: uncertain exposure vis-à-vis counterparties, uncertain valuation regarding financial assets or financial risks. In such a context, what should we do to return to normality?

Economic theory provides a set of conditions to be fulfilled for a market to function efficiently: full information, enforceable property rights and contracts, absence of externalities just to mention the most important ones. In times of stress, these conditions are not fulfilled. But they are hardly met in normal times either. Moving from one situation, to the other, does not necessarily involve a huge economic shock. Small changes in economic sentiment or "animal spirit" may bring financial markets to a point of near collapse.

The past ten years are a striking case in point. The development of securitisation was initially perceived as improving welfare through better risk management and allocation. Overall, it was seen as a move towards more complete and efficient markets.

The crisis has shown that this was not necessarily the case: the process was plagued by information asymmetries and moral hazard, and created high risk concentration on a limited number of counterparties, It also led to the build-up of financial imbalances which proved unsustainable. In those conditions, a minor change may suffice to trigger a financial market collapse. It is difficult to rationalise such an outcome unless it is the result of some kind of coordination between economic agents on a bad equilibrium. Some contributions presented here mentioned strategic complementarities, an explanation which cannot be completely ruled out. Indeed, it seems that the driving force behind the massive securitisation era was, for most participants, regulatory arbitrage.

Therefore, it comes as no surprise that the main policy response has focused on regulation. Indeed, there is a widespread consensus that the cause of the current financial meltdown stems from the failure or even the absence of regulation in important segments of the financial system. But it may also have implications for monetary policy, to which I turn now.

## **Some implications for monetary policy**

Central banks have been on the frontline since the crisis unfolded in the summer of 2007. A dramatic change occurred however after the collapse of Lehman Brothers where we had the sentiment that we were moving into uncharted territories: spreads reached unprecedented levels both on the money and credit markets, leading to a worsening of financing conditions across industrialised countries. Without action some important parts of the transmission mechanisms would have been significantly impaired.

In such a context, major central banks embarked on unconventional policies by:

- Increasing central bank liquidity;
- Influencing risk premia on private financial and credit instruments. Such policies are referred to as credit easing policies;
- Pre-committing to conducting very low interest rate policies for as long as necessary in countries where the interest rate has already reached its lower bound.

All these policies are set out as temporary policies and deemed to be used in times of stress only. It is obviously too early to gauge their overall impact. So far, they have been effective with regard to market confidence, and have contributed to a significant reduction in various credit risk premia. One channel relies on portfolio composition effects. I know that some contributions presented here made that point in a very sophisticated framework, i.e. positive feedback effects may be generated through the greater liquidity of investing entrepreneurs. Obviously, the soundness of the financial system is critical to the success of these unconventional policies.

These policies must be viewed as state contingent policies: they are conditional on the state of the economy. A significant part of the intervention is short-term oriented, as the acquisitions focus on short-maturity assets. Furthermore, the assets purchased are usually of very good quality. In most cases, and in particular in the Eurosystem, the increase in the monetary base is determined endogenously by the banking system, motivated by banks' preference for liquidity and thus by the state of stress of the banking system. Finally, these measures tend to address aggregate risks.

These unconventional measures would automatically unwind, as improvements in inter-bank and credit markets would reduce the need to use these facilities. Financial market indicators, risk premia components and their determinants as well as monetary indicators (inflation expectations in addition to monetary and credit developments) should be taken into account to carry out the assessment.

## **Some implications for financial stability**

This crisis has triggered a debate regarding possible tools to be developed to prevent the build up of financial imbalances and design countercyclical regulatory policies.

Some papers presented during this conference made such a point, calling for a new macro-prudential approach and proposing measures of systemic risks that capture risk spillovers and tail risk correlations. I am of course very sympathetic to this approach and I also think that such measures should form the basis of any macro-prudential regulation.

The general principle of this macro-prudential regulation is straightforward: it consists in ensuring that supervision manages to limit risks for the stability not only of a particular institution, but also of the entire financial system. Its implementation is however a bit more complex and raises several policy issues: first, there are questions on how to calibrate these macro-prudential instruments so as to address common exposures across financial institutions and the contribution of each institution to system-wide risk; a second issue is how to dampen the inherent procyclicality of the financial system; a third issue is the respective importance of rule-based approaches versus more discretionary tools. Finally, questions

remain regarding the institutional set-up, in particular as to which institutions should be involved in the process and make the decisions. These issues are currently being debated in various circles and the recently-published de Larosière report made some substantial proposals regarding the institutional set-up. I will not elaborate on all these issues but simply touch on a couple of them.

The most important features of a macro-prudential approach is that it treats aggregate risks as endogenous and considers possible feedback effects between the real economy and the soundness of financial institutions. Its ultimate objective is to prevent costly recessions such as the one we are currently experiencing. Consequently, its implementation must be grounded on some welfare analysis. This is an area in which further research is required. It is very important that the implementation of this macro-prudential approach finds the right balance between efficiency and stability in the financial sector, It should therefore be constructed so as to act directly on the incentive to take risk and the rewards provided by risk taking.

Should central banks be involved in? Clearly, they should play a pivotal role: they are a major player during financial and liquidity crises. They are well equipped to assess cyclical positions and they have a strong incentive since the efficacy of their monetary policy relies on the smooth functioning of the transmission mechanism. On the other hand, they are not alone in caring about financial stability and their primary mandate, which is price stability, does not always necessarily coincide with financial stability.

As a conclusion, I would like to thank you very much for your attention and for your kind participation and thank once again the organisers and the teams involved in the preparation of this conference.