# Christian Noyer: Is speculation the enemy of investment?

Speech by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, Aix-en-Provence Economic Forum, Aix-en-Provence, 5 July 2014.

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### *Between paradox and illusion: a narrow path for finance*

Seven years after the start of the crisis, the French public – and they are not alone in this – remain largely hostile to the world of finance. Despite huge efforts at reform, there are still doubts hanging over the sector. Is finance useful for the economy? Or, in its current form, is it merely a tool for ever-increasing speculation, at the expense of investment and the long-term needs of the economy? The fact that we still need to ask this question shows that we are living in difficult and paradoxical times, where the inner workings of the economy are often a mystery. In this context, it is tempting to fall back on simple solutions; but that would be dangerous, and I will try to sketch out, in just a few minutes, what I believe would be a good middle ground between an unconditional love for and an exaggerated hatred of financial activity.

## I/ – When we look at the economic and financial environment today, we can see that it is characterised by five paradoxes

***1/ – First paradox***: ***we have carried out a lot of reforms, but the flow of credit, at least of bank credit, to the economy is still insufficient***. After three years of intense efforts, the main international regulatory bodies – the Basel Committee, FSB, and G20 – have achieved impressive results. We have significantly reinforced financial regulation, tightened capital and liquidity requirements, built more robust and efficient banks with healthier and more solid balance sheets. But despite this, bank lending remains sluggish. At the same time, bond issues have shot up, including those by less creditworthy borrowers, while issuance conditions have become less and less rigorous. The main losers in this two-pronged scenario are SMEs.

***2/ – Second paradox: the economy is struggling but stock markets are soaring***. As you know, although many countries are now seeing a marked recovery, the overall pace of growth remains disappointing. Recent figures for the US are below expectations. There’s still some uncertainty over Chinese growth. And the euro area is struggling to get off the ground. Despite this, the main stock market indices have risen by around 50% in the past two years. For many, this contradiction serves to confirm the idea that finance exists within a world of its own and is disconnected from the “real” economy.

***3/ – Third paradox***: ***we have made the banks “secure”, but financial risks are appearing in other areas***. As I have already said, we now have robust banks and, in Europe, the soon-to-be completed asset quality review, conducted under the aegis of the ECB, will help to guarantee this. However, this does not mean weaknesses have disappeared. They are still there, only in other parts of the system. At the moment, for example, credit activities are mainly concentrated in the hands of large asset managers who together manage portfolios of several tens of trillions of dollars. These managers are becoming increasingly sophisticated, and therefore more efficient, but at the same time they are getting bigger and bigger. They are judged on their short-term performances, often leading them to follow identical strategies, which in turn results in massive movements in the market. Some – though not all – transform short-term savings into structured products, a practice which, as the crisis has shown, can prove very dangerous.

***4/ – Fourth paradox***: ***our monetary policies are extremely accommodative, but inflation remains low*** and, in some cases, is even declining. Throughout the developed world, central banks have slashed their policy rates close to the zero lower bound. Their balance sheets have ballooned under the impact of asset purchases and liquidity injections. But in all these countries, inflation rates are at levels considered too low with respect to the price stability target – in some cases dangerously so. In the euro area, inflation has been falling steadily for six months. While it would be exaggerated to talk at the moment about deflation, the fact that monetary easing has had such a limited impact on prices is somewhat surprising.

***5/ – The fifth and final paradox***: ***long-term interest rates have never been so low.*** In real terms, they are close to or below zero. But in all countries, ***rates of investment as a proportion of GDP are still between 2 and 4 points below pre-crisis levels***.

It is only right that these paradoxes should have caught the attention of analysts and prompted concern among policy-makers. And it is understandable that questions have been raised over the efficiency of our financial system and the usefulness of certain financial activities. However, in complex situations such as these, simple, knee-jerk responses are rarely the right ones. I shall address this in my second point.

**II/ – There is a very strong temptation at the moment to opt for obvious, attractive solutions, which can unfortunately prove dangerous. I would just like to give you some examples of the assertions that we frequently hear, but which do not fully reflect the reality of the situation and, in some cases, are quite frankly wrong:**

***1st assertion***: ***monetary policy isn't working***. According to this theory, non-standard monetary policies have had a very limited impact and generate too much risk for the financial system. In other words: highly accommodative monetary policies foster speculation rather than kick-starting the economy. To which we can answer: yes, non-standard policies do encourage greater risk-taking. This is precisely their purpose at a time when investment choices are dominated by risk-aversion. As for their effectiveness, we need only think for a minute what things would be like now if we had followed tighter monetary policies. We should be proud that, during the recent crisis, our central banks managed to avoid the errors of the Great Depression.

***Second assertion***: ***only inflation can eliminate the excessive debt levels*** inherited from the crisis and before. This clearly ignores the fact that markets know how to protect themselves from inflation and that the long-term effects of a loss of credibility on the part of central banks would be massively negative. Of course, this does not mean that the extremely low levels of inflation we have today are acceptable. The keyword here is symmetry: central banks need to put the same effort into combating low inflation as they do into preventing high inflation.

***Third assertion***: ***public debt levels are unsustainable and we thus need to start default proceedings or debt restructurings***. This assessment is often based on a limited appreciation of what is sustainable, neglects the highly disruptive effects of debt restructurings on financial stability, and is frequently founded on extremely pessimistic growth forecasts.

***Fourth assertion***, which is the opposite of the previous one: ***we need more debt***; we need to take advantage of low interest rates to rebuild public infrastructure and thus adopt less rigorous – some would say less austere – fiscal policies. There is an economic logic behind this argument, notably with regard to infrastructure. But it ignores the sad reality, which is that no country has sufficient credibility at present to implement this policy effectively. Decades of deficits have created a deep-seated scepticism. The current balance is very fragile and, in this highly volatile environment, any major deviation from the required fiscal path would probably be punished with a sharp rise in interest rates.

***Fifth assertion: within the banks, we need to separate those activities which serve to finance the economy from those that are purely speculative***; and prevent customer deposits or central bank refinancing from being used to fuel dangerous behaviour. The idea in itself is a sound one. Unfortunately, it has often translated into an absurd cleavage between commercial banks (by that I mean lending banks) and investment banks. In fact, it is not possible to make a clear distinction between "good" lending and "evil" markets. What is important is that all participants in the real economy find the right combination of financing to suit their needs. And for that, nothing can rival the universal banking model which provides a one-stop shop for a full range of banking products.

**III/- I'd like to look now at my own proposals for how we can reduce the uncertainty surrounding the *financial sector.***

I have six proposals:

1- ***First, we need to encourage players to take risks, but only the "good" risks;*** in other words we need to restore and repair the mechanisms for supplying credit to the economy, and use the full range of tools at our disposal to achieve this. We must stop trying to draw a line between banking and market activities; we need both, because they complement each other. If banks stop all trading activities, liquidity could evaporate from the debt markets. Similarly, Europe needs to create a healthy securitisation market which eliminates the errors of the past. This is the best way to separate lending from sovereign and bank risks, and revive cross-border transactions within the euro area, putting an end to the fragmentation of the financial and monetary markets.

2- ***Second, we need to eliminate the uncertainty created by public policies***, which is a major obstacle to long-term investment. We are currently in a phase of transition following the crisis, but are also experiencing an even deeper transformation in our structures of production, notably in energy. It is vital that public policies are clear, stable, free of contingencies, and unequivocally long-term in perspective.

3- ***Third, we need to restore our fiscal credibility;*** this is the only thing that will enable us to withstand future shocks. Major progress has been made over the last few years. It would be a shame to undermine that now.

4- ***Fourth, we need to recreate what Keynes called "opportunities to invest".*** Too often, markets are constrained by obstacles, regulations and bans which act as a disincentive for investment. If we are going to apply a Keynesian economic model, then we need to apply it to the full, and avoid distorting his thinking. Structural reform doesn't have to be painful; on the contrary, it often creates a brighter future, and opens up opportunities to those who have none.

5- ***Fifth, we need to incorporate the structural changes in the financial sector into our prudential oversight***. We need to adapt to a new environment where asset managers play the dominant role in capital allocation and asset price formation. This means changing the way we think, as well as our methods of analysis and action. In this context, the French model of integrated supervision is particularly apt.

6- ***Lastly, number six, we need to refocus financial innovation on the long-term***. Today, literally billions of dollars are spent finding ways to shave a few nanoseconds off arbitrage transactions between two trading platforms. At the same time, investors struggle to find secure long-term financing tools for public infrastructure, even though experience has shown that the private (and social) returns of this type of investment are much higher. "Infrastructure bonds" have been shown to offer return/risk ratios that are often higher than those on traditional assets. The G20 has rightly made this issue a priority and is looking for ways to strike a better balance between incentives and initiatives, through regulation and financial engineering.