Christian Noyer: Sovereign crisis, risk contagion and the response of the central bank

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 Global Interdependence Centre (GIC) Conferences, Paris, 17 June 2010.

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Ladies and gentlemen,

I am very much honored to open this second session of conferences in Paris and I would like to thank the Global Interdependence Centre for having Banque de France as a partner of this full week conference.

I will give the point of view of a central banker on the recent events on sovereign markets, the major implied risks and challenges for financial stability and the recovery process. Finally, I will briefly touch on the latest actions of central banks and public authorities to contain those renewed tensions.

I am confident that this opening address will give rise to valuable discussions in the panels where distinguished speakers will express views from different perspectives: central banks, rating agencies, investors and academia.

Sovereign crisis: origins and dynamics

The sovereign debt turmoil is the most recent episode of a crisis that started more than two years ago yet. Some European States are the latest actors of a protracted debt crisis after i) US subprime mortgage borrowers, ii) financial institutions with weak funding situation and iii) non financial companies and households unable to finance their capital needs. It reminds us, if need be, that crisis management is always a difficult and potentially long lasting task. ***Time is a key dimension for fixing the economic and financial systems, which in turn creates the conditions for self sustained recoveries.***

In a couple of weeks, Greece has been at the epicenter of the phenomenon when doubts about the ability of its government to honor billions of debts maturing in 2010 became widespread. The lack of market confidence translated into spectacular increases in government bond yields. While this extreme situation was largely limited to one Member State, the magnitude of these price movements and signs of contagion to other sovereigns led market participants to fully reassess global sovereign risks. In this global reassessment process even less vulnerable countries were broadly and suddenly impacted with spreads widening very rapidly and reaching sometimes unprecedented levels. The issue at stake is certainly not to refute weaknesses of certain fiscal positions. In fact I, and many ECB Governing Council members alike have regularly called on policy makers to pay due attention to debt dynamics. What was very peculiar was the intensity of contagion between member states and between segments of the financial markets. Some observers have voiced concerns that specific mechanisms were at play, highlighting the potential destabilizing role of speculation and called for decisive policy actions to curb its consequences. I will come back to this issue later on.

Looking at the roots of these countries weaknesses, the financial crisis has played a pivotal role. Of course, the structural fiscal deficit of certain countries were already sizeable before the crisis occurred but the crisis has triggered a huge deterioration of public finance situations: first via the mechanism of automatic stabilizers that resulted in rapidly declining fiscal receipts due to the global and synchronized recession; second the imbalances of public accounts have been aggravated by greater public spending via unprecedented fiscal stimuli plans but also large public financial commitments, in particular via capital injection into the banking sector and debt guarantees schemes. Public interventions have been massive to contain the scale of the turmoil but in return have implied a cost and led to a transfer of risk out of the banking sector onto the public sector balance sheet. For instance, interventions from European governments amounted to about 1800 billion EUR or 14% of the European GDP.

The potential contagion channels of the April-May European crisis

What are the reasons behind the strong and unambiguous public authorities' responses to the April-May crisis? As already shown in the previous stages of the financial crisis, strong and prompt public actions are needed to prevent contagion and undesirable second round effects. In that respect, properly handling this sovereign debt crisis is absolutely necessary, lest the shocks on the sovereign debt markets profoundly affect financial markets, banking systems and thus, the real economy. Let me elaborate on these contagion channels.

1) ***Considered theoretically as risk-free securities, government bonds are usually considered as floor rates and constitute the benchmark for pricing almost all other securities****.* Thus, rising sovereign yields mechanically shift funding costs upwards for all private agents. Interest rates on government bonds usually include small premia to compensate for liquidity and credit risk. For a proper monetary policy transmission, these risk premia should not reach such level and volatility that the signal from the key policy rates is no longer perceivable and no longer reaches the real economy. In recent months, the tensions rapidly spread to other markets to a point that jeopardized the transmission of monetary policy, as European government bond markets became largely dysfunctional.

2) The second contagion mechanism goes ***through the banking system***.

   On the liability side, banks are already suffering from increasing government debt issuance which has a crowding out effect and contribute to steepen the yield curve; it is a real issue as banks debts maturing in the next three years are significant while government support and central banks facilities are expected to be gradually removed. In that tense context, the sovereign debt crisis trigger ***increasing funding tensions for European banks*** owing to the contagion of sovereign to banks spreads. It reflects the traditional belief that domestic financial institutions cannot be less risky than the sovereign which are supposed to back them in case of need. Over the past seven months, this fact has been confirmed by the increasingly strong correlation of bank CDS with those of the country where they are located. It is an area of concerns for banks especially in the case of a rapid and abrupt evolution. A surge in the cost of funding will be therefore damaging for banks profitability and their ability to grant credits. Short-term funding may also cause some concerns for banks as multiple sovereign downgrades can lower, either through a decrease in market prices or through an increase in haircuts, the value of government securities used to collateralize refinancing.

   On the asset side, banks are exposed to an abrupt drop in sovereign debt prices through mark-to-market losses on sometimes large trading portfolios of government bonds detained as a liquidity buffer. In addition, banks active on CDS as net protection sellers are also exposed to mark-to-market losses and real losses in case of a debt restructuration which constitutes a credit event triggering the CDS. These losses could erode the capital base of the banks at a time when the risk weighting of assets, based on credit rating levels, increases. The two factors push down capital ratios and reduce the potential for lending to the economy.

   It brings us to our third contagion channel.

3) Lastly, the ***economic channel*** is likely to play a significant role via the fiscal adjustments necessary to repair public finances and restore the credibility of the countries on financial markets. The increase in public investment and spending had mainly contributed to the economic growth of the last semesters; their drop could weigh on the recovery ***even if the calibration and the path of fiscal adjustment are supposed to be fine-tuned to allow a sustainable fiscal consolidation without challenging a long-lasting economic recovery.***

Strong and unambiguous responses from European governments and the Eurosystem

In such a context, the role of central banks and public authorities was crucial to restore confidence and ensure a proper functioning of financial markets. Drawing on the lessons learnt from the financial crisis in 2008–09, European governments and the Eurosystem have therefore rapidly resorted to strong, unprecedented and sizeable actions to contain those tensions and prevent their spill over to the real economy. We could briefly mention the actions of the Heads of States and the central banks.

Government actions helped contain the pressures

1) I first welcome the commitments from many European countries ***to strengthen their fiscal position*** which is a necessary step to restore the credibility of governments and the normalization of sovereign bond markets. As recently pointed out by the G20 Finance Ministers and central bank governors, recent events have highlighted the importance of sustainable public finances : those countries with serious fiscal challenges need to accelerate the pace of fiscal consolidation;

2) Secondly, the announcement of a ***EUR 110 billion financial aid package for Greece***, agreed between the European Commission and the IMF conditioned to a package of substantial fiscal consolidation measures by Greece contributed to alleviate concerns in the markets.

3) Thirdly, to restore confidence in the whole euro area and to contain contagion, a plan with a broader scope has been adopted at the euro area level, the ***European Financial Stabilization Facility***, for a global amount of 750 billion euro with the financial participation of the IMF. One of the key features of this Facility will be the possibility to be used on short notice without involving further national Parliaments.

Finally, let me focus on the other recent actions of the European central bank which have been essential in response to these challenging circumstances.

Central banks complemented these actions by specific and innovated measures

1) After careful consideration of all implications of this option and based on its positive assessment of the Greek consolidation package , the Eurosystem decided to ***suspend the reference to credit rating and current market prices in the collateral requirements*** for marketable debt instruments issued or guaranteed by the Greek government. This decision proved once again the flexibility of our operational framework and contributed to maintain a normal functioning of the monetary policy transmission mechanisms and to mitigate strains on interbank markets. ***It allowed avoiding strong and potentially pro-cyclical threshold effects of credit rating agency unilateral decisions.***

2) Then, the launch of the ***Securities Markets Programme*** (SMP) on the 10th of May marked a new step of the Eurosystem's response to the financial crisis. This measure consists in intervening in the euro area's public and private securities secondary markets to ensure depth and liquidity in markets that have been affected by severe disruptions. The objective of this program is to address the malfunctioning

of securities markets and to restore an appropriate monetary policy transmission mechanism. These interventions were sterilized as liquidity injected was exactly drained, thus fully neutralizing the effects in the banking system. This historical and exceptional type of intervention has stemmed from the spillover of increased financial market volatility, liquidity risks and market dislocations.

3) Additionally, the ECB reactivated, in coordination with other central banks, the temporary ***liquidity swap lines with the Fed and resumed US dollar liquidity providing operations in order to alleviate pressures on funding in dollar***. The reactivation of this measure followed the revival of strains on foreign exchange markets and highlights the central role that cooperation between central banks has taken in recent years in order to preserve cross-border operations and financial stability at the global level.

However while such measures have removed near-term uncertainty, they could prove insufficient to provide a lasting change in the negative sentiment of investors on the medium-term if budget deficits and debt situation are not considerably improved. ***In this context, European authorities have to show their strong level of cooperation and commitments to global and common solutions. Any unilateral and uncoordinated decision may notably prove to be less efficient and may amplify markets volatility.***

Finally, the ***removal of vulnerabilities in the banking sector is desirable to alleviate uncertainties***. Effective risk management, transparency and robust business models are essential to strengthen banks' resilience to shocks and to ensure adequate funding of real economy that underpins sustainable growth and financial stability. ***The effective and timely implementation of the G20 policy orientations is necessary to build the new international system on a solid and stable ground***. This is notably the case for the G 20 provisions on the CDS market and on credit rating agencies.

One cannot deny that certain OTC derivatives (CDS for instance) or certain types of transactions (short sales) are likely to exacerbate price movements or create instability that are detrimental to both issuers and investors. One may thus find it tempting to ban or drastically limit this type of operations and we indeed have observed national proposals going in that direction, including the bank of naked CDS, naked short sales or mandatory shorter time horizon for settling transactions. I am of the view that such measures may not be efficient and, worse, may be counterproductive.

They may not be efficient since security prices are not formed in national contexts but on global markets. What would not be possible in Paris or Frankfurt could still be allowed in London or New York for instance. They may also be counterproductive since they could deter activities away from our market onto others and they could significantly alter the liquidity of securities aimed by the restriction since foreign investors may shy away from them and turn to other opportunities.

Let me be clear, though, this does not mean that nothing should be done. On the contrary, I believe that instead of banning and creating incentives to relocate certain activities elsewhere or circumvent those rules, it is preferable to attract and better supervise. This can be done:

- First by integrating OTC markets into regulated and supervised market infrastructures such as trading platforms, trade repositories and CCPs. In the case of sovereign CDS this will mean that all CDS written on euro area sovereigns should be compensated in a CCP located in the euro area. Incidentally, that requires a fair amount of standardization of these single name CDS.
- Second, by enhancing transparency, both ex ante and ex post to improve our understanding of the price discovery mechanism and our knowledge of actual net positions of financial institutions.

- Finally, by improving risk management by agents active in these markets and ensuring that these practices are compatible with their risk profile. In the case of sovereign CDS, the issue is not necessarily with buyers who ultimately carry limited risks but with sellers. In fact we probably need a specific supervision of credit protection sellers.

Regarding credit rating agencies, the agreement on strengthening the regulatory oversight is becoming a reality with the implementation of the agreed European framework, which will give a pivotal role to the European Securities Market Authority. At the same time there is a need to reduce the dependency on credit rating agencies for regulatory purposes, both in prudential regulation and as eligibility criteria for central bank refinancing.

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Let me now conclude briefly. We are still going through very challenging times. The European banking system seemed to have recovered partly thanks to central banks and governments policies supporting the banking sector. This return to profitability should be used to comfort capital positions in those firms, in views of the various risks I have rapidly discussed. Recent renewed strains on financial markets especially sovereign markets and the subsequent impact on the banking sector show us that the crisis is not fully behind us and those central banks actions are more than necessary to accompany the redefinition of the banking sector, the well-functioning of markets and the return to a self-sustainable recovery. So far, the measures taken by the Eurosystem to stabilize markets and restore their functioning, as well as the establishment of the European Financial Stabilization Facility, have lowered tail and contagion risks. But the seeds of recent events have to be addressed to preserve financial stability in the long run. Indeed, sizeable fiscal imbalances remain and governments have to accelerate fiscal consolidation to ensure the sustainability of public finances and to meet conditions conducive to durable economic growth. In parallel, vulnerable financial institutions that remain over-reliant on enhanced credit and government support will have to be tackled decisively.

Thank you very much for your attention.