

**Remarks on financial markets
present conditions**

- Earnings are up. Growth is, on the whole, on an upward trend.
- Regulation is getting tighter with the objective of increasing the resiliency of the financial system. Market risks (as opposed to risks related to institutions) are being worked on: standardized derivatives transactions should, in principle, be brought on plate-forms or organized markets, cleared on Central Clearing Counterparties (CCPs) and become transparent.

Furthermore, regulators are in the process of increasing bank liquidity requirements and reducing maturity mismatches.

- Although the regulatory effort is, on the whole, moving in the right direction, some of its features seem to go too far in terms of stringency and complexity to the detriment of economic revival and of financial intermediation. Some serious potential unintended consequences must be detected, understood and avoided; for example, concentrating - without sufficient precautions - counterparty risk on a few systemically important clearing houses, that could become “too big to fail”, or reducing the availability of medium term financing to the economy as well as hindering market making capacity or locking liquidity into public Treasury debt instruments (which, by the way, will increase the linkages between banks and sovereign debt...).

Be it as it may, some trends don't seem to fit with that rather sanguine general picture of a system under repair.

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1. A revival of risky transactions with low margins can be observed.

2. An acceleration of inflation in the context of very weak public finances is worrisome.

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I. A revival of riskier instruments

In an environment of very low interest rates (most often negative in real terms) and of high liquidity, the appetite for risk is rising. This is not unusual, but carries bad memories. Let me just mention a few significant recent factors:

- lower rated Corporates (CCC+ and below) accounted for almost 20% of total issuance this year. This percentage is the highest since 2007 ;
- credit derivatives based on high yield bonds and leveraged loans - such as synthetic junk bonds and CLOs - are back and prospering;
- the return of “covenant-lite” loans is spectacular: they represent 25% of total loans originated this year (level not seen since 2007).

All this does not necessarily mean that the situation is becoming very dangerous (deals tend to be shorter-dated, risk models may have become more realistic...).

But there are two potential problems:

- most of this is taking place in the unregulated shadow banking system which is benefiting from a shift of transactions from the more tightly regulated sector to the unregulated one. This can become a source of systemic instability;
- once originated, much of these high yield products end up with retail investors, which could create another set of risks and is inconsistent with the stated objective of consumer protection.

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II. Inflationary risks are increasing

Inflation could reach 4,5 % on average worldwide in 2011 (7 % for Emerging Markets -EM-, 2,5% for advanced countries) against 3,7% in 2010.

Most of this comes from higher commodity prices: since the beginning of 2009, oil and metal prices have trebbled, agricultural prices have doubled.

Out of the 3,3 points of increase in inflation between July 2009 (- 0,6%) and March 2011 (+ 2,7%): 2,8 points come from energy prices and 0,4 point comes from food prices.

In spite of a recent limited decline, these trends do not seem transitory, but the result of an unprecedented demand shock.

3 billion people are embarked on the adventure of globalization and EM represent 90% of the increase of demand for oil worldwide.

What has happened in terms of commodity prices is of the same order of magnitude as the oil shocks of the 70's, although conditions are different:

- wage indexation mechanisms are not prevailing as they were in the 70's;
- remunerations are proving rather stable, to the detriment of real earnings and consumption.

Thus, inflationary expectations (measured by the yields on indexed bonds) have edged up to close to 2,5% on 10 years bonds.

Let us not forget that, in the run up to the crisis, loose monetary conditions were at the origin of asset price inflation, low spreads and risky investments. Hence the importance of macro economic oversight. Central Banks and regulators have, now, the mandate to watch systemic deviations and to make the appropriate recommendations to avoid them.

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In sum, two worlds are presently co-existing:

- half of the world is composed of countries suffering from a negative output gap (actual growth lesser than potential),
- and the other half (essentially EM and Germany) are overheating.

Most of the countries in the second half (over heaters) are in the process of tightening their monetary policies in order to curb inflation and should, but are often reluctant to, allow their exchange rates to rise. This will probably reduce somewhat their rate of growth.

But the first category (negative output countries) cannot use fiscal policy to stimulate their economies because of their huge public deficits. Recent economic research shows, actually, that when public debt exceeds 60% of GDP, fiscal stimulation to boost demand does not work, or even can have negative effects.

This explains that the Fed maintains an accommodative stance, which, in turn, generates market optimism.

But, logically, if inflation were to be contained in the two parts of the world, growth would probably tend to be somewhat less buoyant than expected.

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To conclude, I will add that one of the factors dampening growth in advanced countries is probably to be found in regulatory uncertainty.

The more banking institutions are kept waiting for another layer of capital requirements (SIFI's, anticyclical capital buffers, maximum leverage on non risk weighted assets...) or for a drastic shortening of their maturity horizon (which would hinder their capacity to extend long term loans), the more the financial system will tend to remain coy in financing the economy or/and to seek to increase immediate returns on riskier assets.

In "calibrating" new rules, regulators will have to take into account their cumulative effect and avoid jeopardizing a modest and still fragile economic recovery.

We should always remember one of the main lessons to be drawn from what has happened. The crisis was much less the result of inadequate rules than of insufficient implementation and supervision. Thus the priority should be to strengthen supervision and not to rely exclusively on more and more demanding rules that, in any case, will never be a substitute for good management, adequate risk assessment, and efficient prudential oversight.

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