Jean-Claude Trichet: Preserving monetary and financial stability in an increasingly globalised world

Keynote address by Mr Jean-Claude Trichet, Governor of the Banque de France, at the OECD Forum 2001 on Sustainable Development and the New Economy, Paris, 16 May 2001.

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Ladies and Gentlemen,

It is a great pleasure for me to be invited today to this OECD Forum to talk about preserving monetary and financial stability in an increasingly globalised world.

One should keep in mind that financial globalisation has brought about improved macro-economic efficiency.

As you know, the globalisation of the world economy and the development of financial markets were driven by two key factors:

- firstly, financial deregulation – reinforced in Europe by the setting up of the single market and subsequently of the Economic and Monetary Union – which liberalised capital flows and enhanced competition among financial sectors;
- and secondly, technical and financial innovation, which simultaneously paved the way for the creation of financial markets that are deep, liquid and interconnected.

What is interesting to stress is that the interaction of free capital movements within interconnected markets, increasing integration of market segments and hedging opportunities provided by new financial instruments have allowed **a better fit between the financing capacities and borrowing requirements** of both governments, households and companies. The use of market interest rates, which represent the markets' consensus on the risk incurred at a moment, as a driving force is fully beneficial to an **efficient allocation of capital**.

Lowering the barriers to entering the financial sector, the free circulation of information and fiercer competition have also brought financial markets closer to a situation of **pure and perfect competition**, which is beneficial to all consumers.

Last but not least, the growth of market financing has allowed savings to be channelled directly into investment. Reducing the share of bank financing, and consequently that of money creation, has enabled a **less inflationary** financing of the economy. Thus increased, monetary stability has produced tangible and positive effects and contributed decisively to **a strong and sustainable growth** of the world economy.

Thus, these developments have resulted in ***increased monetary stability*** and a ***more efficient allocation of resources***. However, while globalisation and financial integration have decisively contributed to improving overall economic efficiency, experience also suggests that ***financial cycles may have tended to amplify*** relative to business cycles over recent years.

In particular, financial markets have experienced in some circumstances somewhat erratic developments. The rapid emergence of the "new economy" bubble in 1999 and early 2000 – followed by a series of sharp corrections – illustrated the potential of markets for providing funding to the real economy (particularly to the most innovative sectors); but it also demonstrated the tendency of markets to over-react, moving from excessive optimism to disproportionate pessimism, with the ensuing negative consequences for the behaviour of firms and households.

As a result, financial authorities have been confronted with boom-bust episodes which must be carefully monitored, since they could affect global monetary and financial stability. I would like therefore to consider two issues here:

- Firstly, experience suggests that ***financial cycles may have recently tended to amplify relative to business cycles; what are the driving factors behind this move;***

- Secondly, what are ***the possible policy implications of this development***, from both a monetary and financial stability perspective.

1. Experience suggests that financial cycles have recently tended to amplify relative to business cycles.

A. What are the major features of these amplified financial cycles?

Let us first consider credit cycles. There is no doubt that the amplitude of credit cycles is usually larger than that of business cycles. What is however noticeable here is that, over the last three decades, business cycles have been less frequent and less amplified while credit cycles have tended to remain fairly marked. ***Thus credit cycles have been amplifying in relative terms compared with business cycles.***

Asset price cycles have also become more pronounced even if the fixed interest rate markets have a tendency to be somewhat contra-cyclical.

- In the last two decades market forces have indeed tended to cause clear misalignments between equilibrium and actual asset prices. Stock markets in particular have experienced this phenomenon. But in foreign exchange markets as well, prices have also tended to diverge substantially from their "equilibrium level", although those divergences have been contained through fruitful GVII cooperation during the last 15 years.
- In addition, some markets have seen ***an increase in volatility and frequent volatility peaks.*** Although cyclical moves should be clearly distinguished from volatility, the latter may in some circumstances exceed what can be considered optimal, making the price determination mechanism less efficient and thus contributing to misalignments.
- Moreover, as demonstrated by a number of financial crises during the last two decades, ***contagion among countries and across financial markets has been frequent***. As a result, investors have faced asset price fluctuations that might be more synchronised than before.
- ***Lastly, the connections between credit, asset price and business cycles have tended to amplify cyclical swings***. Credit, in particular, has played an increasing role in asset price fluctuations. Initially observed during the "speculative bubbles" of the 1980s and early 1990s, this trend has persisted. Another example is provided by boom-bust cycles in asset prices and credit activities, which have often been associated with sharp economic contractions.

In sum, the recent period has experienced some amplification of financial cycles, compared with business cycles.

B. What are the factors underlying this possible amplification of financial cycles?

Let us first consider credit cycles:

- the first factor in play is ***the behaviour of banks***, which is closely linked to their environment. Some of them may have tended to artificially increase their return on equity through higher leverage or low provisioning during upswings. As a consequence they tend to become more fragile in the downward phase of the cycle. In parallel, investors have become more reluctant to invest in the banking sector when profit expectations are low, making it difficult for banks to raise new funds. Banks' soundness therefore tends to be more correlated to economic fluctuations than in the past, contributing to the amplification of the credit cycle.
- Accounting regulations so far may also contribute to amplifying credit cycles to some extent. In most financial centres, ***current provisioning behaviour does not allow banks to take a forward-looking view of their risks,*** as accounting and tax rules only accept loan-loss provisions for impaired loans. Such a regulatory environment may amplify the credit cycle, contributing to low provisioning and over-lending during upswings and paving the way to sharp corrections during downswings. Using full fair value accounting for loan portfolios might further amplify credit cycles by increasing the volatility of banks' earnings.
- ***Prudential rules may also have been unable so far to always prevent these developments.*** Current capital adequacy rules are not risk-sensitive; as a result, credit

deterioration does not require additional regulatory capital unless loan losses erode the capital base under minimum requirements. As most banks – particularly large ones – have capital far beyond the prudential minimum requirements, they can bear a reduction of their capital base without being compelled to restrict their credit granting. Therefore, ***capital ratio is not pro-cyclical as such.*** The point is that, even while capital requirements are fulfilled, losses can reduce banks' own funds at a time when capital issuance is difficult or costly; in such a juncture, some analysts argue that banks may be led to restrict credit lending during downswings although they are not bound to do so for prudential reasons. I consider that the future capital requirements of the New Accord will significantly improve the situation as regards the risk-sensitivity of capital requirements.

Let us now turn to asset price moves.

As previously mentioned, financial asset prices may fluctuate widely and sometimes deviate from economic fundamentals for long periods of time. Several factors may be in play when this happens. I shall give a few examples.

- Some market participants may have become more inclined to engage in ***"short-termism***", that is, they are only preoccupied with their short-term results. This trend might result, in particular, from growing pressure to yield high immediate financial results that are not necessarily sustainable. Marking-to-market financial products may also have contributed to this widespread focus on immediate financial performances. This focus on short-term performance can translate into additional volatility in the price discovery process: the shorter the investment horizon of market participants, the bigger the impact of any new information on prices.
- ***Mimetic behaviour*** is of course by no means a new phenomenon on financial markets. Technological developments on markets may however have gradually reinforced this type of behaviour, as ***participants*** are increasingly incited to follow their peers through matching the performance of a benchmark. There is no doubt that the spread of benchmarking allows fund managers and clients to better assess their performance against that of other funds. But, in a context of growing competition within the sector, it may well have increased mimetic behaviour. Some economic operators (whose own compensation is closely linked to the relative, rather than absolute, profit and losses they generate) may indeed have come to the conclusion that it would be better to be wrong along with everybody else, rather than running the risk of being wrong alone. A striking example of rational mimetic behaviour is the influence that hedge funds enjoyed as "opinion leaders" and trend makers. By its nature, trend following amplifies the imbalance that may at some point affect a market, potentially leading to vicious circles of price adjustments and liquidation of positions.
- Another factor to be taken into consideration is the spectacular development of certain ***fund management techniques***, such as ***index management.*** As it has proven very popular on equity markets, index management may have contributed to exacerbating movements in financial asset prices. Because their goal is to mimic the performance of indexes, “passive managers” try constantly to match the composition of their benchmark. They thus help to amplify market trends, buying more as the market rises and liquidating more as the market drops. It can be argued that index funds distort the price of the targeted indexes and that, as a result, the indices end up creating rather than measuring performance.
- Last but not least, ***the impact of risk management techniques on market dynamics*** is particularly enlightening with regard to the question of asset price overshooting. Value-at-risk calculations have become a crucial element of the standard approach used by market participants to evaluate the risk inherent in their market activities and to set up exposure limits. Of course, central banks and financial institutions should continue to encourage the use of these instruments. But, in times of financial turmoil, the growing use of sophisticated risk management techniques by financial intermediaries might have had the paradoxical effect of amplifying the initial shock, exhausting liquidity and contributing to contagion phenomena. Regardless of the intrinsic qualities of these risk management tools, we see that their growing use may have produced pernicious effects. When market players rely on converging risk evaluations, they tend to take the same decisions at the same time, thus amplifying the initial shock to prices and trading volumes.

All those factors have one consequence in common: they encourage ***homogenous behaviour and reactions*** to the detriment of the diversity that is indispensable to the smooth functioning of financial markets.

2. Possible policy implications of such developments from a monetary and a financial stability perspective

All the factors I have just mentioned require authorities to consider – in conjunction with the financial industry – ways of preserving monetary and financial stability in this changing environment.

A. A stability-oriented monetary policy is a fundamental prerequisite for the smooth functioning of financial cycles.

Financial deregulation has radically changed the conduct of monetary policies.

More open economies and greater interdependence between financial systems have completely overhauled the context in which monetary policy is implemented.

- Financial markets can now penalise inflationary monetary policies by withdrawing capital, with a subsequent rise in long-term interest rates and/or depreciation of the exchange rate.
- At the same time, monetary policy transmission mechanisms have become more diversified and complex.

This situation has prompted the authorities to separate the different instruments for implementing economic policy. In this context, monetary policy has been clearly been assigned the objective of maintaining price stability.

Today, monetary policies are conducted within a framework characterised by three features:

- Firstly, reducing inflation expectations depends on compliance with a number of rules that have been clearly defined in advance. Consequently, this policy can only be effective if the authority responsible for defining and implementing it is credible. The conjunction of a clear, overriding objective of price stability (which has been explicitly laid down in the statute of the ECB), with well-established institutional independence ensures the continuity of the monetary policy decisions made by the authorities.
- Secondly, the emergence of a globalised market has quite naturally led to new developments in monetary policy instruments. The interest-rate instrument is overwhelmingly used to the detriment of quantitative and regulatory instruments.
- Lastly, these instruments serve converging strategies. The ECB's monetary policy framework, for instance, is based on an analysis of growth in the monetary aggregate – the EMU reference value for M3 growth is 4.5% – combined with a wide range of economic and financial indicators to monitor inflationary risks.

In such a context, monetary policy acts as a stabiliser.

Monetary policy alone cannot guarantee the stability of financial systems, which may be jeopardised by shocks from both the financial and the real economies. However, it must be stressed that an adequate monetary policy is a fundamental prerequisite to a smooth functioning of the financial cycles. An appropriate monetary stance –both in terms of interest rate and money supply – is crucial for banks and monetary participants to base their decisions on solid ground. The objective of price stability lowers economic agents' uncertainty regarding future price developments. In addition, by committing itself to a long-term objective, the central bank reduces market uncertainty, which can be a source of disruption to the financial economy. Interest rates and money supply are less volatile as a result, which is of benefit to the long-term growth of the economy.

However, for financial systems to be stable, monetary policy must be consistent with the other aspects of economic policy, that is, fiscal policy and structural programmes. The policy mix must be well-balanced at the international as well as the domestic levels. Placing too heavy a burden on monetary policy in terms of achieving the main economic and financial balances is detrimental to its effectiveness. In particular, it diminishes its ability to maintain and consolidate financial market stability. This concern underlies the implementation of the Growth and Stability Pact in Economic and Monetary Union. By obliging fiscal policies to commit to stability, the pact allows the fiscal buffers to fulfil their role as stabilisers. Indeed, by their information and expectations, investors can penalise

imbalances affecting the main world economies or diverging developments in different countries. To reduce this constraint, economic and monetary policies must be harmonised at the international level in order to achieve more balanced international financial relations.

B. Financial authorities have to soften as much as possible some of the side-effects of the new financial market features.

Let us first consider a few possible improvements as regards credit cycles:

- Provisioning standards should allow banks' lending to be less pro-cyclical. As a general rule, provisioning standards require improvements so that provisions better reflect the actual inherent credit risk of loan portfolios. They should also be improved for macroeconomic purposes, so that banks' lending behaviour becomes less pro-cyclical. ***These objectives could be achieved through a more forward-looking provisioning, whereby provisions are set up earlier*** – that is to say, in a perfect world, as soon as a loan is granted. Current accounting and tax frameworks hamper the widespread adoption of dynamic provisioning by requiring that risks on specific loans be identified prior to provisioning. Discussions among accounting standard-setters, tax authorities and regulators are essential to encourage such a reform.
- Globalisation and the development of financial markets have created a real need for reliable information and harmonised accounting practices. We fully support such trends towards increased transparency. But, it is nonetheless vital to ensure that, when applied to banks, some of the new widespread accounting practices neither distort the presentation of banks' individual situations, nor disrupt their management practices. A "full fair value" approach assumes that a "fair value" can be determined for all financial instruments; but this does not necessarily apply to banking activities, since loans and deposits are essentially neither liquid nor tradable. ***Using the full fair value approach for the banking book might result in sharp swings in banks' earnings and prompt banks to curtail their lending activity.*** This approach might further amplify the credit cycle and could potentially affect financial stability. This is the reason why an increasing number of bank regulators are not in favour of this approach as regards banking book.

Let us now focus on asset prices moves. Financial authorities might reflect on some ways to foster behavioural diversity in financial markets.

As we have seen before, a series of factors, such as short-termism, mimetic behaviour or index management, have tended to make "contrarians" less pro-active on financial markets. This has resulted in somewhat modified market dynamics and less efficient price determination mechanisms. In order to safeguard the smooth functioning of the markets, the diversity of participants' behaviours must be protected or even reinforced. This necessary diversity should logically reflect natural differences in time horizons, strategies and reaction functions of market players. On this point, I would like to explore three possible avenues for future action for both authorities and the industry.

First avenue: Strengthen the continuing efforts aiming at market transparency

- Experience shows that uncertainty and incomplete information are determining factors in mimetic behaviour. These shortfalls in market transparency make mimetic behaviour seem rational to agents, who prefer to follow bigger participants, who are thought to be better informed, rather than develop their own analysis. Strengthening transparency therefore continues to be a priority.
- One of the objectives of transparency is to enable better differentiation of borrower creditworthiness. A key feature of mimetic behaviour is that all borrowers are "tarred with the same brush". So when one emerging economy encounters difficulties, all neighbouring countries are treated in the same way – regardless of their actual economic and financial situation. The same applies to businesses operating in the same economic sector. Transparency as substantially improved since the Asian crisis thanks to a solid global consensus. Let us continue and reinforce these efforts.

Second possible avenue: Taking into account the medium and long-term perspective of some market participants.

- Some investors, such as pension funds and insurance companies, have to invest funds in order to enable their customers to build up wealth over the medium and long term, notably in

preparation for retirement. Consequently, this type of investor are supposed to behave differently from traders and short-term investors, who are working on a very different time horizon. But at times it seems that they are all pushed to behave in much the same way, on the basis of a very short-term horizon.

- To preserve, and even restore, their specific investment approach, these investors might be more shielded from excessive short-term pressures. This objective raises considerable difficulties, because it touches on the way in which the performances of medium and long-term funds and life insurance companies are assessed. In other words, this objective concerns the accounting standards and practices they use. It might imply that some rules and standards would be adapted to the medium and long-term horizon used by these entities.

Third possible avenue: Diversify the risk management tools of financial institutions:

- As I mentioned earlier, even the best techniques can have adverse effects when used by too many participants. To some degree, this is perhaps what has happened to value-at-risk based techniques, which have been massively adopted by the financial industry. Because they use more or less similar parameters and suffer from the same weaknesses – for example, they took inadequate account of market liquidity at the time of the 1998 crisis –, such tools might tend to give converging signals to those that use them. They thus encourage the mimetic behaviour that I discussed previously.
- Of course, the fact that some market participants are more sophisticated than the average is a guarantee that standardisation will remain limited, since they will develop techniques that are little used by others.
- However, supervisors might help, and obviously are already helping to spread the idea that financial institutions should round out their current range of risk management tools to include extensive use of stress testing. This technique offers a better reflection of the varying situations of institutions and of the diverse perceptions that institutions have of exceptional events. The application of stress testing techniques and their results are thus inherently more diversified than those resulting from methods based on the value-at-risk approach.

These are only examples of possible options to help improve the functioning of the financial cycles and smooth their interaction with the business cycles. ***There is probably some merit to embark in an overall review of regulatory, accounting and tax rules and regulations, as well as of codes of good conduct and good practices and of structural developments of markets themselves, to identify possible amendments and improvements that could help, protect and enhance the behavorial and conceptual diversity of modern financial markets.***

In conclusion, let me stress the important role played by central banks in preserving monetary and financial stability in an increasingly globalised world.

- The recent years have shown the benefits of monetary stability in terms of growth in a globalised world. It is of course closely linked to central banks' independence, which is no longer a matter of debate.
- Financial authorities are nevertheless faced with a new challenge, which is to strengthen financial stability, in a context of amplified financial cycles, in conjunction with monetary stability. I would like to stress what I feel is the highly complementary nature of price stability and financial stability objectives: price stability is the bedrock on which financial stability is built.
- Central banks have a undoubtedly special responsibility due to their position at the heart of financial systems:
  - they contribute directly to supplying liquidity to the economy,
  - their close and constant contact with credit institutions gives them a thorough understanding of banking systems,
  - they are responsible for ensuring that payment systems operate smoothly,
  - and they contribute to banking supervision.

I thank you for your attention.