Jean-Claude Trichet: The international financial architecture - where do we stand?

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Conference "Dollars, Debt and Deficits - 60 Years after Bretton Woods", Madrid, 14 June 2004.

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It is a great pleasure to be here in Madrid at the invitation of the Banco de España and the International Monetary Fund. The 60th anniversary of the Bretton Woods institutions is indeed an important opportunity to take stock of key events, developments and issues that have shaped and are shaping the international financial system. Let me thank the organisers, and especially our host Jaime Caruana, for setting up a very interesting programme for this conference that encompasses all these key topics. Tonight, I would like to offer some thoughts on the question "the international financial architecture - where do we stand?" In my remarks, I will first have a short look back at the changes to the international architecture over time, before concentrating on reform efforts that have been undertaken in four areas, namely the institutional setup, transparency and best practices, regulation of financial markets and crisis prevention and resolution.

Let me briefly look at the changes to the international financial architecture over time. The key aim of today's policy makers has not changed compared to those at the Bretton Woods times - it has been, and still is, global prosperity and stability - but the environment in which we are acting has changed profoundly. The founders of the IMF and the World Bank wanted to create institutions that prevent countries from falling back into autarky and protectionism and that help them to raise growth and increase stability in a world of fixed exchange rates with still a large degree of capital controls. Today we are striving for stability of the international financial system in a world of free capital flows with a growing importance of private flows and increasing trade and financial integration. Among the major factors that we have to take into account, I would like to mention in particular:

- The financial globalisation phenomenon: capital market liberalisation, both domestically and internationally, technological advances and buoyant financial innovations have contributed to set up a totally unknown degree of financial globalisation - with great benefits, but also new risks.
- The policy responsibility which still lies mainly with sovereign states; thus, the challenge is to promote global financial stability very largely through national actions enlightened and co-ordinated through a larger degree of intimate international co-operation.
- A very large consensus on giving the private sector and markets a central role on the one hand, and relying upon sound public institutions to provide market participants with the appropriate environment on the other hand. This shift from direct public involvement to private activities is particular striking when looking at financial flows to emerging markets: in the 1980s, official flows were dominant, reaching on average over 60% of total flows to emerging markets. By contrast, the 1990s saw a dramatic increase in private flows, which on average accounted for around 85% (in the period from 1990 until 2003). Equally striking is the shift from bank loans to negotiable securities as the major financing tool for the developing countries.
- The integration of the European Union, reinforced with the introduction of the euro, has increased the economic, monetary and financial stability of a region that constitutes today the world's largest trading partner and the second largest economy. The EU has also been crucial in anchoring the transition process in central and eastern Europe, and in fostering stability and prosperity in this region.

The dynamics of today's world call for continued adjustment at a global level. New challenges have been added to existing ones, such as poverty reduction. New actors gained prominence on the international scene, with developing and emerging markets becoming progressively full participants in the globalised economy. The financial crises of the 1980s and the 1990s, characterised by large and sudden private financial flow reversals, marked by a very powerful contagion phenomenon and demonstrating some of the potential and actual vulnerabilities of the newly globalised financial system, led to an ambitious reform agenda to strengthen the international financial architecture.

Let me focus on the lessons from the crises in the 1990s and the ensuing work on the international financial architecture.

On the basis of the experience with the Mexican crisis in 1994/95, the G7 summit in Halifax in June 1995 initiated work on improved crisis prevention and management. It called for improved transparency, both at the level of individual countries and at the IMF, and for strengthened IMF surveillance. The Halifax summit also pointed to the importance of effective financial regulation, market-reinforced prudential supervision and enhanced international co-operation among regulators and supervisors. As for crisis management, concrete proposals were presented in the Rey report to G10 Ministers and Governors in May 1996.

Work was stepped up in the aftermath of the Asian crises, which revealed further vulnerabilities in national and international financial systems. But most importantly, the crises in the later 1990s showed that the systemic changes in the world's financial markets required systematic changes in the policy framework that underlies the international financial system. Almost a decade later, we can say that many of these proposals have been implemented. Let me now focus on four different areas, which I consider most important:

The first area concerns the international institutional set-up, which, in my view, has been strengthened significantly since the 1990s. The existing international financial institutions, in particular the IMF, the World Bank and the BIS maintained their central role in the system. But they were subject to several changes to sharpen their respective focus, to reinforce their policy advice and financial support, to enhance their transparency and accountability and to strengthen their governance. The Bretton Woods institutions, and particularly the IMF, underwent profound changes to adapt to the new environment. In addition, new fora have been created in response to the widening of the number of actors in the global economy and the growing importance of international financial markets. The creation of the G20 in 1999 constituted in my view a decisive and highly welcomed step to reflect adequately the newly globalised economy. The G20 has turned into the international forum for appropriate dialogue and consensus building between all economies that have a systemic influence, whether industrialised, emerging, or in transition. Equally important is the Financial Stability Forum, which is the first informal grouping to fully recognise the existence of a global integrated economic and financial system. It is also the first forum to set the goal of systemic optimisation of each of the subcomponents of the system, whether it is banking surveillance, insurance surveillance, securities market control, accounting rules, good practices of public and private sectors, functioning of the major market places, governance of the IFIs etc. At the regional level, the European Union has established a whole universe of arrangements for co-operation that is constantly being adjusted to its changing needs and European institutions are becoming increasingly involved at the international scene, for instance with the EU-US regulatory dialogue.

Overall, improving the governance of the international institutions and optimising the work of the informal groupings will always remain a moving target given that these entities permanently will have to adapt to a changing environment. However, with the changes introduced in the recent years, the foundations of the international financial system have been strengthened considerably.

The second area I would like to highlight regards the work to enhance transparency and promote best practices, where significant progress has been achieved in a number of fields. Indeed, a wide-spread consensus has developed, which considers reliable and timely information on economic and financial data as a precondition for well-functioning markets, since it facilitates better risk assessment and management and hence strengthened market discipline. The IMF's special standard for dissemination of economic and financial data has become a widely recognised benchmark to which a large and increasing number of countries have subscribed. There is now a presumption that IMF papers on Article IV consultations and on Fund programmes are published. International codes of good practices have been agreed upon, such as the ones on transparency in fiscal policy and on transparency in monetary and financial polices. Moreover, countries' compliance with the 12 most important standards and codes are regularly examined by the IMF and the World Bank in so-called ROSCs (Reports on the Observance of Standards and Codes), many of which are made publicly available and have a positive impact on the market's assessments of the countries concerned.[1] I consider that the progress made in the field of transparency after the Asian Crisis is one

[1] The IMF and the World Bank have recognised 12 standards as useful for their operational work. These comprise accounting; auditing; anti-money laundering and countering the financing of terrorism (AML/CFT); banking supervision;

of the main explanations for the absence of contagion in the emerging world when the Argentine crisis erupted.

Transparency in the private sector is also crucial for well-functioning international financial markets. Reliable and timely company information are one key element to transparency, which is provided mainly through financial statements. Recent corporate scandals have again brought to our minds the crucial role that accounting standards play in this respect. In this context, I attach great importance to the reform of the International Accounting Standards (IAS) and the key role of these standards in advancing the European single market. The IAS, which will apply to all listed companies in the EU, are expected to have a major impact on the European banking system. The banking sector will particularly be affected through the proposed valuation rules for financial instruments and through the rules on disclosure.

The ECB has a strong interest in this debate mainly from its focus on contributing to the maintenance of financial stability. Thus, the primary objective of this reform has our full support as it aims to minimise the gap between the reported information and the true risk profile of a company. I am also fully aware of the complexities stemming from the interrelation of accounting standards with other reporting schemes for supervisory and statistical purposes. However, some proposals have given rise to concerns also within the ECB. In particular, those proposals relating to an extensive use of fair values raised concerns about the possible adverse implications on the volatility of bank income and, eventually, on bank behaviour and on financial stability. As a consequence, the ECB contributed to this debate, highlighting the concerns and showing their relevance. The more recent proposals from the IASB moved into the direction of limiting the use of fair values for those items that can be reliably measured. The revised proposals should help to avoid undesirable consequences such as an artificial increase in income volatility. At the current juncture, the ECB is carrying out an exercise to check the likely impact of the new standard.

While these issues apply to all financial markets, the EU faces a particular challenge relating to the advancement of the single market. The introduction of harmonised EU rules regarding the setting-up of financial statements are considered to be a crucial step towards the further integration of the financial markets in the euro area and the European Union. Indeed, improved comparability of disclosed information would facilitate cross-border investment and further market integration. Thus, in 2002 the European Parliament and Council adopted a Regulation requiring listed companies to prepare consolidated financial statements in accordance with IAS from 1st January 2005. A specific endorsement process is in place to ensure legal certainty and consistency with EU public policy concerns. This process already allowed to endorse all IAS with the exception of the two standards concerning recognition, measurement and disclosure of financial instruments. Recently, in order to deal with the remaining controversial issues, the Commission took the initiative to establish a high-level dialogue between all the constituencies interested in high quality accounting principles. I remain confident about the positive impact of prudently implemented International Accounting Standards on the stability and efficiency of financial markets in the EU.

The third area relates to the strengthening of financial regulation in industrialised countries. Here, let me recall that recent crises exposed weaknesses in the risk management practices on the part of creditors and investors in industrial countries, pointing to the importance of financial market regulation and supervision.

We all are aware of the importance of effective financial regulation and supervision to maintain financial stability and protect consumers, also in light of the increased complexity of financial services and products. Let me say one word on one important aspect of financial regulation, which is the reform of the Basel Capital Accord, coined Basel II. I am convinced that our host, Mr. Caruana, who is the chairman of the Basel Committee on Banking Supervision, could off hand fill the evening by elaborating over the main features of this reform. From what I gather, your efforts are bearing fruits and we may expect a final text to be hopefully endorsed by the G10 Governors and the Heads of banking supervisory authorities in the forthcoming weeks.

The Basel II reform is of key importance. New and bold developments in the banking industry are the ultimate reason for engaging in this reform.

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corporate governance; data dissemination; fiscal transparency; insolvency and creditor rights; insurance supervision; monetary and financial policy transparency; payments systems; and securities regulation.

The ECB has expressed on various occasions its supportive stance to the new framework. The ECB was also among the first to point out the possible macro-financial implications of any banking prudential scheme, highlighting the potential procyclical effects that might be induced by any framework relying on a comprehensive real time risk analysis. These concerns have been taken into account in the final version of the new framework which aims at being neutral over the cycle. Looking ahead, we have to recognise that we stand at the beginning of the road. The success of this reform will crucially hinge on a sound implementation of the new framework requiring strong co-ordinating efforts among the supervisory authorities on a global basis. With regard to the EU context, the new institutional setting based on the Lamfalussy framework comprising a two-tier structure of regulatory and supervisory committees is expected to play an important role in ensuring a more uniform and flexible EU regulation and consistent implementation resulting from convergence in supervisory practices.

As fourth and last area, I would like to mention crisis prevention and management. Of course, the various efforts I mentioned so far should be conducive to prevent crises from happening. However, **crisis prevention** primarily rests with every single country with strengthened macroeconomic policies and financial systems. In that context, the experience of the past decade has highlighted the crucial importance of well-functioning domestic rules, regulations and institutions namely the legal framework, the regulatory system, the enforcement mechanisms, and authorities that shape and permit the optimal functioning of a market economy with its financial markets. This includes, in particular, central bank independence, rules for monetary policy and for fiscal policies, appropriate supervisory frameworks and authorities. There is strong evidence linking well-functioning institutions and good governance to positive economic and social outcomes. Institutional factors appear to be as important as productive factor endowments or any other explanations in determining cross-country differences in the overall level of development.

I am confident that these lessons feed into improving domestic policy-making in emerging market economies, making them more resilient to withstand shocks. The continued efforts to strengthen IMF surveillance play also a crucial role in that respect.

It is clear that crisis prevention must remain the key area of all our efforts. Crises are costly for the countries concerned and also for the international system. Given the increasing economic and financial importance of emerging markets, major events in these countries are bound to have spill-over effects to the rest of the world. Let me underpin this argument with some figures: In the last four years, major emerging markets contributed to about half of global real GDP growth (in PPP terms), accounted for roughly 30% of world exports and received about 20% of global FDI.

Turning to crisis management, important lessons have been learnt. There has been a growing recognition that more predictability is required on the side of the official sector in order to set the right incentives for all the actors involved. Moral hazard concerns and the limited availability of official funds also led to increasing discussions about the appropriate involvement of the private sector in crisis management. Of course, every single crisis is different and hence there is in each case the need to find the appropriate balance in the triangle of domestic adjustment, private sector involvement and official support. Therefore, crisis management in practice still has to struggle with the inherent tension between rules and clarity on the one hand and discretion and flexibility on the other.

However, considerable progress has been achieved. First, specific criteria and procedures have been set up last year to make exceptional access to Fund resources subject to rules and hence more predictable. We in Europe have been very much in favour of setting such clear rules and clear limits to Fund financing in view of the very large financing packages provided to countries in the 1990s. The IMF's debt sustainability analysis will play an important role in that context, since clear limits to official financing must be respected especially when a country faces an unsustainable debt burden and hence requires a debt restructuring. All IMF shareholders now need to stick by these rules, not least in order to provide the right signals to the markets and to avoid the impression that the official sector suffers from time inconsistency between the approval of policy principles and their actual implementation.

Second, following Mexico's bond issue with Collective Action Clauses (CACs) in February 2003, several emerging markets included CACs in bonds issued under New York law. More than 70% of new bond issues since early 2004 include CACs. As you probably know, no discernible impact on borrowing costs could be detected. In order to help making CACs a standard feature in sovereign bond contracts, the EU Member States committed themselves to include CACs when issuing new bonds under foreign jurisdiction. All this progress is very remarkable, especially when comparing it to the rather sceptical stance many countries and many private sector representatives had taken in the past vis-à-vis the recommendations in the Rey report after the Mexican crises. Of course, so far these clauses have not been tested in practice and it will take some time until CACs are included in the entire stock of debt.

Finally, work is proceeding on a so-called Code of Good Conduct, which I suggested myself at the IMF Annual Meetings in September 2002. Such a Code would define best practices and guidelines for the behaviour of debtor countries and creditors regarding information-sharing, dialogue and close co-operation in times of financial distress. While the IMF and the G7 encouraged further work and the G20 is closely following the process, at present the official sector confines itself to a catalysing role and leaves the floor to the true stakeholders in the process, i.e. emerging market issuers and private sector representatives. I understand that currently intensive discussions are taking place on the main elements of such a Code. I would like to encourage all parties to be as active and constructive as possible in working out what could be a significant new tool to prevent and help solving potential crises.

Closing remarks

We have the unique chance of living in a world which is full of opportunities, very inspiring and very complex, very rewarding and very demanding, full of chances and of risks. We have all been the witness of two incredible transformations of the global economy over the last twenty five years. The technological surge which has permitted to compute and to transfer information at practically no cost. The globalisation process which aims at connecting all economies and finances of the world within the same market-economy based framework. So that goods, services, capital, technologies, concepts, ideas are moving very rapidly or even instantaneously all over the globe, expanding considerably, in quality and in quantity, the domain of the Ricardian comparative advantage. The significant surge of labour productivity in a number of industrialised economies, the taking off of India, China and a very large number of emerging countries, the rapid race of global growth. These are great successes of today's economic world of which global finance, mirror-image of a global economy, is both the emblem and the very powerful tool. But there is no economic success without risks. We have been living permanently in a risky environment over the last twenty-five years. Amongst many risks, we might mention: the debt crisis during the 1980s, starting with Poland and Mexico and spreading to Latin America, Africa, the Middle East and the Soviet Union; the stock exchange fall in 1987; the Mexican crisis in 1994; the bond market crash in 1994; the Asian crisis starting in 1997; the LTCM and Russian crises in 1998; the recent stock exchange fall and the collapse of the technology bubble in 2000. We have surmounted all these crisis episodes. We have learned a lot and we have improved a lot in these occasions. One of my friends used to say: "Good management comes out from experience and experience comes out from bad management!" I think we are pretty experienced now and I take it that thanks to the lessons drawn we have now achieved a level of crisis prevention which is much better. But we should never forget that the risks are still there because they are intimately associated with the structural transformation of the global economy. This is not, in any respect, a time for complacency.

If I had to sum up what should be our today's mottos, I would make the following five recommendations:

- Let us not forget the crucial role of the IFIs, in particular the Bretton Woods institutions, in the management of the present global economy. The constant improvement of their management and instruments is key;
- Let us tirelessly improve transparency in all fields: it is the best recipe for avoiding both misallocation of capital and global crisis contagion;
- Let us continuously improve the flexibility of our economies through bold structural reforms. Not only because it improves efficiency but also, all the more, because it improves resilience in a world where shocks are to be expected;
- Let us reinforce our methodology to ensure that we do not amplify "pro-cyclical" phenomena: the best envisaged at a local or sectoral level can be the enemy of the good at a global systemic level. In this respect such informal groupings like the G20 and the Financial Stability Forum are of the essence;
- Let us join efforts to improve our scientific knowledge of the new world economy. Still today, academics and practitioners are observers and actors within the environment of largely uncharted territories. The more profoundly we understand the functioning of today's global

economy, the more efficient we will be to weather stocks, to prevent crisis, and to pave the way for continental and global job creation, steady growth and overall stability.