Jean-Claude Trichet: Reflections on the international financial architecture

Keynote address by Mr Jean-Claude Trichet, President of the European Central Bank, at the 2007 Salzburg Seminar "Challenges to the International Monetary System: Rebalancing currencies, institutions, and rules", Salzburg, 29 September 2007.

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I. Introduction:

Ladies and gentlemen, it is a great pleasure to be here at Schloss Leopoldsbrunn in Salzburg. Both the Schloss and the city are places with a lot of history and famous inhabitants! I am sure that this wonderful location will inspire your work over the coming days. The Salzburg Seminars have long been a forum for discussion of global issues and the focus of this particular seminar promises very interesting exchanges of views on very topical issues. As you know, Salzburg traditionally has been a facilitator of cultural exchanges across European countries and beyond since the 18th century. I am afraid that by its very nature, my talk tonight might be less "entertaining" than most other events taking place here in this wonderful city.

I would like to offer some reflections on the various changes in the set up of the global economic and financial system. Over the last two decades the international community has been confronted with tremendous challenges arising from important structural changes in the global system linked to technological advances and trade and financial integration. During this period the international community has learnt critical lessons and has launched profound adjustments to what has been termed the international financial architecture that is the network of institutions and fora with varying degrees of coordination at the global or sometimes regional level.

As in other parts of life, the most radical changes to structures and to behaviour are often launched during or after times of crisis. This has also been the case at the global level. The Asian crisis, which started exactly 10 years ago, is one case in point. The crisis that began in summer of 1997 with the fall of the Thai baht – and by the end of 1997 had engulfed Indonesia, Korea, Malaysia and the Philippines with spill over effects felt in Singapore and Hong Kong – did not remain confined to emerging markets but affected the global system. Remember that by August 1998, we had the Russian default, followed by the LTCM crisis in September the same year.

I do not want to enter into a discussion of the Asian crisis tonight. It is clear, this crisis was not the first one – we had to deal with the debt crisis in the 1980s and witnessed in 1994/5 how Tesobonos in Mexico developed from a local phenomenon into an issue for the international community. And it was certainly not the last one; the global system had to digest crises in Turkey and Argentina as well as shocks in the private sector such the stock exchange fall and the bursting of the technology bubble in 2000. But it was the Asian crisis that revealed a number of vulnerabilities in national and international financial systems and that led to an enormous reform agenda at the international level.

All these crisis episodes that we were confronted with brought to the fore new insights and lessons. They illustrated forcefully the challenges linked to a more globalised world and the increasing importance of private capital flows. I would like to highlight two more general lessons which have remained still important today:

First, one about the interlinkages between countries and the implications for the institutional set up. The world has changed dramatically over the past decades. The steady opening up of goods and capital markets has led to the growing integration of countries around the globe. Integration is of course a welcome development in itself because more and more countries participate in the global exchange of goods and services and can benefit from the transfer of know how and technologies. As proven by the experience of many economies, including in the EU, trade openness is the best catching up strategy for developing countries. But the contagion effects we have seen from time to time demonstrate the main challenges associated with interdependence. Globalisation has put all countries around the globe into one boat. Something that happens in one economy is often not just a local event but can have implications for the global system. From this fact it follows that all economies which have a systemic importance should be involved in discussing and participating in the collegial response of the international community as regards issues of global relevance.

Second, another important lesson from my point of view is the fact that efforts to improve the resilience of the global international system are not a static matter for which one can claim a lasting victory at one point in time. The globalisation and catching up process is far from being completed; likewise, very rapid technological and financial innovations will continue to be a feature of the modern world for dozens of years to come. Thus, trying to ensure the public good of global stability is a constant task that requires continuous scrutiny and effort. Each crisis, or episode of significant market correction, is different from the one before. They differ in origin, nature and magnitude. Each time new insights are gained about potential root causes of crises – often painful ones that go beyond simply lax macroeconomic policies and point to a lack of transparency or appropriate oversight.

These two lessons – that is, the need to involve all important players and to undertake continuous effort to prevent crises and ensure global stability – are in my view the driving force of all reform efforts at the international level since the 1990s, be they focused on frameworks for dialogue and cooperation or on actual policy matters. I will come back to these two aspects in a short while, but I would first like to highlight some facts which illustrate the changing global landscape we are living in, and give cause to reflect on the course and stewardship of the global economy.

II. Changing landscape

There has been a dramatic increase in trade integration over the past two or three decades that has simultaneously increased opportunities and vulnerabilities. World trade has grown four-fold in real terms since 1980; its share of world GDP has risen from 36 percent to 55 percent over this period. Part of this impressive development is explained by the integration of the former communist countries into the global trading system in the 1990s. Also developing Asia progressively dismantled barriers to trade. Over the past two decades, many emerging and developing countries have been catching up with advanced economies that shifted earlier to more open trading regimes.

Likewise, financial globalisation has proceeded at a dizzying pace over the past two decades. Take the sum of countries' gross external assets and liabilities relative to GDP as a proxy for financial integration. Since the creation of the euro in 1999 until 2005, total cross-border financial assets increased from 87 % of GDP to 124 % in the euro area, and from 80 % to 90 % in the US ; international liabilities increased in the euro area from 92 % of GDP to 137% and from 91 % to 110 % of GDP in the US . Advanced economies still continue to be the most financially integrated. Yet other regions of the world have also increased their cross border asset and liabilities positions, albeit at a much more moderate pace. These differences can be explained with different capital control regimes as well as a range of other factors, including different degrees of institutional quality and domestic financial development.

But globalisation does not only imply the exchange of final goods, services and capital, but also outsourcing and off shoring of parts of the production chain. It is probably especially this aspect of globalisation that often leads to negative perceptions in the general public since it entails distributional effects among and within countries despite the fact that technological innovations probably played a more important role in that respect.

One of the most important changes in the global landscape concerns the role of emerging market economies.[1] They have become increasingly significant players on the global scene and are catching up with advanced countries through continued strong growth. Over the past five years, these economies grew at about 7% per annum on average; emerging Asia has been growing faster, at close to 8% per annum. This rapid growth has made emerging markets the main engine of world growth. Last year China, India and Russia alone accounted for about one half of global growth (in PPP terms). Likewise, the share of emerging economies in world exports of goods and services doubled between the early 1990s and 2006, to reach roughly 30%. As mentioned before, their share in financial integration is still lagging behind advanced economies, but is constantly improving.

What does the present tell us about the future? Will emerging markets overtake those countries that are currently the major economies in the world? China has already risen from the 9th largest economy in 1980 to become the second largest (in PPP terms). There are several studies that try to analyse this question and that deliver interesting results regarding the growth prospects of emerging markets over the next decades. According to one study, the so-called BRICs, i.e. Brazil, Russia, India and China, could account for over half the size of today's six largest economies in 2025 (at market exchange rates), and by 2039 they could be larger than these countries.[2] Similarly, another study concludes that seven emerging markets will by 2050 be around 25% larger than the current G7 countries when measured at markets exchange rates, or around 75% larger in PPP terms. This contrasts dramatically with the situation in 2005 when they were only around 20% the size of the G7 at market exchange rates and around 75% of its size in PPP terms. According to this study, China will rank number two on the list of largest economies in 2050 (measured at market exchange rates), India number three and Brazil number five. Of the current G7 economies, only the US, the euro area and Japan would remain among the largest economies, the others would be replaced by emerging market economies.[3]

Certainly, any projection is subject to a large degree of uncertainty. This holds even more for projections that try to cover very distant horizons; they are inevitably somewhat speculative. But such studies might nevertheless provide some indications as to how the global economy could look like in 30 or 40 years. Even if you do not take their results at face value, the projections point to a profound rebalancing in the distribution of global output if these countries make full use of their potential for growth. In any way, they leave no doubt that the prospects of emerging markets will be critical to how the world economy evolves over the next decades. The current discussions on the appropriate representation of emerging markets at the International Monetary Fund show that policy makers do take seriously the current setting and these future prospects.

Returning to today's world, let us consider the implications of the emergence of these fast growing countries for the euro area. Growth in emerging markets increases the demand for those euro area goods and services where the euro area has competitive advantages. And since the euro area is much more open than other major economies both with respect to

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[1] There is no single definition of the group of emerging markets. In line with the article entitled "Financial flows to emerging market economies: changing patterns and recent developments" published in the ECB's Monthly Bulletin of Janaury 2005, the term emerging markets here is meant to comprise Russia and Turkey in Europe; Argentina, Brazil, Chile, Colombia, Mexico and Venezuela in Latin America; and China, Hong Kong SAR, India, Indonesia, Malaysia, Singapore, South Korea, Taiwan and Thailand in Asia.

[2] See "Dreaming with BRICs: The path to 2050", Global Economics paper No. 99, Goldman Sachs, 1 October 2003.

[3] See John Hawksworth, "The world in 2050 – How big will the major emerging market economies get and how can the OECD compete?", Price Waterhouse Coopers, March 2006. In a speech on "The new global economic geography"dated 25 August 2006, Stanley Fischer, Governor of the Bank of Israel, referred to a study by Angus Maddison, Evidence to the Select Committee on Economic Affairs, House of Lords, February 2005.

trade and financial openness the euro area has the potential to take advantage of the new opportunities. Our exports and imports of goods and services account for around one fifth of GDP, more than in the US or Japan. And indeed, our trade relations with emerging markets have strengthened considerably over the time. The share of emerging markets in euro area trade has grown from about one third in 1999 to more than 40% today. Moreover, the euro area has become a destination for foreign direct investment (FDI) from emerging markets. For example, the stock of FDI from the BRIC countries in the euro area tripled in the period 1999-2005 to reach the still modest amount of €12 billion. Conversely, the amount of euro area FDI in emerging market economies also rose quickly: between 1999 and 2005, the stock of outward FDI to the BRICs rose by 111% to €133bn.

All in all, we can only benefit from increasing our trade and financial relations with these countries. While it often entails adjustments to former configurations, one should not forget that competition from emerging markets strengthens the incentives for structural reforms in our economies. These reforms have to be undertaken in any case not only to improve efficiency but also to improve flexibility and resilience in a world where different kind of shocks can hit an economy.

III. International rules of the game

After this quick snapshot of the changing global landscape I would like to turn now to the implications for the governance of the global system. It is obvious that the systemic changes we are observing in the world's economic and financial system require systematic changes in the policy framework. The rules of the game need to adapt in order to keep pace with developments. This recognition is not new. It was felt already in the 1970s with the break down of the Bretton Woods system. And it was felt very strongly in the aftermath of the Asian crisis ten years ago. At that juncture, the work on improving the international architecture – which had started with the G7 Ministers and Governors and the summit of industrialised nations taking place after the Mexican crises in 1995 – was considerably stepped up. This links me to the two lessons that I outlined at the beginning of this talk, namely the need to adapt the institutional set up and to involve all important players in a fruitful policy dialogue and the need for continuous efforts to preserve global stability. One can consider the reform efforts that have taken place over the years from these two angles. The question is thus what changes to the international rules of the game have been introduced over time in terms of format and substance. These two aspects are often interwoven, i.e. institutional changes often go hand in hand with and are aimed at improving the resilience the global system. Yet I will try to deal with them one after the other.

Let's first consider the changes in terms of format: With the growing importance of emerging markets for the global economy – which was felt quite profoundly during and after the Asian crisis – it became obvious that new ways had to be found to integrate them better into the international policy dialogue. In response, finance ministers and central bank governors from 22 systemically important countries met in April 1998 to examine issues related to the functioning of the international financial system.[4] This "Group of 22" became in 1999 the "Group of 20". Since 1999, the G20 has developed into an important international forum for dialogue and consensus-building among systemically important countries, both industrialised and emerging. Discussions in the G20 have facilitated consensus on important elements of the international reform agenda. It has held numerous workshops to deepen the understanding of issues of global relevance and has engaged in a process of peer reviews to

[4] This grouping consisted of: Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Malaysia, Mexico, Poland, Russia, Singpaore, South Africa, Thailand, the UK and the US. The heads of the BIS, IMF, OECD and the World Bank, as well as the Chair of the Interim Committee (was has been transformed later in the International Monetary and Financial Committee), attended as observers.

promote countries' implementation of market-based economic systems. In the early years of its existence, emphasis was placed on financial stability and crisis prevention, including issues such as prudent debt management, domestic financial deepening, and exchange rate regimes. Over time however, the range of topics on the agenda has widened, and now includes issues such as development, energy, climate change. The G20 has also played a decisive role in leading by example to promote the wider compliance with standards and codes in various areas and was instrumental in the process leading to the "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets". At present, the G20 is also actively involved in the efforts to reform the IMF and the World Bank, especially in the current discussions on reforming the IMF's quota and voice system. In my view, it is the composition and size of the membership that strike a good balance between giving this informal forum a rather high degree of legitimacy while at the same time also allowing for frank dialogue between the members.

Frank dialogue is also one of the important aspects of the continued relevance of the G7. The G7/G8 process is often criticised for no longer reflecting the political and economic realities of the 21st century. But the meetings of G7 finance ministers and central bank governors that I have attended over the past 18 years have proven an invaluable forum for policy cooperation on macroeconomic policies and when appropriate signals given to foreign exchange markets. G7 countries have also recognised the need to involve emerging markets in their discussions, and it is now standard practice for finance ministers and governors from emerging economies – and at times also from developing countries – to be invited to join the discussions of their G7 colleagues.

A very recent example of a new form of informal cooperation is the Heiligendamm process that started at the G8 summit this summer. Here again the G8 acknowledged that there can be no solution to global challenges without active participation of emerging market economies. At that meeting, along with heads of state and government of Brazil, China, India, Mexico and South Africa, all countries committed to embark on a high-level dialogue on a number of global challenges, specifically in the fields of cross-border investment, research and innovation, energy efficiency, and development.[5] Such a process is welcome because it provides the chance to listen to different views on global challenges, to build a shared understanding and to develop joint proposals to address these challenges.

Also at the International Monetary Fund there are currently major reform efforts underway in the context of the medium-term strategy to adjust the institution to a changed environment and new constellations of players. One of these reforms – the quota and voice reform I already mentioned – concerns the representation of members in the institution and is thus considered as crucial for the future governance and the credibility of the Fund. Moreover, the introduction of multilateral consultations last year constituted a new approach to bring together countries with a shared responsibility for global issues. The first of these consultations was dedicated to global imbalances and involved the euro area, the US, Japan, China and Saudi Arabia. We at the ECB welcomed these discussions as a way to foster the implementation of the agreed strategy to address global imbalances. More related to substance than to procedures, let me also mention the recent reform of the Fund's framework for surveillance, which should help to strengthen this important part of the IMF's mandate given the current climate of reduced IMF lending.

Before moving on from important changes in the institutional set-up of the international system, I would like to highlight the Financial Stability Forum (FSF). Its creation back in 1999 was also motivated by the Asian crisis. The FSF is today the only forum which enables cross-sectoral cooperation among national and international entities in charge of supervision.

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5 The Joint Statement of 8 June 2007 envisages that the discussion will be continud in a structured manner for a period of two years untile the G7 summit in 2009 where they will review progress made. The OECD was asked to provide a platform for dialogue between the G8 and the five other countries.

Since it includes the major financial centres and holds regular regional meetings involving countries in the Asia-Pacific region as well as in Latin America, it has a particularly large reach out to a number of systemically important countries.

Let me turn now to the changes in terms of substance which have been introduced since the crisis events in the 1990s. Here I have to be selective because initiatives have been undertaken in many areas to improve countries' macroeconomic and financial sector institutions and policies and thus their resilience to crisis. The increased focus on financial sector issues, such as in the framework of the FSF or the changes in progress in the IMF to place much greater emphasis in surveillance on this matter, is certainly very welcome.

But I would like to highlight three more general concepts which I consider to be of utmost importance. Firstly, greater transparency, both in the public and private sector, has been one of the major achievements since the 1990s. Transparency is a precondition for well-functioning markets since it facilitates better risk management and leads to strengthened market discipline, which in turn has a positive impact on the conduct of macroeconomic and structural policies. Enhanced transparency also enables investors to better differentiate between economies and thus helps to counter herding behaviour and contagion effects. 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. Transparency in the private sector is also crucial for well-functioning global financial markets. All in all, I am pleased to note that considerable progress has been achieved over the years. But there are still areas where there is room for improvements, including in the reporting to the IMF on the currency composition of countries' foreign exchange reserves.

My second point relates to standards and codes, which have been internationally agreed for a wide variety of areas such as macroeconomic and data transparency, banking supervision, corporate governance, accounting, payment and settlement systems, to name just a few. The IMF and the FSF have designated twelve of these standards as being of particular importance for sound and stable economic and financial systems. Such standards distil and set out what is widely accepted as good practices or guidelines in a given area. Here the international community had made large strides over the years in the development of new standards and their implementation as well as in systematically and often publicly examining countries' compliance. In my view, standard setting and implementation can help to promote domestic and international stability. The attractiveness of this approach is the fact that is does not rely solely on rules set and enforced by authorities but also on voluntary standards adopted by economic agents of the private sector.

My third and last point is linked to the previous one and concerns the fruitful dialogue between the public and the private sector. Sometimes it might be wise to have principles voluntarily agreed by the private sector rather than aiming at a heavy-handed public approach. One prominent example are the "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets" I referred to earlier. These Principles have been set up at a time when the international community was discussing seriously the proposal for an international sovereign debt restructuring mechanism that was meant to improve the resolution of financial crises. The Principles are also aiming at this objective but follow a different route. Debtor countries and private investors agreed on best practices and guidelines for information-sharing, dialogue and close cooperation both in normal times and in periods of financial distress. Since I suggested myself such a voluntary code of conduct at the IMF Annual Meetings in 2002, I am very pleased to see that the Principles are increasingly becoming an important framework for cooperative actions by debtors and creditors. These Principles might also set an example for a similar approach adopted in other areas, such as the hedge fund industry – the highly leveraged institutions and other non regulated entities – which should develop as actively as possible voluntary benchmarks for good practices, as also recommended by the Financial Stability Forum for hedge funds.

IV. Concluding remarks

Ladies and gentlemen, over the past two decades we have been witnessing the incredible transformations of the global economy, such as impressive technological advances, deeper and wider trade and financial integration, and the emergence of powerful economic giants. These are all great successes of today's interlinked world. Success, however, does not come without major challenges and we have been confronted with risks to the global economic and financial stability more than once over the past 25 years. With each crisis or turbulent episode we had to cope with, we have learnt numerous lessons. Amongst the most important ones that are very much common to all of these episodes I will mention four:

First, be as lucid as possible from the outset. It is always a recipe for additional difficulty to over-assess the gravity of a particular situation and therefore to over-react. But it is equally dangerous to misjudge a particular situation by underestimating its gravity and the risks that are at stake. Therefore the quality of the first appreciation, the lucidity of the judgement which is worked out at the beginning is always of the essence. And for this judgement to be as just and pertinent as possible my experience is that you need three ingredients: an excellent analytical preparation, a confrontation of various views within a college of wise persons, and a great deal of experience within that college. Particularly in those hectic circumstances that are always complex and multi-dimensional, with a great deal of non-linearities, the textbook solution might not be of great use. Experience is of the essence.

Second, often the lucidity and pertinence of the judgement – and depending on this judgement – is the rapidity of action. In the development of a very complex situation a slight change at the start turns out in very significant discrepancies after a certain period of time and these significant discrepancies can make all the difference between a situation which would be under control and a situation clearly out of control. So time is absolutely of the essence in regaining control of a hectic situation: acting expeditiously is a must.

Third, whatever the nature of the turbulences, which would hit the global financial system, the multiplicity of entities and parties involved, whether private of public makes it necessary to agree as much as possible ex-ante on the appropriate ways for handling the situation. From that standpoint stress-tests are extremely useful. Also useful would be the working out of voluntary "Principles" stating ex-ante what would be expected from each parties concerned in a difficult situation. This working out of voluntary principles has already been done, as I have already mentioned, in the domain of the private financing of emerging economies.

Fourth, and finally, let me mention one constant lesson that we have drawn from all previous turbulent episodes: to minimise contagion in all compartments of global finance, whether in the domain of sovereign risks, or in the financial markets of industrialised countries, transparency appears to be the key principle. In hectic times, when fear dominates, absence of transparency foster herd behaviour and amplifies considerably the initial shock that triggered the turbulences. It was one of the main lessons we draw rightly from the Asian crisis. Transparency vis-à-vis investors and savers, transparency vis-à-vis surveillance authorities, appears to be the best vaccine against contagion which is at the heart of the epidemic.

I thank you for your attention.