Jean-Claude Trichet: Shaping a new world – the crisis and global economic governance

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, for a lecture at Bocconi University, Milano, 9 April 2010.

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Ladies and Gentlemen:

It is a real pleasure to be back at Bocconi University, after having been here two years ago.

Going through my remarks then, I was struck at how much has changed in the world economy in so short a period.

My intervention took place a few months before the collapse of Lehman Brothers, which marked the peak of the global financial crisis. Back in the spring of 2008, we were keenly aware of the risks ahead but few could have imagined the proportions of what eventually came to happen in the autumn of the same year.

According to the calculations made by two economists, Barry Eichengreen and Kevin O'Rourke, the initial decline in global production between mid-2008 and mid-2009 was broadly comparable with that between mid-1929 and mid-1930, i.e. during the Great Depression, while the corresponding correction in global equity prices and global trade volumes were even larger.[1]

However, the good news is that the global economy has now turned the corner, also thanks to the unprecedented support measures taken by both central banks and governments, which have helped restore confidence. Global financial and economic conditions have improved significantly over 2009. According to the latest projections published by the International Monetary Fund (IMF), global output is expected to rise by about 4 percent this year after a contraction of about half a percent last year.

However, the recovery remains fragile. In Europe, we expect it to be modest and we do not exclude a bumpy road ahead of us. Available indicators suggest that the economic recovery in the euro area is on track, although it is likely to remain uneven. Inflation is expected to remain moderate over the policy-relevant horizon. Activity remains dependent on past support measures to a significant extent. Central banks have started to implement their gradual exit from non-standard support measures and it is of paramount importance that governments implement rigorously consolidation strategies in the near future.

Above all, we cannot afford to be again in such a dramatic situation at the global level, nor can we expect taxpayers to be ready to put again as much as 25 percent of GDP at risk in order to avert a collapse in the financial sector.

We have an absolute obligation to make the global financial system more solid and sustainable, and the international community is keenly aware of this need.

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In my remarks today, I will focus on global governance and in particular on the lessons that can be drawn from the extraordinary events of the past two years. I will first elaborate on why we need a set of rules, institutions and international relations that we call "global governance". Second, I will analyse how, in hindsight, the existing global governance has

[1] See B. Eichengreen and K.H. O'Rourke's three columns on VoxEU (including the one entitled "What do the new data tell us?" of 8 March 2010, http://www.voxeu.org/index.php?q=node/3421).

fared during the global financial crisis. Finally, I will deal with the evolution of the system as a response to the crisis, and in particular I will discuss the rise of new key players in the world economy such as the G20 and the Financial Stability Board.

Being in Italy, I cannot resist mentioning the teachings of Nicolò Machiavelli. He has become known worldwide for his pessimistic and cynical attitude towards power, but in fact one of his main messages was that freedom is not possible without rules, i.e. without good institutions. For example, in his *Discorsi* he admires the Roman Republic where rules and the respect for law allowed men to be free – in contrast with what he saw with his contemporaries, who were corrupt and unable to stick to rules and therefore needed a tyrant. A famous sentence of his is *"un principe che può fare ciò ch'ei vuole è pazzo; un popolo che può fare ciò che vuole non è savio"*.[2]

Likewise, economic freedom is not possible without an adequate set of rules and this is valid both within countries as well as in the international realm.

1. Why do we need global economic governance?

Let me begin by explaining what we mean by "global economic governance" and why we need it. By global economic governance we mean, at least in the economic sphere, the set of supra-national institutions and laws as well as the international relations between countries that have an effect on cross-border economic and financial transactions.

Indeed, no market, even the market in the back street, can survive without an institutional infrastructure, i.e. a set of rules and this is particularly true at the international level, where natural barriers to transactions are already formidable. I therefore agree with the late Horst Siebert that one of global governance's primary aims should be that of reducing transaction costs, and that the process of doing so is evolutionary and characterised by continuous change and learning by doing.[3] One therefore needs to maintain a pragmatic approach with respect to what arrangements may work and not work in facilitating trade and keeping transaction costs low, depending on the circumstances.

Moreover, the more complex and durable the goods and services exchanged, the larger the need for a sound institutional infrastructure. In this respect, finance stands out as a field where global rules may be particular beneficial. More generally, the crisis has weakened the arguments of those who think that de-regulation is always and necessarily conducive to a better functioning of markets; we have learnt again that markets cannot function properly without a proper regulatory and supervisory infrastructure.

Of course, there are clear limits to what internationally agreed rules can and should achieve.

First, the principle of subsidiarity remains valid, implying that no rule should be imposed at a global level that cannot be more or equally effectively set at the local level. Incidentally, this principle is enshrined in the Lisbon Treaty and is therefore part of primary EU law; the Lisbon Treaty, in particular, has explicitly recognised a role for national Parliaments in monitoring subsidiarity in the EU. This principle might also imply that the "burden of the proof" should rest on those who want to establish global, as opposed to local, rules and institutions.

Second, there is a risk that common rules are not optimal and in particular they are too lax, since they have to be the "common minimum denominator" across many different local positions.[4]

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[2] "A prince who can do whatever he wants is mad; a people who can do whatever it wants is unwise".

[3] Siebert (2008).

[4] See D. Rodrick's Economic Focus in *The Economist* of 12 May 2009.

Third, some argue that imposing a common rule also implies limiting the range of national experiences and therefore the potential for learning about the best institutional setting. It would therefore prevent the best rules from emerging from free competition among different systems. Finally, and perhaps most importantly, it is not easy to set common rules in particular in complex and innovative fields like finance. In particular, I agree with the assessment of the former BIS General Manager Andrew Crockett made in a recent speech, that *"To be successful, an international financial architecture has to harness, not run counter to, perceived national interests"*.[5]

The global financial crisis has, however, weakened some of these arguments and shattered previously held convictions that "putting one's house in order" is the only principle that matters to ensure global welfare, and that international spillovers need not be taken into account. We have certainly become more aware of the negative externalities that globalization, in particular financial globalization, can create. This is epitomised in the sentence *"the crisis is global, the solutions need to be global"*. In my view, international interdependencies are too large for purely national or regional rules to be optimal and there is a clear need to strengthen global governance, in particular in the financial field. For example, the crisis has exposed the risk of regulatory arbitrage, shedding a more negative light on the competition among different systems and rules. In addition, the view that local governments are always driven by the welfare of their citizens needs to be qualified, as special interests often matter a great deal. Those special interests are likely to exert less influence if the rules are agreed on at the international level.[6]

2. How has global economic governance fared during the global financial crisis?

Let me now turn to analyse how our global institutions have fared during the global financial crisis.

Global governance in the decades before the financial crisis was characterised by a number of multilateral institutions and relations, in particular three key supra-national institutions, the IMF, the World Bank and the World Trade Organisation (WTO) were (and still are) in charge of the international monetary system, long-term development and trade respectively, while the G7 was the main forum for strategic impulse. To give just one example, I have a vivid memory that without the input of the G7 meeting in Halifax in June 1995 the "core principles" of the Basel Committee would not have been possible.

Another distinctive feature of the decade before the financial crisis has been a progressive and largely beneficial trade liberalisation and integration, driven by the WTO. Trade liberalisation has reshaped the world economy, leading to the integration of key emerging economies such as China and India in a market-based system, a trend which has benefited consumers the world over. At the peak of the crisis, there was a legitimate concern that such progresses would be stalled or reversed as countries focused on their own economic growth even at the expense of growth elsewhere. Protectionist and "beggar-thy-neighbour" policies would have certainly aggravated the crisis, as they notoriously did in the 1930s, and yet somehow it could have been expected in such dire circumstances and given the political difficulties associated to them. A good system is one where these self-defeating pressures could be resisted. How has the global system fared in this regard? I will look into five dimensions, namely (i) protectionism, (ii) central bank cooperation, (iii) regulatory arbitrage, and (iv) global imbalances.

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5 Crockett (2009).

6 Frieden (2009).

2.1 Protectionism

A systematic look at recent trends in global protectionism indicates that there has so far been an only moderate increase in actual protectionist measures to restrict trade through tariff and non-tariff barriers. According to the WTO, a significant outbreak of trade protectionism has been avoided since the start of the crisis: the new trade-restricting or distorting measures introduced between October 2008 and October 2009 accounted together for 0.8% of world imports, while those adopted between September 2009 and February 2010 amounted to an additional 0.4% of world imports.

Yet more protectionist pressures might be on the pipeline. First, evidence from surveys shows that public pressure for more economic protection not only has been mounting since the mid-2000s, namely well ahead of the crisis, but has intensified since its start. Second, the Global Trade Alert, an initiative of a network of five independent research institutes across the world, reports that 390 trade-damaging state measures were announced by G20 members in the 14 months from November 2008 to December 2009. Over the same period, the G20 passed only 56 measures that benefited importers.[7]

This leads me to conclude that in the trade field, while a repetition of the experience of the 1930s is not in the cards, there is certainly no room for complacency and vigilance needs to remain high.[8]

2.2 Central bank cooperation

Another dimension of international cooperation that has worked well during the financial crisis has been that among central banks, channelled through the various Basel and Bank for International Settlements (BIS) committees. This institutionalised cooperation has ensured an unprecedented degree of collaboration and coordination in the provision of cross border liquidity.[9]

Information sharing among central banks has also worked very well, for example on the occasion of the Bank for International Settlements (BIS) Global Economy meetings that are held every two months in Basel and where central bank governors from systemic economies have the occasion to discuss issues the global economic outlook, international monetary and financial issues and other issues of mutual interest. Clearly, these fora have turned out to be very useful in times of global financial distress and we should continue to invest on them in the future.

I would also like to mention that the BIS as an institution has been "ahead of the curve" in terms of identifying unsustainable trends in the financial sector and more generally in the global economy – such as the under-appreciation of risk and excessive credit growth – which eventually led to the global financial crisis. It could do so based on a high degree of analytical depth and information sharing at a global level that the BIS and the Basel committees have been able to develop over time. These analytical contributions have played a non-negligible contribution to form the strong and coordinated policy response that we have witnessed during the financial crisis.

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[7] See Baldwin (2010), in particular Chapter 5 by S. J. Evenett.

[8] Model-based simulations (Bussière et al. 2010) suggest that the impairment of the global flow of trade would hamper the recovery from the crisis, as well as the long-term growth potential of the global economy. At the same time, it is unlikely that protectionism would help to correct existing current account imbalances. Moreover, the countries implementing protectionist measures should expect a deterioration of their international competitiveness, which would further affect the potential for longer-term real GDP growth.

[9] See CGFS (2010).

2.3 Where the system has fared less well: regulatory arbitrage and global imbalances

As much as global governance appears to have passed the severe test of the global financial crisis, we should not remain oblivious to the fact that there were significant shortcomings that may have contributed to create the conditions for the crisis to happen in the first place. I will mention, in particular, two dimensions: the insufficiencies in terms of financial regulation and international coordination, on the one hand, as well as the constellation of global imbalances, on the other. Let me deal with both in turn.

The lack of integration and coordination in financial regulation was pervasive before the crisis, even though this was not properly appreciated at the time, and has encouraged financial institutions to engage in a large degree of regulatory arbitrage.[10] This was the unavoidable result of the fact that, while finance was becoming more and more global, with some financial institutions having operations in dozens of jurisdictions, financial regulation has remained largely national, with only some form of mild and non-binding coordination at the European and international level. Later, I will discuss how the international community is addressing this problem under the leadership of the Financial Stability Board.

As regards global imbalances the insufficient orientation of macroeconomic policies towards the medium-term, stability and sustainability led to the build-up of unsustainable external imbalances among key deficit and surplus economies prior to the crisis. It is a widely held (though not totally uncontroversial[11]) opinion that excessive reserve accumulation by emerging countries may have made global imbalances too easy to finance, compressed global interest rates and ultimately result in too high risk taking and leverage in those (advanced) countries that were receiving a large degree of capital inflows, ultimately creating the conditions for the financial crisis to unfold.[12] Moreover, there was a distinct perception of a lack of an effective mechanism to influence macroeconomic and structural policies in key countries where those appeared unsustainable from the standpoint of global economic and financial stability. In other words, the global public good of international financial stability was under-supplied. This is, again, an area where reform is needed.

3. The evolution of the system

Finally, let me now turn to the question of how the financial crisis has moved the direction or the speed at which global governance is moving. Some of these trends are not yet fully clear, nor free of challenges, as we shall see.

3.1 From the G7 to the G20

One distinctive feature of this crisis has been its originating at the centre of the system, differently from past major crises in the previous three decades (such as the Asian crisis). Although emerging countries have also been severely affected, they have overall been, at least taken as a group, a source of strength for the world economy. It is therefore not surprising that the crisis has led to an even better recognition of their increased economic importance and to a better integration in global governance. It is notable that emerging markets now represent about one third of world GDP at nominal exchange rates, and close to a half in Purchasing Power Parity (PPP). To be sure, the acknowledgement of the

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[10] See, among others, V. Acharya and M. Richardson (eds) (2009): *Restoring Financial Stability: How to Repair a Failed System*, Wiley, March.

[11] See, e.g., Hume and Sentance (2009), in particular pp. 24–25.

[12] See, among others, Obstfeld and Rogoff (2009).

increased role of emerging countries is a trend which precedes the global financial crisis, but that has been made significantly faster, and perceived more pressing, by it.

Global governance – and indeed collective decision making in general – always faces a trade-off between efficiency and legitimacy. With few, homogeneous players around the table, decisions are taken more quickly and perhaps implemented more easily; but they may not be seen as legitimate from those excluded from the same table. Therefore, devising institutions for collective decision making is always a delicate balancing act, even more so at the global level. The international community has agreed that, from now on, the G20 is the main forum for international economic cooperation and it includes 11 emerging economies. The G7 still has a meaningful role to play in particular in the area of floating currencies.

To be sure, the G20 has already been in existence for over a decade. The main innovation is to make it as the key informal forum for strategic global impulse at the level of the leaders as well as at the level of Ministers and Governors.

3.2 The G20 Framework

An important decision, taken at the G20 Pittsburgh summit in March 2009, has been the G20 Framework on cooperative mutual assessment of members' policies. I consider this an important step forward in order to address one of the main shortcomings of the pre-crisis regime, namely the lack of a way to ensure that macroeconomic and structural policies of key countries take into consideration their external spillovers and in particular the risks that they entail for the global financial system. This should not imply that the G20 should enter in macroeconomic decisions on a short term basis or micro-manage economic policies, but rather that a mechanism should be put in place in order to evaluate whether medium to long term policy objectives are mutually compatible. However, whether this or similar initiatives will eventually lead to more multilateralism in economic decision making is still far from obvious, and only time will tell.[13]

Notably, the Framework's predecessor, the IMF's 2007 multilateral surveillance initiative, encountered significant compliance problems, which makes the G20 ownership of the new Framework particularly promising and noteworthy. At the same time, we still cannot be sure that the Framework will be implemented effectively. It is therefore paramount that the international community presses ahead now and fully lives up to the commitments taken in the G20 context; in particular, it is important that efforts are maintained even after the most acute phase of the global financial crisis appears to be behind us.

As far as the EU and the euro area are concerned, it is important that the Framework recognises their unique institutional features, in particular as regards the role of monetary policy in the euro area.

3.3 Further strengthening of central bank cooperation

In the area of central bank cooperation, discrete, but decisive steps have been made since the onset of the crisis. A core feature of this crisis has been not only the central importance of domestic liquidity provision by central banks, but also its complementary *cross-border* dimension, that is, the network of temporary currency swaps or repos set up bilaterally by major central banks such as the ECB and the Federal Reserve, which has involved many other central banks in the world. At the same time, progress has been also made in deepening central bank cooperation and extending its geographical scope.

The main forum of global central bank cooperation is the Global Economy Meeting (GEM) which takes place in Basel. Over the past few years, this forum has been including

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[13] See, e.g., Woods (2010).

34 governors as permanent members plus a number of other governors attending on a revolving basis. The GEM is an important forum as it assesses global economic and financial conditions, analyses economic and financial policy issues of common interest to central banks, and provides guidance for the central bank cooperative activities conducted by various Basel-based central bank committees under the auspices of the BIS.

It is remarkable that the Global Economy Meeting has now replaced the G10 grouping of central bank governors as the prime forum for the governance of cooperation amongst central banks. We have now a fully extensive global ownership of the governance of this cooperation extending to systemic emerging economies. It is also remarkable that this global ownership even goes significantly beyond the borders of the G20 membership.

I have the privilege to chair the GEM, and must say that I find the frank and very rich discussions we hold at its bi-monthly meetings of invaluable importance for the central bank community at large.

3.4 The rise of the FSB

Another crucial innovation of the past couple of years has been the expansion of both membership and range of competencies of Financial Stability Board (FSB) chaired by Mario Draghi, and in charge, together with the IMF, of strengthening the international financial architecture and of global financial stability. The expanded membership – now largely overlapping with the G20 – and the stronger mandate significantly raises the profile of the FSB. The broad membership of the FSB – where both central banks and regulatory authorities are involved – ensures an unprecedented degree of international cooperation in regulatory matters. The FSB has been working actively on drawing the lessons from the crisis from the standpoint of the global principles for prudential rules regulations and supervision of all financial activities. In any case progress in building a global financial regulation architecture that is broadly agreed and at the same time effective is not easy, and we need a very strong consistent and determined action of all parties involved.

Let me also mention that the ECB is actively involved in the G20 (at the Ministers and Governors level) and the FSB, being a full member of both fora, and participates to their sub-structures at the technical level.

3.5 IMF reform

In discussing the evolution of global governance I must also touch upon the reform of the Bretton Woods institutions, in particular the IMF. Also in this case, this is a question that was already present in everybody's mind before the crisis, but which has become more pressing during and after it. In particular, the reform of the quota and voice at the IMF, which is ongoing, should foster its legitimacy and inclusiveness, improving overall global governance in line with the decision of transferring competencies and responsibilities from the G7 to the G20.

An important by-product of the crisis has been the realisation that the IMF lending capacity should be bolstered, after years of progressive decline in the IMF lending activities. At the 2009 G-20 London summit, it was decided that the IMF would require additional financial resources to meet prospective needs of its member countries during the then ongoing global financial crisis. In particular, the G-20 leaders pledged to increase the IMF's supplemental cash to $500 billion, and to allocate to member countries another $250 billion via Special Drawing Rights. In this respect, it is important that a careful assessment is made whether this high level of resources is justified by the actual financing needs, which means that a review should be conducted at some stage.

Also, the IMF will need to re-focus its activity towards monitoring the international financial system and the threats to global financial stability, drawing from and strengthening its analytical capabilities. An important step in this direction is the implementation of the joint

IMF-FSB Early Warning exercise, which is aimed at strengthening the assessment of systemic, low probability-high impact risks to the global economy and identifying possible mitigating actions.

3.6 Summing up

Overall, the system is moving decisively towards an ownership of global governance that is really inclusive and comprehends systemic emerging economies as well as industrialised countries. This very significant transformation of global governance that we are engineering today can be illustrated strikingly by three examples: first, the G20 replaces the G7 as the prime group for global economic and financial governance at the level of Ministers and Governors and at the level of Heads of State or Government. Second, the Global Economy Meeting of central bank governors replaces the G10 group of governors as the prime group for the governance of central bank cooperation. And third, the Financial Stability Board membership is extended far beyond the borders of the G7. Not surprisingly after a global financial crisis, the economic and financial sectors are areas where a new concept of global governance has been decided, and we can expect a number of tests of this new bold concept in the years to come.

4. Conclusions

Let me conclude.

We are living in a time that we will remember for long, a defining moment perhaps a bit like Bretton Woods in 1944.

The word "crisis" comes originally from the Greek "κρίσις", which means "decision" and "judgement". The global financial crisis has shattered the world and changed our beliefs, but we can still harness it for the better and live in a more integrated and stable world.

If I were to summarise the key lessons of the global financial crisis that I have been talking about today, I would emphasise three main points:

Firstly, a very profound transformation of economy and finance at the global level has taken place over the last thirty years. The combination of a technological revolution which is still ongoing, particularly, but not exclusively, in the field of information technology, with the fall of the Soviet Empire and the generalisation of market economies at a global level, has contributed to create a new entity, which is the globally integrated economy with its associated global financial system.

We have attained a level of intertwining and interdependencies at the global level which was previously unseen in terms of intensity of the links and also the rapidity of global transmission of shocks. The fact that a sole event, namely Lehman Brothers' bankruptcy, was transmitted in all economies – whether industrialised or emerging – and in all sectors – whether financial or non-financial – in a few half days, was a "première" in the history of economy and finance.

Secondly, the fact that the pertinent economic and financial entity is now global, calls for an appropriate concept of global governance. In this respect, the crisis has been revealing. Extremely bold changes that seemed unthinkable have been triggered by the intensification of the crisis in mid-September 2008. It is imperative that all institutions, governments, central banks and parties concerned do what they can to make the new constellation of global governance work exemplary.

Thirdly, the central issue for executive branches is that, even if the pertinent entity is the global economy and global finance, major decisions have to be taken at the level of individual countries. Only to speak of the industrialised world, it is necessary to make our public opinions sufficiently aware of the externalities of national decisions, and consequently on the necessity to internalize complex concepts like global economic prosperity and global financial stability.

In our democracies, very fortunately, decisions depend on the sentiment of the people. I consider that one of the most formidable challenges of today is to optimize tireless explanations to our own public opinions of the very nature of the new globalised world in which we are living.

Academia has a very important role to play in this domain.

Thank you for your attention.

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