Jean-Claude Trichet: Preventing spillovers on the global economy

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Bretton Woods Committee, International Council Meeting 2011, Washington DC, 23 September 2011.

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Ladies and Gentlemen,

It is now four years after the outbreak of the global financial crisis, and three years after the collapse of Lehman Brothers, which were stark reminders of how much financial integration and globalisation made all economies interdependent.

This interdependence creates benefits but also adverse spillovers which may arise in all domains, from inadequate macro policy choices to private market imperfections. I will focus today on two key areas of policy interest to address spillovers in the global economy: (1) reforming global finance, and (2) strengthening policy discipline at the domestic and global level, before turning to how the euro area can contribute to global stability.

1. Reforming global finance

At the Pittsburgh Summit in 2009, G20 leaders agreed "to do everything needed to repair our financial system and to maintain the global flow of capital". The November 2011 G20 Cannes summit will take stock of where we stand in terms of implementation of this important reform agenda.

In a number of areas, important decision have already been taken, notably as regards the improvement of bank capital with the agreement on Basel III, and the development of macro-prudential frameworks. In other areas, we are close to concluding our work, in particular as regards a new global framework on systemically important financial institutions (SIFIs).

In those areas where decisions have already been taken by the international community, implementation is now key. The G20 yesterday committed to full implementation of Basel III along the agreed timelines. The EU has already started this process early with the European Commission putting its proposals on the table for the so-called Capital Requirements Directive IV, which will translate Basel III into the legal framework of the EU Member States.

In terms of macro-prudential framework, the European Systemic Risk Board has started its operation this year. All jurisdictions must ensure timely implementation so that we can ensure that we have done everything to make a difference as regards the resilience of the global, regional and national financial systems.

Let me briefly highlight three key areas on which we need to stay committed and where swift progress is of the essence.

The first challenge may come from the shadow banking sector. The introduction of more stringent capital requirements may provide incentives for banks to shift part of their activities outside the regulatory realm. It is therefore decisive that we continue our work to improve our capacity to identify and assess the potential risks stemming from the shadow banking system. This includes regulatory reform of money market funds, securitisation and the interaction with the banking sector.

The second challenge is how to keep pace with financial innovation. Improving the OTC and commodity derivatives markets is a key part of this agenda, It is a complex matter and one in which alignment of details is essential to avoid regulatory arbitrage.

The third challenge is to enhance transparency across the board: with regards to markets, institutions, and products. Insufficient information contributes to mispricing of risks, mistrust among market participants, which can result into downturns and crises. At our October meeting of G20 Finance Ministers and Central Banks Governors we will be discussing IOSCO "recommendations to promote markets' integrity and efficiency to mitigate the risks posed to the financial system by the latest technological developments".

2. Improving policy discipline globally

Aside from a more resilient global financial system, we need to have more disciplined macro policies as the lack of discipline in macroeconomic policies in several countries led to the build-up of unsustainable external imbalances before the financial crisis.

There is still a gap between the degree of economic integration and the willingness of policy makers to take into account interdependence and spillovers.

Keeping one's house in order is no longer sufficient in an integrated world. Spillovers from the rest of the world can influence economies considerably. Multilateral surveillance is now being enhanced along two tracks. The informal G20 track and the formal IMF track.

The G20 Framework for Strong, Sustainable and Balanced Growth, incorporates a first systematic multilateral assessment of global imbalances. It comes at an appropriate time because four years after the crisis, global imbalances remain unsustainably high. The sum of the current account balance (in absolute terms) of the major economies are projected to remain close to 2.5% of world GDP in the next few years. This is less than their pre-crisis peak (over 3% of world GDP), but still twice as high as in the early 1990s, before the acceleration in financial and real globalization.

It is now of foremost importance to implement the Framework effectively, and to fully live up to the expectations that the G20 process raised internationally. The G20 Cannes Summit will provide a litmus test.

Multilateral surveillance of domestic policies of systemic countries to ensure their orientation towards medium term stability and sustainability is being strengthened in the IMF as well.

The recently conducted first round of IMF spillover reports, the Consolidated Multilateral Surveillance Report to the IMFC and the current triennial review of IMF surveillance can be seen as useful steps towards a broader and more comprehensive framework.

3. Strengthening governance in the euro area

The need to strengthen discipline is understood strongly on our side of the Atlantic, so that the euro area can do its part in contributing to global stability.

The earlier economic governance framework has proved to be insufficiently binding while lacking appropriate comprehensiveness.

The requirements for a very significant reinforcement of the fiscal surveillance of the Stability and Growth Pact and for the creation of a new surveillance of competitive indicators and macroeconomic policy have been discussed widely and in much detail by euro area authorities. We have embarked on a deep and comprehensive reform of its economic governance to reinforce economic policy coordination.

The Governing Council of the ECB has called for a "quantum leap" in the economic governance of the euro area. This includes in particular (i) greater automaticity of sanctioning mechanisms, particularly in the Stability and Growth Pact (ii) as well as truly independent fiscal and economic analyses of macroeconomic imbalances.

The recent conclusion of the negotiations between the European Parliament and the EU Council on the economic governance reform package are welcome. Fiscal surveillance will become stronger and more coherent with the reinforcement of the Stability and Growth Pact. While falling short of the quantum leap that the ECB was advocating, this agreement strengthens the initial Commission proposals in many ways and is thus a step in the right direction.

The EU budgetary frameworks will also be strengthened, including through the introduction of fiscal rules at the national level. The so-called "European Semester" can be expected to provide ex-ante and integrated guidance to the Member States for the formulation of national budgets and structural reforms for the following year.

This will be complemented by the introduction of a macroeconomic surveillance procedure, which closes an important gap in the economic governance framework. It is key for this framework to be rigorously applied, including in terms of the indicators used, in order to consolidate the effectiveness of this new procedure to assess in particular euro area Member States experiencing sustained losses of competitiveness and large current account deficits. The focus needs to be on the prevention of situations creating risks to economic, budgetary and financial stability in the euro area. In addition, this macroeconomic surveillance procedure should rely on transparent and effective trigger mechanisms.

Conclusions

Let me conclude with three key messages to policy makers – in advanced and emerging market economies alike – who all have a role to play to address the challenges that are ahead of us.

First, what has already been decided has to be implemented expeditiously, comprehensively and fully. This requires resolve and fortitude on the part of the public authorities, but also lucidity on the part of the private sector.

Second, there can be no complacency as regards the unfinished part of our reform agenda for a stronger international financial architecture. And I cannot help saying that on top of what is clearly identified by the international community as the urgent issues under discussion in the Financial Stability Board and the G20, we are far from understanding the potential global systemic instability that is associated today with the sheer size of the non-banking sector which experienced an exponential growth over the last 20 years.

Third, as regards the euro area and the sovereign debt crisis, of which the euro area is currently the epicentre, the euro area central banks, and the ECB in particular, have been permanently calling for sound economic policy management, in particular in the fiscal domain, for structural reforms and for reinforced economic governance. As independent institutions that are devoted to stability and that are medium- to long-term oriented, we are an anchor of stability and confidence. This is especially valuable in the turbulent market environment that we are witnessing and that is characterised by acute tensions of some sovereign signatures which are causing negative spillovers on others.

Only a few weeks ago, the central bankers were all meeting in the BIS headquarters in Basel in our Global Economy Meeting. Reporting to the press afterwards, I stressed that we were all very closely "united in purpose": each of us in our own economy, with its different features and challenges, striving to solidly anchor inflation expectations, preserve stability and consolidate confidence. Meeting here in Washington, authorities have the opportunity to display the same unity in purpose to address their economic challenges at home, prevent negative spillovers for the global economy and consolidate confidence in the world recovery.

Now, at the end of this exposition, it might be useful for me to tell you what is the assessment that the European Systemic Risk Board has expressed after its last meeting only two days ago:

Since its previous meeting on 22 June 2011, risks to the stability of the EU financial system have increased considerably. Key risks stem from potential further adverse feedback effects between sovereign risks, funding vulnerabilities with the EU banking sector, and a weakening growth outlook both at the global and the EU level. Over the past few months, sovereign stress had moved from smaller economies to some of the larger EU countries. Signs of stress are evident in many European government bond markets, while the high volatility in equity markets indicates that tensions have spread across capital markets around the world. The situation has been aggravated by the progressive drying-up of bank funding markets, and availability of US dollar funding to EU banks had also decreased significantly. In that context, central banks have decided on coordinated US dollar liquidity-providing operations with longer maturities. The high interconnectedness in the EU financial system has led to a rapidly rising risk of significant contagion. This is threatening financial stability in the EU as a whole and adversely impacts the real economy in Europe and beyond.

Looking ahead, decisive and swift action is required from all authorities. In the immediate future this includes: (1) implementing, fully and rapidly, the measures agreed upon at the 21 July meeting of the Heads of State or Government of the euro area; (2) adopting sustainable fiscal policies and growth-enhancing structural measures so as to achieve or maintain credibility of sovereign signatures in global markets; and (3) enhancing the coordination and consistency of communication.

Authorities must act in unison with a total commitment to safeguard financial stability. Supervisors should coordinate efforts to strengthen bank capital, including having recourse to backstop facilities, taking benefit from the possibility of the European Financial Stability Facility to lend to governments in order to recapitalise banks, including in non-programme countries.

I thank you for your attention.