Mr Trichet gives an address on the risks and challenges of the international financial scene

Text of the Third Hong Kong Monetary Authority Distinguished Lecture delivered by Mr Jean-Claude Trichet, Governor of the Banque de France, the central bank of France, in Hong Kong on 8 July 1999.

It is a great pleasure to be here in Hong Kong and I am greatly honoured to have been invited to deliver the Third Hong Kong Monetary Authority Distinguished Lecture. So I would like to thank you for giving me the opportunity to express my views on the challenges and opportunities of the international financial scene.

The international financial scene has been faced with two major changes over the last quarters:

- the recurrence of financial crises, originating generally in emerging or transition economies, which has emphasised the need to reform the architecture of the international financial system;
- the introduction of a new currency, the euro, which should contribute to a balanced international monetary system.

FINANCIAL CRISES AND THE REFORM OF THE ARCHITECTURE OF THE INTERNATIONAL FINANCIAL SYSTEM

Two major explanations of the recent financial crises have been put forward:

- one which can be called the "fundamentalist" view argues that Asia's healthy macroeconomic indicators – low inflation, fiscal balance, low government debt, high rates of savings and investment – offered a misleading picture. This view points out that many Asian governments provided implicit guarantees to the banking sector, which often engaged in borrowing abroad and in reckless lending to unqualified borrowers. This, in conjunction with poor corporate governance ended up in large stocks of non-performing loans which, together with governments' implicit guarantees, created a sizeable "contingent fiscal liability";
- the other main explanation views the self-fulfilling pessimism of international lenders as the root cause of the crisis. This analysis puts emphasis on panic and on herd behaviour of foreign investors and lenders. The crisis is the result of shortcomings in the international capital markets and their vulnerability to sudden changes in market sentiment. According to this view, the macroeconomic and microeconomic imbalances were not severe enough to warrant a financial crisis of the magnitude that took place in 1997 and 1998.

I do not consider these two explanations as competing or conflicting but see them rather as complementary. In short, the first approach focuses on what is wrong in crisis countries, the second on what is wrong in international financial markets and international financial institutions that "govern" global finance.

The severity of the Asian's financial crisis, the speed with which it spread and the shortcomings of the international response have contributed to a wide-ranging debate on the basic rules and institutions that govern global finance.

Recent efforts to improve the global financial architecture began at the Halifax Summit of the G7 leaders in 1995. The meeting of the G7 finance ministers and central bank governors (held in London, 21 February 1998) called for a "profound and broad-ranging debate on the lessons of events in Asia and their implications for strengthening the international monetary system, building on the reforms initiated at Halifax". The G7 identified five main areas where progress had to be made.

This is not the place to take stock of the proposals that have been put forward. Let me just air a few remarks on certain measures, which I consider as particularly important. I would like to discuss the proposals addressing imbalances and structural distortions in the crisis countries before considering those concerning the international financial markets and institutions issues.

Efforts to strengthen emerging countries financial systems making them more resilient to external shocks

The main effort contributing to the strengthening of emerging market economies' banking systems is the adoption of the set of Core Principles for Effective Banking Supervision which have been widely endorsed by emerging countries authorities. The IMF in coordination with the Basel Committee on Banking Supervision is designing indicators to assess progress in implementation by emerging countries. The adoption of the implementation of the Core Principles as a criterion giving access to the newly created Contingent Credit Line is a strong incentive for members to adopt them effectively.

The design of Deposit Insurance Schemes is another important measure contributing to reduce or eliminate implicit government guarantees limiting moral hazard on the lenders as well as on the borrowers side.

Foreign direct investment in the banking and the financial sector should also be encouraged as it allows the transfer of technology and management skills. But it should be clear that such an opening up of the capital account should, in times of financial stress, not lead to fire-sale prices.

Measures aiming at protecting the financial system liquidity from the adverse consequences of sudden changes in market sentiment (the so-called "liquidity-at-risk policy") should be given further consideration. The Argentine authorities have adopted such a policy by introducing a liquidity requirement on banks' short-term liabilities (foreign as well as domestic liabilities). This system has been supplemented by a Contingent Liquidity Facility with a number of international banks.

More generally, policies designed to discourage excessive short-term foreign borrowing and based. on market mechanisms should be supported. For instance, unremunerated reserve requirements on short-term foreign liabilities are an incentive to lengthen debt maturity; domestic savings should be more systematically mobilised through a development of domestic financial markets (promotion of larger and deeper financial markets). In particular, making short-term foreign liabilities more costly would also promote borrowing in local currency, making the financial system less vulnerable to external shocks.

International financial markets and international governance issues

As to the promotion of efficient functioning of global markets, I would like to insist on three points:

- Firstly the specific dangers associated with the “herd instinct” of market participants. This behaviour has been observed in the recent financial turmoil both as regards investors’ attitude vis-à-vis emerging economies and certainly also vis-à-vis markets in industrialised countries themselves. One of the most effective recipes for countering this behaviour is full transparency of each particular entity, of each particular country, of each particular borrower, of each particular signature. Full and reliable transparency for all, both public and private sector entities, is needed to allow a proper judgement of the merits of each case. In particular, more transparency between market players is necessary for proper risk management. In a recent report by the Basel Committee on Banking Supervision, recommendations are made to strengthen prudent management of banks’ exposures to highly leveraged institutions (HLIs). Just like any other financial institution, HLIs should comply with minimal transparency, disclosure and regulation requirements anti overall leverages should be monitored to avoid risks of systemic crisis or disruptions in the international markets;
- Secondly the decision to introduce a new capital adequacy framework to replace the 1988 Accord is an important step towards a more comprehensive approach to addressing risks and should, in particular, focus on internationally active banks. The new framework should significantly improve the way regulatory capital requirements reflect underlying risks;
- Thirdly the design and implementation of internationally agreed standards is of utmost importance for ensuring effective transparency at the international level. For instance, there is evidence that in some cases discretionary accounting practices are instrumental in enabling banks to comply with international capital regulation. Such practices may be misleading in judging the compliance with regulation.

However these efforts may reduce risks but could be insufficient to avoid financial crises. Therefore, ways should be designed to ***involve more effectively the private sector in crisis resolution*** (the “burden-sharing” issue).

In the wake of the Mexican crisis, the G10 Finance Ministers and Central Bank Governors endorsed the recommendation of the Group of Ten Report on “The Resolution of Sovereign Liquidity Crises” to introduce in sovereign bond contracts collective action clauses. The G7 endorsed this recommendation. Efforts undertaken recently by the G10 Deputies to design concrete steps to implement this proposal should also be supported.

Another way to promote private sector implication is the voluntary roll-over or restructuring of short-term debt coming to maturity. The Korean experience has been replicated, yet in different conditions, with success in the case of Brazil. Such a solution worked well after the Brazilian authorities committed firmly to, and implemented, fiscal adjustment.

The use of financial innovative techniques should also be considered: for instance, the introduction of roll-over options in debt contract (Buiter proposal) or put options associated with significant debt reduction.

As to the role of the international community:

The IMF has a central role to play in macroeconomic surveillance which is its main mission. The conditionality associated with financial assistance is essential to give economic agents a clear assessment of the efforts made by Members committed to implement adjustment programmes.

Furthermore, the IMF can improve its action as regards prevention. Improvements in the SDDS and more transparency regarding Article IV reports, letters of Intent and policy papers will certainly improve risk assessment. This could help prevent economic problems from turning into crises and to prevent contagion to other countries. Progress has to be made as regards incentives for sound management. The creation of the CCL is a step in this direction. Designing appropriate incentives is the more effective way to make Members adopt more prudent debt management, effective banking supervision…

Given the large number of institutions and fora involved in the efforts aiming at a better global financial architecture, the creation of the Financial Stability Forum reflects an important effort to coordinate work in progress and identify issues not yet addressed.

THE EUROPEAN MONETARY UNION WILL YIELD A SUBSTANTIAL CONTRIBUTION TO BETTER ECONOMIC AND MONETARY EQUILIBRIUM IN THE WORLD

The introduction of the euro six months ago is the other major event I would like to deal with now. The irreversible nature of this change has convinced an increasing number of political and economic actors that the success of the euro is a necessity for Europe. It is a keystone of the single market.

It is clear that, now and for the future, we have to face a number of challenges to make this success sustainable. I would like to draw your attention to the following issues:

- first, the euro area will have to face up a number of challenges to confirm its initial success;
- second, the success of the euro will make a contribution towards encouraging a balanced international monetary situation.

I believe that in the current overall economic situation, the success of the euro will help not only Europe but also the rest of the world which will benefit from European prosperity and growth as part of a healthy world economy. This would help facilitate the current accounts adjustments of the countries affected by the crisis.

The success of the euro will be complete if a number of challenges are taken up

A few years ago, it was necessary to convince a great deal of sceptic people that the euro was a viable project. Many of them pointed to its presumed contradictions and its alleged inconsistencies: for example, the impossibility of achieving an efficient policy mix without a political federation; the impossibility of avoiding some “asymmetric shocks”; the lack of sufficient flexibility of the economy and real mobility of the labour force in the European countries, etc. The result was that the euro would never exist!

These criticisms proved wrong as to the introduction of the euro. But they are useful to help answer the question of what are the conditions for ensuring that the euro is a complete success.

Four conditions can be identified:

- ***The first condition*** is the credibility of monetary policy guaranteed by the independence of the European Central Bank, which is enshrined in the Maastricht Treaty and rooted in the independence of each national central bank. The euro is a currency which is designed to be a good store of value, having the legacy of the best European currencies. It must and will carefully keep and consolidate the confidence of the 290 million Europeans in the euro area and the confidence of non-Europeans with whom we do business. Satisfying this first condition will be facilitated by the harmonious functioning of the European monetary team which is composed of the ECB and the eleven national central banks of the euro area.

- ***The second condition*** is compliance with the provisions of the Treaty and the Guidelines laid down in the Stability and Growth Pact with regard to fiscal policy. Close coordination of fiscal policies and vigilant peer surveillance within the informal council of the eleven participating member states – the so-called "Euro Eleven" – and by the ministers of finance of the 15 member States convened in the Ecofin Council is essential in ensuring a balanced policy mix throughout the euro zone. Adherence to the medium-term objective of bringing national budgets close to balance or in surplus is a condition for the Union as a whole to weather periods of economic difficulty and for individual countries to withstand possible economic downturns which affect only their own economy.

We have to understand that monetary policy alone cannot ensure price stability without the appropriate fiscal discipline at the overall level of the Economic and Monetary Union.

For my part, I would give three economic justifications for the Treaty provisions that gave rise to the Stability and Growth Pact.

Firstly, by coordinating the fiscal policies of the Member States of the Monetary Union, the Pact ensures a good policy mix within the euro area. This is essential for monetary policy. Since Europe does not have a significant federal budget, just as Europe has no federal government, the sum of the national budgets must serve as an overall budget for the area as a whole. This calls for close mutual surveillance and coordination of fiscal policies within the euro area. That is the reason why sanctions, including fines, can be decided against bad behaviours. Europe has not practised benign neglect as regards fiscal policy: it has given the Council, which is the political body at the centre of Europe much more influence and power on the fiscal policy of Member States that in any existing federation or confederation.

Secondly, the Pact helps prevent well-run economics from having to bear unjustified risk premia by setting up a system of penalties for excessive deficits.

Thirdly, the Stability Pact allows us to disprove the assertion that the euro area has no automatic stabilisers in the event of asymmetric shocks to a member economy. Indeed, by urging governments to aim for a fiscal position close to balance or in surplus in the medium term, the Pact enables them to let fiscal deficits increase during recessions without exceeding the 3% reference value. In short, it allows them to create a fiscal buffer during normal economic periods that can be drawn on, if an asymmetric shock occurs.

− ***The third condition*** is that all European countries must undertake structural reforms. Continental Europe is experiencing high levels of unemployment, despite the fact that the jobless rate has been declining slightly in most of its economics. According to the IMF, around 80% of this unemployment is structural, that is, generated by our burdensome rules and regulations. The Monetary Policy Council of the Banque de France agrees with this analysis.

Just recently, some external observers were still blaming Europe for its focus on the euro, instead of what they considered the more urgent task, namely the implementation of structural reforms necessary for more dynamic job creation.

These critics were wrong regarding the untimeliness of the euro, but their assessment of the problems of the European economy is obviously correct. The euro will be a stimulus to structural reforms. Most importantly, the single currency is decisively contributing to achieve the single market in the three markets of goods, services and capital within the euro zone. And the euro will also encourage "cross fertilisation" of best practices through stronger co ordination of member states policies in areas such as labour markets, education and training, job creation incentives, effective welfare safety nets, etc. In this sense, the euro – which is in itself a major structural reform- must, and will certainly, bring about other structural reforms.

− ***The fourth condition*** is that all economic leaders in Europe must be clearsighted with regard to the crucial matter of competitiveness. Pre-euro economic policy meant in particular monitoring trade balances, the balance of payments and the foreign exchange and interest rate markets. Economic leaders thus received constant and to a large extent real time feedback on key indicators affecting national economic performance and could react accordingly.

These indicators remain on the euro-wide level: this is why the mutual surveillance of fiscal and economic policies provided for by the Treaty is so important. But they have disappeared at the national level with the advent of the euro, whilst the. rules of a market economy continue to apply to each economy participating in the euro zone. Jobs are created by consumers when they choose the goods and services they feel are the best value for money. Businessmen allocate these jobs to different possible locations in different countries according to the relative competitive advantages of these locations. Therefore the leaders of each national economy must monitor competitiveness through indicators such as unit production costs, tax and regulatory frameworks and so forth. This is even more important than before.

The EMU will reinforce monetary and financial stability

The international role of the euro

With regard to the international role of the euro, let me say that the Eurosystem does not regard it as part of a zero sum game in an atmosphere of confrontation. On the contrary, I view it as a positive sum game, based upon close international cooperation and certainly not on confrontation. The international role of a currency is a complex matter. A currency can be used by different groups of economic agents for different purposes, as an anchor and reserve currency on the official side, as an invoicing and payment currency for international trade, as well as a currency of denomination for financial assets, on the private side.

My understanding of the process towards internationalisation of the euro is based on the following observations:

- firstly the euro , as I said before, has the full legacy of the most credible currencies in Europe, taking into account the fact that the European monetary convergence process has been based upon a benchmarking principle. The euro is not starting from scratch but from the solid soil of currencies having proved their solidity over time like the franc, the DM, the guilder, and so forth;

- secondly, the policy which is pursued by the European Central Bank is a policy of stability, credibility, low inflation so that the euro will be an excellent store of value. This is called upon us by the Treaty. It is clearly the will of the European people. Only to give you an example of the support of the public opinion for a reliable euro: according to a French poll, 95% of the population was in favour of a euro at least as solid, reliable and strong as our previous “franc fort” national currency;

- thirdly, the process of economic and financial globalisation, the trend of increase in international trade calls in the long run for increased demand worldwide for official reserves and for highly reliable monetary and financial instruments. This explains why the progressive internationalisation of the euro will, in my eyes, be totally non-confrontational but cooperative.

The exchange rate relationships of the euro area vis-à-vis key global currencies

As regards the exchange rate relationship vis-à-vis major currencies, I think the best for me would be to reiterate the position of the Eurosystem which has been expressed by Wim Duisenberg in the name of the full body of the Council of Governors of the Eurosystem:

“In the view of the Governing Council the major economic factor behind the short-term developments observed in the exchange markets is constituted by cyclical differences between the euro area and the United States, which are expected to diminish over the course of this year and thereafter. The euro is a currency firmly based on internal price stability and therefore has a clear potential for a stronger external value.”

To sum up we have two main messages to global investors and savers: firstly, we pursue a policy which is designed towards price stability and currency solidity in a steady medium and long-term perspective; secondly, the euro has a significant potential for appreciation.

In conclusion, let me stress the following:

The international cooperation under the aegis, in particular, of the G7, has been very fruitful regarding key issues dealing with the strengthening of the international financial architecture. There is sometimes too much emphasis being put, in my view, on the different feelings or positions that appear here and there. What I think more important is the fact that the international community fully agrees on many key issues which are extensively mentioned in the Communiqué of G7 Finance Ministers and Central Bank Governors, 20 February 1999. Other fora have significantly contributed to the very useful exchange of views on ways to reform the international financial system. The Financial Stability Forum is making progress on important issues: Highly Leveraged Institutions, short-term capital flows and offshore centres. Following the statement at the Summit of the Heads of Government of the G7, the Forum will be broadened. I am very happy that Hong Kong is invited to participate in the Forum’s next meeting.