Jean-Claude Trichet: The role of central banks in a globalised economy

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, on the occasion of the 13th Conférence de Montréal, Montreal, 18 June 2007.

* * *

Ladies and Gentlemen,

Thank you for inviting me to the 13th Conference of Montreal hosted by the International Economic Forum of the Americas. I am delighted to speak today before such a distinguished audience. I greatly appreciate your objective to organise wide-ranging and open discussions on major international economic issues. The theme of this year's conference – *Succeeding through uncertainty: from risk evaluation to strategic decisions* – is a very timely and challenging one. We at the European Central Bank often have to navigate uncertainties and find that our monetary policy strategy is of great help in setting the course.

One of the themes most discussed in the conference programme is globalisation, and rightly so given its huge importance. I would like to investigate with you the role of central banks in a globalised economy. First, I will outline some of the features of the debate. Second, I will reflect on the integration of the euro area within the globalised economy. Third, I will reflect on some of the implications of globalisation for central banks.

1. Globalisation and some of its underlying trends

Globalisation encompasses several phenomena and trends which have led to a growing interdependence of most economies throughout the world. It displays its effects through a strong increase in cross-border transactions in goods and services, capital, labour and natural resources. I would add that, at the same time, we are witnessing a substantial increase in the cross-border exchanges of ideas and concepts between the various institutions, organisations and non-trading companies. The concept of globalisation has been of vital importance over the last 20 years – and has been even more so in the last ten years – thanks to a combination of factors, including the diffusion of ever more sophisticated and affordable information and communication technologies. The cost of shipping goods has fallen. Economies have continued to open up and many trade and financial barriers have been lifted. National barriers to the circulation of goods, services and production factors are diminishing everywhere. Foreign direct investment (FDI) flows have also surged, leading to an internationalisation of production processes and new ways of doing business as companies have established affiliates abroad both to gain access to foreign markets and to reduce input costs.

Globalisation has allowed many emerging countries to enter and compete in world markets. In order to measure the phenomenon on a global scale, it should be noted that the labour force available for participating in globalised markets has probably doubled from 1.5 billion to 3 billion with the opening-up of China, India, many formerly centrally planned economies and several other emerging countries. Although labour mobility is still limited worldwide, the increased flexibility of capital flows implies that firms now have much easier access to global labour supply than before. As a result, many industries have set up supply chains on a global scale.

Let me now provide you with some figures to document the magnitude and scope of globalisation. Global trade openness – measured as world exports and imports of goods and services as a share of world GDP – has practically doubled over the last 20 years, from 33.9% of world GDP in 1986 to 60% of world GDP in 2006. An increasingly decisive factor has been the increase in trade in intermediate goods and services as a result of the rising internationalisation of production processes.

Financial systems have also been deeply affected. As investors' incentives to hold foreign assets in their portfolios and the possibilities to diversify and spread financial risks globally have grown, this has affected all facets of financial systems, be it markets, infrastructures or institutions.

Let me briefly illustrate some impressive developments. The share of gross international asset holdings in world GDP – which provides a measure of financial openness – has shown an eightfold increase over the last 25 years and now stands at more than 130% of world GDP. As far as global capital flows are concerned, it is noteworthy that their composition has changed significantly over

recent years. While FDI and international equity flows were dominant in the late 1990s, international transactions in mainly liquid assets have risen in recent years, making up most of the increase in global capital movements. International risk-sharing and the transfer of net savings across countries are important features of this process.

Emerging market economies are gaining a larger share of global GDP. Aggregated data show that they posted net private capital flows of USD 650 billion in 2006 compared with USD 458 billion in 2005. Net direct investments remained globally unchanged over this period, with net inflows of USD 267 billion in 2006. Portfolio investments, on the other hand, which include the public sector, recorded higher outflows in 2006 of USD 379 billion, compared with USD 258 billion in 2005, while portfolio investments to emerging market economies decreased slightly. On the whole, emerging market economies have most recently been providing the rest of the world with net resources corresponding to their current account surpluses. The main drivers are limited domestic absorptive capacities and underdeveloped domestic financial systems.

Globalisation is fostering economic prosperity and raising living standards through various channels. There is stronger international competition and a greater transfer of technology and knowledge. This is promoting productivity gains and global economic growth. Higher efficiencies are helping to lower both costs for firms and prices of tradables. The availability of new product varieties is increasing. Resources are allocated to the most profitable activities across the world, and there are new possibilities to diversify and share risks globally. Also, scrutiny by international investors serves as a disciplining device, which enhances the quality of domestic economic policies and thus contributes to improved economic fundamentals.

However, globalisation also presents some challenges and poses some risks. The ever closer global integration and the surge in capital mobility have rendered the international financial system more exposed to changes in investor sentiment. Furthermore, international trade and financial links might intensify the transmission of shocks from one country to another and amplify cross-border spillover. We should not forget that, a few years ago, a number of financial crises posed a major threat to the international financial system, including the Asian crisis starting in 1997 and the Russian crisis in 1998. Each of these crises was different and the international community managed to resolve them successfully. Each crisis illustrated the need for adequate investment in institutions and human capital to strengthen economic governance. I will come back to the impact of major financial crises for central banks in my third reflection. Past crises illustrate the vulnerability of the global economic and financial system and remind us of the importance of always being alert and never being complacent.

2. The integration of the euro area within a globalised economy

My second reflection is about the economic and financial links between the euro area and the rest of the world. I will argue that integration within Europe has gone hand-in-hand with the integration of Europe within the global economy. In trade terms, for example, the euro area is very open vis-à-vis the rest of the world; more open than the United States and Japan. Extra-euro area exports of goods and services account for around 20% of euro area GDP, roughly the same share as extra-euro area imports. This is substantially higher than in the United States, where exports of goods and services represent about 10% of GDP and imports 16%, as well as in Japan, where total exports amount to 15% of GDP and imports 13.4%. Moreover, particularly noteworthy for the euro area is that the increase in trade with the rest of the world has been even greater than the increase in exchanges within the euro area.

What is even more remarkable, perhaps, is that the euro area is more financially open than the United States and Japan. Let me present four observations. The **first observation** is that the external assets and liabilities of the euro area, as a percentage of GDP, are very large and account for around 124% and 137%, respectively. By comparison, in the United States, the corresponding figures are substantially lower: 90% of GDP for assets and 110% for liabilities. In Japan, foreign financial assets are likewise significantly lower than in the euro area (94% of GDP in 2005), and the difference is even greater for liabilities, which represent only 60% of GDP, i.e. less than half of the corresponding figure for the euro area. This highlights how the euro area is very outward-looking.

My **second observation** is that the euro has very probably contributed to the financial opening of the euro area. On the assets side, stocks of euro area assets held abroad increased from less than 87% of GDP in 1999 to, as mentioned, over 124% in 2005. On the liabilities side, the increase was also very substantial, from around 92% to 137%. The rise has actually been much less pronounced for the

United States: US assets have grown from 80% of GDP in 1999 to 90% today, and US liabilities have increased from 91% to 110% of GDP. In other words, the euro area has witnessed a more substantial increase since the start of Economic and Monetary Union.

My **third observation** is that the euro area is an attractive place for FDI. A breakdown reveals that inward FDI amounts to more than 27% of euro area GDP, against 22.5% for the United States. The euro area seems to have received, proportionally to GDP, a similar amount of FDI as China – 27.3% for both economies – according to IMF statistics. In net terms, the stock of direct investment abroad is only slightly higher than that of FDI within the euro area (30.4% against 27.3%, respectively).

My **fourth observation** concerns bilateral FDI linkages of the euro area. Based on available data, it is worth noting that the stock of euro area FDI abroad is mostly held with mature economies: nearly 21% in the United States, 24% in the United Kingdom, 9% in Switzerland, and between 2.5% and 3% in Sweden, Canada and Japan. Likewise, on the liabilities side, the United Kingdom and the United States account for a larger share than on the assets side (nearly 40% and 23.5%, respectively).

I should also stress that the amount of euro area FDI in emerging market economies rose quickly. Between 1999 and 2005, outward FDI from the euro area to the so-called BRIC group – which includes Brazil, Russia, India and China – increased markedly. Over this period, the stock of outward FDI in the BRIC group rose from €63 billion to €133 billion (or by 111%). In comparison, the stock of euro area FDI in the United States increased by 55%, from €360 billion to €558 billion, during the same period.

The euro area itself has also become more attractive as a destination for FDI from the BRIC countries: between 1999 and 2005, FDI stocks from the BRIC group in the euro area tripled, from €4 billion to €12 billion. This is still low in comparative terms but is not insignificant. In terms of comparison, the figures for US FDI stocks in the euro area rose from €322 billion to €560 billion over the same period. Brazilian and Russian firms account for the bulk of the BRIC countries' FDI surge in the euro area, but Chinese and Indian FDI has picked up in recent years.

On the whole, this evidence suggests that there is no "fortress Europe" or "fortress euro area"

3. The implications of globalisation for central banks

My third reflection is about the implications of globalisation for central banks in their two principal functions, i.e. setting monetary policy and helping to secure financial stability.

Globalisation and monetary policy.

The issue of the impact that we have observed for some months of the historic episode of accelerated globalisation on inflation is both important and much debated. Economic theory has numerous channels through which globalisation can influence the level of prices, but these influences are not one-directional.

I have already mentioned the basic phenomenon of the increase in the pool of labour available to the world economy with the widespread opening-up of emerging economies and the former centrally planned economies. The phenomenon exerts pressure, in particular, at the slightest rise in the cost of labour, especially unskilled labour. In a more general manner, it tends to modify significantly the previous balance between capital and labour at the global level. Globalisation also exerts pressure conducive to price stability by strengthening global competition, by reducing the ability of firms to fix prices and by exerting pressure on unit production costs in the industrialised countries.

A third influence, which is in keeping with my previous two points, is that globalisation has also exerted a positive effect on the productivity of the global productive sector by facilitating, and accelerating, the phenomenon of restructuring and optimisation of the division of labour in a wider cross-border context.

But it would be naive to think that the effects of globalisation on inflation go in one direction only.

Indeed, the sudden emergence of fast-growing economies in the global economy is exerting upward pressure on prices for mining products and fossil fuels. This phenomenon has been particularly visible since 2003.

The same phenomenon of rising prices is observable in certain areas of agricultural production. The attainment of considerably higher living standards by a new and numerous middle class translates into major changes in eating habits and, as a result, in the meat, cereal and fresh produce sectors of the world economy.

Since the theoretical influences that globalisation can be said to have on prices are numerous and work in different directions, it might perhaps be natural to suppose that globalisation, as a continuous phenomenon with medium-term effects, will translate into substantial changes in relative prices – the prices of manufactures falling and those of oil, gas and certain commodities rising – without the general level of prices being significantly affected.

Empirical research does not allow this conjecture to be either irrefutably confirmed or disproved in the recent period. All in all, the available data indeed confirm that the prices of manufacturing imports in the euro area were at end-2006 still below their 2001 level. Although import prices for raw materials have risen strongly since 2003, it can be said that, over the same period, the acceleration in import prices overall, all products taken together, has been moderated by the growing proportion of euro area imports coming from countries with low production costs (countries in eastern Europe and Asia, particularly China).

It remains that the phenomenon of globalisation and of its acceleration since the mid-1990s has coincided with a decline in global inflation and in its volatility. Concomitantly and as a consequence of this stabilisation of inflation at a low level, we have also seen lower volatility in macroeconomic variables.

But it would be wrong to conclude that this correlation between globalisation and low inflation demonstrates a causal relationship. Indeed several other factors – independent of globalisation – can be identified as helping to explain these good results. I see at least four.

In the first place, the very **rapid progress in science and technology**, in particular information and communication technologies – leading to significant productivity gains which coincide with globalisation and, moreover, are one of its underlying causes. In the second place, **structural reforms** which have been introduced in the industrialised world from the beginning of the 1980s and which have gradually increased throughout these economies. These structural reforms, like the spread of technological progress, have helped to increase the growth potential of the economies and thus to facilitate price stability. In the third place, the **greater budgetary discipline** which has recently characterised most economies following the previous period of poor fiscal management. And finally, the **monetary policy pursued by the central banks and their enhanced credibility**.

I would particularly like to stress the last point. Whatever the influences being exerted in the context of globalisation, the basic principle which allows the anchoring of monetary policy remains: in the long run, inflation is a monetary phenomenon. As a consequence, globalisation does not affect the central role and overriding responsibility of central banks to preserve price stability.

In the short term, the central bank must continue anchoring inflation expectations at a level that is consistent with the central bank's definition of price stability. Let me illustrate this by means of an example. Let's take the significant increase in energy prices over the last few years. I will assume that a central bank credibly commits to maintain stable prices and is fully and unequivocally trusted by the public and by other policy-makers. The corporate sector, which uses energy as an input for its production processes, observes a significant and sharp rise in the price of oil. Since there is a credible commitment to price stability over the medium term and inflation expectations are well anchored at low levels, entrepreneurs easily understand that it is the relative price of energy that is rising, while the aggregate price level may not increase as much. Therefore, their incentives to fully pass the increase in input prices to consumers are reduced because, if they did, their competitiveness could be significantly eroded, especially in an increasingly competitive global environment. Hence, in this example, the credibility of the central bank clearly reduces second-round inflationary effects and minimises macroeconomic fluctuations in output and inflation.

Now let me turn to the role of central banks in mitigating risks to financial stability stemming from globalisation.

Widespread interlinking of the financial systems has created a global financial system that it becoming a real, significant entity at the global level. This affects the **financial stability assessment** performed by central banks in two ways.

- The first way is that it calls for a growing global focus on their financial stability analysis. For instance, for the euro area, a complete and comprehensive view on the key sources of risk and vulnerabilities facing the financial system cannot be formed without taking due account of wide global imbalances or concerns about excess global liquidity.

- The second way is that it calls for enhanced cross-border cooperation and exchange of information among central banks (and between them and other authorities contributing to financial stability). This should produce a comprehensive picture of risks and vulnerabilities and identify appropriate and effective mitigating policy actions. In the European Union this goal is pursued mainly through the activity of the Economic and Financial Committee in its Financial Stability Table set-up, comprising representatives from ministries of finance, central banks and the supervisory committees in banking, securities and insurance, as well as the ESCB/Eurosystem. At the level of the G-10, this goal is pursued by the Financial Stability Forum and other sectoral committees.

The globalisation of financial systems also affects the role of central banks in the **design of financial regulation and supervision**. This role is played by central banks because they either have a direct supervisory responsibility or act in an advisory capacity to governments. In general, financial globalisation calls for an intensification of efforts among regulators on a cross-border basis to produce consistent regulatory and supervisory standards. The aim is to promote a level playing-field and reduce regulatory arbitrage. This is clearly illustrated by the experience of the European Union where the establishment of a single financial market is a main strategic objective and presupposes the removal of potential regulatory and supervisory barriers. The EU experience also shows the usefulness of proceeding in steps in the process of convergence by focusing first on regulatory requirements and subsequently on supervisory standards and practices. In this context, I would like to offer three considerations:

- First, in the areas clearly identified previously it is important that the regulators of the major financial systems deepen and strengthen their dialogue at the global level. Therefore, the initiative of the European Commission to extend its traditional regulatory dialogue with the United States to other major countries, including China and Japan, is supported in particular.
- Second, we see an increase in the number of new areas in which the need for a consistent approach at the global level is becoming apparent. Financial institutions with high leverage are a good example here. On the basis of the mandate given informally by the G8, the Financial Stability Forum has played and continues to play a crucial role in developing recommendations at the global level targeted at regulators, counterparties of the leverage funds and investors in these funds. The institutions themselves have been encouraged to develop, voluntarily and under their own responsibility, their principles of best practice ("benchmarks"), both in terms of transparency towards their counterparties and their own investors, and in terms of their optimal management of risks. Credit derivatives markets could also be mentioned as another area that requires a consistent approach at the global level.
- Third, in general terms, there is a still a great deal of progress to be made in harmonising effective supervisory practices at the international level. This is particularly paradoxical regarding the banks, since the Basel Committee is the oldest and most advanced in terms of ensuring that uniform principles and concepts of prudential supervision are defined at the global level. However, given the diversity of practices, a significant harmonisation effort is still necessary and is currently being made by the Basel Committee's Accord Implementation Group (AIG), which is mandated to work on practical implementation issues for achieving convergence of banking supervision practices at the international level.

4. Conclusion

I would like to conclude by drawing your particular attention to the following five points:

First, let us never forget that scientific and technological progress is very much at the root of globalisation. There would be no low-cost, instantaneous transmission of information, concepts and services at the global level without new information and communication technologies. There would be no extremely rapid expansion of international trade in goods without technological progress in sea and air transport.

Second, if science and technology are at the root of the current globalisation, this could be a trend that not only lasts, but also strengthens. There is no indication that scientific and technological progress is tending to slow down. In fact, the opposite is the case.

Third, the rapid growth that we are seeing at the global level, and highly significant transformations which are both the cause and effect of this growth at the level of each of the economies, rapid changes of the respective economic weightings of the various continents and of the structure of the global economy all combine as a consequence to make predictions based on past regularities less reliable. Consequently, uncertainty tends to increase and economic and financial risks with a weak or very weak probability, but a strong destabilising potential, appear as the inevitable, and in fact, "normal" counterpart to an unprecedented period of economic prosperity. Now is not a time to be complacent.

Fourth, more than ever during a period of accelerated globalisation, central bank credibility is essential for anchoring solidly inflation expectations and for forming a solid base for monetary and financial stability in a brilliant, mobile international economy in which uncertainty and risks cannot be ignored.

Fifth and finally, it is crucial to deepen and strengthen global governance by exploiting to the full all possibilities offered by all formal and informal institutions that exist and by consolidating global financial stability, not only by unifying the principles and concepts of prudential supervision and regulation, but also by achieving real unification, resulting at the global level from the practical implementation of regulation and supervision.

Ladies and gentlemen, thank you for your attention.

Selected references

Baumann, U. and F. di Mauro (2007), *Globalisation and euro area trade: interaction and challenges*, ECB Occasional Paper Series, no 55.

Borio, C. and Filardo, A. (2007), *Globalisation and inflation: New cross-country evidence on the global determinants of domestic inflation*, BIS Working Papers No. 227.

Devereux, M. B. and Sutherland, A. (2007), *Financial Globalisation and Monetary Policy*, Discussion Paper Series No 6147, International Macroeconomics, Centre for Economic Policy Research.

ECB (2006), *Effects of the rising trade integration of low-cost countries on euro area import prices*, Box in Monthly Bulletin, August.

ECB (2007), Financial integration in Europe, Report that can be downloaded from: http://www.ecb.int/pub/pdf/other/financialintegrationineurope200703en.pdf.

ECB (2007), *Financial Stability Review*, June.

Freeman, R. (2006), *The great doubling: the challenge of the new global labour market*, August.

IMF (2006), *How has globalisation affected inflation?*, World Economic Outlook, Chapter III, April.

OECD (2006), *Globalisation and inflation in the OECD economies*, ECO/CPE/WPI.

Papademos, L. (2006), *Monetary Policy in a Changing World: Commitment, Strategy and Credibility*, Speech at the Fourth Conference of the International Research Forum on Monetary Policy, Washington D.C., 1 December.

Paramo, G. (2007), *Globalisation and monetary policy*, Speech posted on ECB website at: http://www.ecb.int/press/key/date/2007/html/sp070316.en.html.

Rogoff, K. (2006), *Impact of Globalization on Monetary Policy*, Harvard University (prepared for symposium sponsored by the Federal Reserve Bank of Kansas City on "The New Economic Geography: Effects and Policy Implications" Jackson Hole, Wyoming, 24-26 August).

Trichet, J-C. (2006), *Economic integration in the euro area*, 15th European Regional Conference of the Board of Governors – Tel Aviv University, Paris, 31 March.

Trichet, J-C. (2007), The current state of European Financial Integration, University of Stirling, 11 May.