Jean-Claude Trichet: Euro prospects and international financial reforms

Speech by Mr Jean-Claude Trichet, Governor of the Banque de France, at the 21st Century Forum, sponsored by the National Committee Chinese People's Consultative Conference, held in Beijing, on 15 June 2000.

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It is a great privilege to participate in such an extraordinary forum. I want to express all my gratitude to the National Committee Chinese People's Consultative Conference, and particularly its chairman, for having sponsored this 21st Century Forum, here in Beijing.

Let me take this opportunity to present some views on international issues. I would like to focus on two major topics,

– the international financial architecture and its necessary evolution;

– the economic strengths and scope for further progress in the euro area.

Both topics are in fact related: both have a bearing on the future of the International Monetary and Financial System; both illustrate the worldwide efforts to build more stable economic and monetary relationships in an increasingly globalized world.

1. Let's consider first the international financial architecture

Several complex issues, often inter-related, are currently at stake. On each of them, the Eurosystem (i.e. the European Central Bank - ECB - and the eleven National Central Banks - NCBs - of the euro area) have elaborated a common view. It is this common view that I will present to you now as I have had occasions of presenting it, as the position of Banque de France, in the last G VII meeting, last April.

I see five major points that are of systemic interest:

– the orderly liberalization of capital movements;

– the question of reserve and debt management;

– the key issue of transparency;

– the question of the moral hazard associated with private sector involvement;

– and finally the choice of the exchange rate regime.

1.1 Orderly liberalization of capital movements

The liberalization of capital movements benefits both individual countries and the world economy: it enhances long-term growth potential and improves savings/investments allocation. However, the two following principles need to be carefully taken into account in order to minimize risks:

– the restructuring of domestic financial systems and the strengthening of domestic regulatory and supervisory frameworks are preconditions of utmost importance: emerging economies should bring their domestic financial systems into line with regulatory and supervisory minimum requirements prevailing in mature economies. In that respect, the international community plays an important role through the Financial Stability Forum, the implementation of standards such as the "Core Principles for Effective Banking Supervision" or the Financial Sector Assessment Programs developed by the IMF in order to identify financial systems' strengths and vulnerabilities.

– The liberalization process should be carefully sequenced, starting from the more stable capital flows (e.g. FDI), in line with the progress mode in the financial sector solidity and soundness; recent crises illustrated disruptive capital outflows generated by external debts highly concentrated on short-term maturities.

1.2 Improved reserve and debt management

To mitigate the volatility of capital flows and especially short term flows and reap the benefits of capital account liberalization, one should adopt a risk management strategy that involves a system for monitoring and assessing the risks and liquidity of the economy as a whole, including at a sectoral level.

The international community may assist in developing best practices related to reserve and debt management: let me quote for example the more stringent publishing obligations on net foreign exchange reserves adopted within the context of the IMF Special Data Dissemination Standard (SDDS) or the IMF and the World Bank initiative to promote good practices in reserve and sovereign liability management.

As recommended by the Financial Stability Forum Working Group on Capital Flows, an improved risk management by the banking sector is desirable, particularly as regards banks in emerging markets receiving flows and international banks extending cross-border credit, with the help of revised Guidelines from the Basel Committee on managing liquidity risk.

Let me also note that implementing a strategy assessing the liquidity risk and foreign exposure of the economy as a whole calls for an adequate balance sheet information from both the public and the private financial and corporate sectors.

1.3 Transparency and enhanced surveillance

The efficiency of international capital markets depends on the availability of reliable and timely information both on debtor countries and market participants.

– As regards the public sector, many efforts have been achieved, such as the IMF codes of good practices on transparency in the field of fiscal policy or monetary and financial policies or the promotion by the IMF of statistical standards (the so-called SDDS).

– International Financial Institutions have also continued to proceed toward greater transparency. Several initiatives have been launched, I will particularly point out the participation of 60 countries on a voluntary basis in the pilot experience for the release of IMF article IV reports.

– As far as the private sector is concerned, parallel efforts need to be pursued. Progress may take the form of improved disclosure on a voluntary basis, more demanding statistical reporting and extended requirements for non-transparent segments of the financial markets.

Thanks to improved transparency important progress is being made to strengthen IFI’s surveillance in key areas, including financial sector issues, external debt and capital account developments, exchange rate policies.

As Prime Minister Fraser has mentioned, the definition of internationally agreed standards and codes is also strongly impacting the IMF surveillance; the implementation of these standards will reduce emerging market economies’ financial vulnerabilities and together with enhanced transparency, improve market discipline and market participants’ ability to better assess the risks of their investment decisions.

Efforts have now to be pursued as regards the prioritization of these Standards and Codes (the Financial Stability Forum Task Force on Implementation identified 12 of such Codes and Standards out of 65) and the development of incentives to implement them. Is there a better demonstration that we are experiencing globalization than to observe that 65 global workshops including countries in transition and emerging economies have worked out 65 Codes and Standards to be implemented universally? The commitment of economies to implement Codes and Standards might be reinforced if market participants reflect information on observance of Codes and Standards in differentiated credit ratings.

1.4 Private sector involvement

The main objectives of private sector involvement is to avoid moral hazard and other distortions in the functioning of international financial markets and to facilitate more orderly adjustments in case of crisis.

Market participants should be encouraged to assess adequately the risks involved in investment decisions on the basis of a country's underlying fundamentals, including the soundness of its financial system, rather than on the expectation that official flows will possibly support repayments to them in times of crisis.

We have to promote approaches that permit appropriate coordination among creditors, and between creditors and borrowers. Appropriate instruments to reach that goal include collective action clauses, private contingent credit lines, call options on interbank credit lines and the removal of put options from bond contracts.

I think that pragmatism should prevail as to the form of the private sector involvement in crises resolution. But there is a need for general principles to highlight the roles and responsibilities of the public and private sectors, such as those that have been defined in the framework adopted by the G7 at the Köln Summit in June 1999. Among these principles, I would particularly stress:

– the focus on the medium term sustainability of a country's financing position;

– the objective to achieve comparability of treatment between and within a country's bilateral official and private creditors.

1.5 Choice of the right exchange rate regime

The sustainability of any exchange rate regime depends crucially on its consistency with a country's domestic macroeconomic and structural policy framework.

This being said, the choice of an exchange rate regime should rest on the following principles:

– So-called "corner solutions" are not necessarily the only available options. Free floating rates may help to accommodate volatile capital flows and asymmetric shocks; however, they might not prevent misalignments leading to balance of payments desequilibrium, they might prove disruptive for the real sector of small open economies, which often lack the size for developing the necessary market infrastructure to cope with exchange rate instability. Currency boards can be warranted only under very specific circumstances.

– Requirements for sustaining pegs have become very demanding in an environment of high capital mobility; however, "intermediate solutions" may still remain a relevant option for a number of countries; particularly for open economies with close links to a partner country or a partner single currency area that maintains price stability or for countries experiencing high inflation, where anchoring the currency provides a simple and credible rule for monetary policy. Needless to say that the intermediate solutions are considered particularly appropriate in the European framework where the belonging to an exchange rate mechanism plays a major role in the preparation to join the single currency.

– In cases where countries need to respond to very large capital inflows and related risks of inflation and real appreciation, greater exchange rate flexibility might become desirable.

Let me conclude these considerations with two observations:

– First, we should concentrate all our efforts on implementation of existing codes and standards. Implementation is the key word at present times. Applying standards and codes in all economies of the world, including emerging economies and economies in transition is an immense, challenging and urgent endeavor.

– Second, as regards the private sector involvement, I will recommend being as pragmatic and as consistent as possible. Pragmatic because a case by case assessment is always needed and there is, in my opinion, no mechanistic "a priori" approach which would be advisable. Consistent, meaning that once the assessment is made by the international community on the concept of the participation of the private sector in the crisis solution, we have to stick to it.

2. Let me turn now to the second topic of my presentation which relates to the economic strengths of the euro zone and its impact on the euro itself

More specifically, I would like to stress the three reasons which make me confident in the euro zone and therefore convinced that the euro will significantly appreciate in the future:

– the euro zone may expect a long phase of steady economic growth;

– structural reforms are underway so that a strong economic growth will be sustainable;

– European firms are restructuring themselves and entering further into the global competition.

2.1 The euro zone may expect a long phase of steady economic growth

In the past months, the euro zone has benefited from a strong economic recovery. At the end of 1998 and more notably in the first half of 1999, most European countries faced a temporary economic slowdown, partly resulting from the financial and economic turmoil of East Asia. But since then, the euro zone has benefited from a strong economic recovery (4% in annual term during the second half of 1999). One important feature of this evolution is the fact that countries whose economic growth had been lagging so far are now catching up.

This present economic recovery is taking place in a sound economic environment. Inflation level remains under control even though the balance of risks to price stability has recently gone up: some pressures have resulted from recent oil price rises or may result from some capacity constraints that could be encountered in the course of next years. Needless to say that the Governing Council of the Eurosystem has been and will remain vigilant in order to secure our primary objective of price stability.

Besides, the current account is slightly in surplus and fiscal deficits are, in the euro zone as a whole, on a downward trend.

It is worth stressing that European economies have never been creating so many new jobs so fast. The past two years (1998 and 1999) have seen very rapid job growth (about +1.5% a year) and a very big decrease in unemployment. In France, the rise has been sharper since almost 900,000 new jobs were created by enterprises (excluding Government administration) from December 1996 to December 1999 i.e. +6.6% over three years. With the economic growth speeding up, we can expect a further drop in the unemployment rate which is presently below 10%.

Due to this economic recovery, the growth differential between the US and the euro zone is progressively to disappear. This gap between the two economic zones in terms of economic growth has resulted in the past years from the lag between their economic cycles. According to the present analysts' consensus, growth differential between the two zones is to narrow this year and practically disappear next year. According to the IMF forecasts, growth should reach 3.2% in the US in 2001 compared to 3.0% in the euro zone.

2.2 Structural reforms which are underway in Europe are likely to permit a sustainable non-inflationary growth

The undertaking and speeding up of structural reforms is one of the conditions for a complete success of the euro. In this regard, the Lisbon European Council, held last 23 April, can be viewed as a further important step towards the necessary medium term strategy for structural reforms in the Union. The labor market has become more flexible in the past few years in Europe. I would like to give a few examples of this evolution. In all countries, the number of people on fixed-term contracts has quickly increased; they counted for a large part of jobs created between 1995 and 1998 and the trend has continued since then. In many countries, fiscal measures (for instance reduction of non-wage costs) have given incentives to hire younger and less-skilled people (France, Italy, Spain and Germany). Another key change is the rapid growth in part-time employment, especially among women.

While Europe has long had a strong tradition of economic regulation, it must be acknowledged that deregulation is well underway in most countries. The change is particularly noticeable in several key sectors such as telecommunication (mobile phones in particular), transportation (particularly airlines) and the power-supply industry (electricity and gas) to only mention a few of them.

Major countries have embarked on an ambitious overhaul of their public sector. In countries with a large public sector, such as Italy or France, ambitious privatization programs have steadily reduced the number of state enterprises (banking and insurance sectors, manufacturing sector…). It is noteworthy that these programs have been carried out by various governments with different political orientation. In addition to privatization, state enterprises are changing; companies that remain government owned are becoming more profit-minded (particularly airlines, railways…).

2.3 European firms are restructuring and entering further into the global competition

European firms are going through a deep restructuring. Mergers and acquisitions have hit new records as companies seek to create national, regional or global market-leaders (M&As close to $1,500bn in 1999 against 500bn in 1997). Venture capital and start-ups are booming as investors and entrepreneurs become more convinced that Europe can compete with America in knowledge-based industries. Heavy industries and large conglomerates are restructuring as never before. Finally, new rules on corporate governance are spreading over.

The outflows of foreign direct investments merely mirror the dynamism of European firms. European firms were lagging behind US firms in terms of foreign direct investments and they are catching up. European firms have entered in a “globalization process” whereby they aim to reach a global size through external purchases.

As a conclusion, I would like to make three remarks: on the global financial markets, on the euro and on the People’s Republic of China.

– On the global financial markets, I will draw our attention to one of the most important challenges we have to face up with: the “*herd instinct*” of *market participants,* which, in certain cases, can amplify considerably volatility, create or augment misalignments and induce large-scale global contagion in case of local crisis. The herd instinct is probably profoundly enshrined in the functioning of the marketplace. In order to minimize its effects, I have three provisional conclusions:

  - Perhaps we should have a second look at the very rapid generalization of day to day *mark to market accountings.* Perhaps a better medium term functioning of the market would call for a clear distinction between various market participants depending on their own time horizons.

  - It seems to me that it would also be important to reflect upon the consequences of the very rapid increase of mutual funds in some major markets. All the managers of these funds have to prove permanently on a very short-term basis that they are better managed than the average. This creates a very powerful potential herd instinct.

  - Finally, I profoundly think that *full transparency is the most efficient tool* to counter the setting up of a “herd” and to cope with potential “herd” behavior. When one knows all about a particular “signature” or about a particular country, there is much less reason to embark into blind crisis contagion. Here is the motto I would like to be accepted globally by market participants: “Let us judge the quality and creditworthiness of any particular signature upon its own peculiar fundamentals, upon its own, particular, assets and liabilities”.

– On the euro, I want to stress that the euro zone has adopted a sound macro policy and has embarked in a fairly comprehensive program of structural reforms. These reforms will take time to be fully completed. But they have already boosted economic growth, job creation and the restructuring of firms. I am impressed by what has been achieved during the past years and National Central Banks as well as the ECB are strongly encouraging governments and corporate businesses to foster structural reforms and business restructuring in the future.

  The Eurosystem, which is the guardian of the euro for the sake of the people of Europe, knows that our fellow citizens want the single currency to be at least as solid as were their previous national currencies: in France, to give only one example, 96% of the people are calling for the euro to be at least as solid as the Franc; needless to say that it is the same in Germany and in all other countries of the Monetary Union. That is the reason why I fully subscribe to the declaration of our President, Wim Duisenberg, in the name of the Governing Council: “European citizens can be assured that the future of the euro is that of a strong currency, based on price stability and the strength of the European economy.”

  A stable, a solid, a strong euro is in the interest of Europe.

– On the People’s Republic of China, I would like to praise the highly responsible attitude which has been adopted by Beijing during the Asian crisis. China has played a decisive role in helping stabilize the full body of the Region and has gained an immense credit not only in Asia but in the global community as a whole. I entirely share the sentiment of Premier Zhu on the role of the prudent monetary policy of the People’s Bank of China in that success.

I have been impressed by the quality of the contributions delivered in the occasion of the 21st Century Forum.

If there is a lesson I draw from the exchange of views, here under the auspices of the National Committee of the Chinese People’s Political Consultative Conference, it would be the decisive importance of foreign direct investments in the development of the economy of China. FDI’s are the best recipe for a successful and balanced globalization.