Jean-Claude Trichet: Views on recent economic developments in the euro area and international financial architecture

Address by Mr Jean-Claude Trichet, Governor of the Banque de France, at the Institute of International Finance Spring Membership Meeting held in Hong Kong on 1 June 2001.

* * *

Ladies and Gentlemen,

It's a great pleasure for me to share some views with such a distinguished audience on two topics of great importance: the first one deals with recent economic developments in the euro area and the motivations of the last 25bps rate cut by the ECB on its 10 May's meeting. The second point deals with the very important question of international financial architecture.

Let me start with the first topic.

The global outlook for 2001 continues to be characterised by sizeable uncertainties, amid the readjustments taking place in the American and Japanese economies, and their impact on the rest of the world. In the United States, however, while the GDP growth estimate for the first quarter of 2001 indicates that the slowdown has been substantial, the economy is still driven so far by firm consumer expenditure.

Economic activity in the euro area in 2000 expanded at an annualised rate of 3.4%, the strongest growth since 1990, driven by buoyant domestic and foreign demand. The general outlook for this year and next one remains positive, even if, clearly, some impact of the American slowdown is already visible. Private investment and consumption are expected to continue growing at a sustained pace, whereas the impact of slower world economic growth is expected to weigh on exports, with also a transitory impact on inventories. Indeed, economic activity in the euro area is largely determined by domestic factors such as long-term financing costs and disposable income developments, which have remained favourable. Furthermore, the still high rates of capacity utilisation in the manufacturing sector, the ongoing growth in employment and continued declines in unemployment should help maintain positive growth in private investment and consumption.

Employment in the euro area is estimated to have increased by 0.6% in the first quarter of 2001, compared with the previous quarter, confirming continued solid job growth creation over the recent months.

Notwithstanding sustained reductions in the aggregate unemployment rate and relatively rapid employment growth, **wage increases** in the euro area have so far remained moderate. Per capita nominal compensation of employees grew by 2.0% in 1999 and by 2.4% in 2000, while unit labour costs increased by 1.3% and 0.9%, respectively. There are a number of factors that help to explain why the increases in oil prices and their impact on inflation have not influenced wage developments in a period of falling unemployment. They include the employers and the general public's confidence in the capacity of the ECB to ensure price stability. It is crucial that social partners continue the process of wage moderation seen in the past. This will not only facilitate the task of monetary policy, but will contribute to the continued reduction of unemployment in the euro area. It is the best recipe for sustainable robust growth.

In addition, long-term growth perspectives for the euro area will be strengthened if Member States intensify fiscal consolidation. All in all, looking ahead, GDP for the euro area is expected to grow approximately close to trend potential growth.

In a context of moderate but still substantial economic growth and of inflationary pressures, which are expected to weaken over the medium run, the Governing Council of the ECB decided on its Thursday 10 May's meeting to adjust the key ECB rates by 25 basis points. More precisely, as our President Wim Duisenberg explained on behalf of the Governing Council, the decision was grounded on the following key monetary, financial and economical developments:

On the monetary side, which constitutes as you may know the first pillar of the ECB monetary policy strategy, M3 growth no longer poses a risk to price stability. Such a statement results from the following considerations:

- M3 growth has been on a gradual downward trend since the beginning of last year, reflecting the tightening of the ECB monetary policy, which started in November 1999. In the period from February to April 2001, the three-months average of the annual growth rates of M3 adjusted for holdings by residents outside the euro area of money market fund shares was 4.6%, which roughly corresponds to the reference value of 4.5%. Although credit aggregate figures remained dynamic, some slowdown has also been observed in their case.
- in addition, there is now clear evidence that M3 figures are distorted upwards by non-euro area residents' purchases of negotiable paper included in M3. This distortion has become more sizeable recently and can roughly be estimated to around half a percentage point.

All in all, information gathered from the first pillar pointed out that there were less risks to price stability over the medium-term emanating from monetary developments.

As regards the second pillar of the ECB monetary policy strategy, upward risks to price stability over the medium-term also have diminished somewhat.

Still, HICP growth rate has accelerated on a year-on-year basis in April to 2.9% and possibly the figure for May will not be very good. But these developments mainly seem to be generated by temporary factors that should substantially diminish over next 12 months to permit inflation to go back below the level of 2% which is our ceiling for the definition of price stability.

However, evidence as well as global uncertainties regarding the international context also require continuous monitoring of growth trends and wage developments.

Temporary factors could still affect price developments for some months to come: health concerns related to meat consumption and the consequences of the outbreak of foot-and-mouth disease could continue to affect unprocessed food prices. Furthermore, pass trough of past rises in oil prices and the depreciation of the euro are likely to affect price developments for some months.

Let me now turn to the question of International Financial Architecture.

Impressive progress has been achieved in the recent years to reinforce international financial stability and to enhance prevention. We must continue our efforts toward further progress as regards the reform of the financial architecture. I also think that fruitful lessons can be drawn from the assessment of the new characteristics of financial markets and their impact on financial stability.

1. We must pursue and reinforce our efforts towards a renewed international financial architecture.

These efforts should tend to improve prevention and management of financial crises.

1.1 Strengthening prevention

Strengthening prevention calls for parallel efforts from all actors, international financial institutions, investors and public authorities. Prevention lays on appropriate surveillance and adequate macro-economic policies.

*1.1.1 As regards **surveillance**, much progress has already been achieved:*

- In the *institutional field*, important changes have recently occurred: let me mention the impressive work carried out by the Financial Stability Forum in 1999 (e.g. reports on Highly Leverage Institutions, Capital flows, Incentives to Foster Implementation of Standards). I could also quote the work of the G20 or the International Monetary and Financial Committee. Together with the existing institutions such as the IMF, the World Bank and the BIS at the international level, we have probably now an efficient structure to cope with current and future international financial challenges.
- The implementation of internationally acknowledged *standards* will contribute to 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.
    - Many efforts have already been achieved with the design of 65 internationally agreed standards and codes; the Financial Stability Forum identified 12 out of them as key for

the international financial stability and suggested incentives to implement them. The implementation of these standards is in the self interest of all partners in the process of economic and financial globalisation. The commitment of countries to implement Codes and Standards is likely to be reinforced if market participants actually reflect information on observance of Codes and Standards in differentiated credit ratings.

- International Financial Institutions have also continued to proceed toward greater transparency, in particular the participation of 60 countries on a voluntary basis in the pilot initiative for the release of IMF article IV reports.
- As regards the private sector, progress may take the form of voluntary improved disclosure, more demanding statistical reporting and extended requirements for non-transparent segments of the financial markets.

1.1.2 Prevention also lays on sound economic conditions.

A sound macro-economic framework and appropriate macro-economic policies are essential as they condition the resilience of any economy to external shocks. Three issues are worth being addressed in that respect:

– As far as the choice of an *exchange rate regime* is concerned, the sustainability of any regime depends crucially on its consistency with a country's domestic macroeconomic and structural policy framework. As a consequence, the so called "corner solutions" are not necessarily the only available options; "intermediate solutions" remain relevant options, particularly for open economies with close links to a partner country (or a single currency area) that maintains price stability, or for countries experiencing high inflation anchoring the currency provides a simple and credible rule for monetary policy; in that regard, intermediate solutions might be particularly appropriate for countries which apply to join the European Union.

– The *soundness of domestic financial systems* is a core element in the ability of an economy to resist external shocks; furthermore, it is clear that weaknesses in the financial system can lead to financial instability and therefore trigger capital outflows, as experienced in the context of recent financial crises. As a consequence, emerging market economies should establish an appropriate institutional, supervisory and regulatory framework, building on international standards, such as the Core Principles for Effective Banking Supervision issued by the Basle Committee on Banking Supervision.

– The implementation of *sound macro-economic policies* is also key as regards crisis prevention. In that respect, let me just say a few words on 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 sector 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.

1.2 Clarify the principles governing crisis resolution and the distribution of roles among actors

I would like to give you my views on two issues at stake which are of great importance and strongly inter-related, i.e. the role of the IMF and the involvement of the private sector.

1.2.1 The IMF should remain at the centre of the process for crisis resolution

Whatever the prevention features, crises will still occur in the future. In that respect, I would like to focus on the roles of the IMF as regards both international lending and crisis management.

– As regards its *lending role*, in my view, the IMF cannot act as an international lender of last resort. First, it has only limited resources that can not match private capital flows; second, the perception of such a role would increase *moral hazard*. The IMF should not thus provide unlimited and unconditional financial support, its catalytic role remaining a core element of financial crisis resolution. As a consequence, IMF financial assistance should be ex ante limited in terms of quotas. Access above these regular limits should be exceptional and allowed only in cases of systemic risks. However, if short-term financing is the bulk of IMF lending role, the IMF should also promote macro-stability, including structural matters relevant for macro-economic policies. As a consequence, the IMF needs a medium and long term surveillance and medium and long term facilities for adjustments to take hold.

– As regards its role in *crisis management*, the IMF could concentrate on agreeing with the crisis country a program which ensures adjustment and financing over the short and medium-term:

  - This means, for example, that IMF conditionality should cover short and medium and long term issues. The Asian crisis has led to an extension of IMF conditionality to structural areas, mainly as regards financial systems restructuring issues. This extension was somewhat criticised but I do not share such views: including structural matters in the IMF conditionality is clearly in line with IMF missions as regards financial stability and should reinforce its efficiency. In that respect, the review of IMF conditionality under process should not mean, in my opinion, that it should necessarily be weakened, by focusing only on short term macroeconomic variables.

  - While facing a financial crisis, the IMF could indicate the relative contributions of official finance and private sector finance as well as the domestic economic adjustments required to fill the gap. Before disbursing its share of financing, it should review and assess the country's efforts to secure the contributions from private creditors required to ensure medium-term sustainability; failing to secure the needed contribution from private creditors could lead to a revision of the program to require additional domestic adjustment.

2. Changes in the functioning of financial markets in the recent years also raise important issues that the international community may have to address.

There is no need to underscore how much financial markets have changed in the last two decades under the combined impact of factors such as financial deregulation, technological and financial innovation, intensifying competition among financial institutions and increasing demands for more transparency and greater profitability. These changes have enhanced the overall efficiency of financial markets and, by extension, that of the developed economies*:*

– Markets have become more transparent and competitive.

– Financial innovations have made it easier for both governments and the corporate sector to raise capital or hedge risks.

– Economic agents with funds to invest, in particular households, can choose from a wider range of investment vehicles offering better returns.

– Growing disintermediation has contributed to less inflationary financing of economies.

Despite all these achievements, there have been some surprising developments on financial asset markets. While the rapid emergence of the "new economy" bubble in 1999 and early 2000, followed by a series of sharp corrections, illustrated once again the potential of modern financial markets, e.g. to finance technological innovation, it also demonstrated their tendency to over-react, moving from excessive optimism to disproportionate pessimism, with the ensuing negative consequences for the behaviour of firms and households.

We should be very attentive to these boom-bust episodes on financial asset markets, since they can affect the monetary and financial stability of the world economy. I would like to discuss two issues here:

– First, some factors encouraging excessively homogeneous market behaviour may hinder a smooth and efficient functioning of the markets, and

– Second, ways of fostering more diverse behaviour on the markets should be considered.

2.1 *Some factors encouraging excessively homogeneous market behaviour may hinder a smooth and efficient functioning of the markets*

Financial asset prices fluctuate widely and sometimes deviate from economic fundamentals for long periods of time. Several factors are in play when this happens. I shall give a few examples.

– Some market participants have become more inclined to engage in "*short-termism*", that is, they are too preoccupied with their short-term results. This trend might result, in particular, from growing pressure to yield immediate financial results that are not necessarily sustainable.

– *Mimetic behaviour* is by no means a new phenomenon on financial markets. However, technological developments on markets may have gradually reinforced this type of behaviour. The spread of benchmarking, which allows fund managers and clients to measure performance against that of other funds, together with the growing competition within the sector, appear to have increased such mimetic behaviour. Some operators have come to the conclusion that it is better to be wrong along with everybody else, rather than take the risk of being wrong alone.

– The spread of certain fund management techniques, in particular *index management*, which has proven very popular on equity markets, may have contributed to amplifying movements in financial asset prices. This technique endeavours to match as accurately as possible developments in stock market benchmark indices. It therefore mechanistically leads managers to accentuate current price trends by buying stocks that are on the rise and selling those that are falling.

– *The impact of risk management techniques on market dynamics* is particularly enlightening with regard to the question of asset price overshooting. Of course, central banks and financial institutions should continue to encourage the use of these instruments. But, in times of financial turmoil, the growing use of sophisticated risk management techniques by financial intermediaries has had the paradoxical effect of amplifying the initial shock and the spill-over effect. Regardless of the intrinsic qualities of these risk management tools, their growing use may have produced pernicious effects. When market players rely on converging risk evaluations, they tend to take the same decisions at the same time, thus amplifying the initial shock to prices and trading volumes.

All these factors have one consequence in common: they encourage *homogenous behaviour and reactions* to the detriment of the diversity that is conducive to the smooth functioning of financial markets.

2.2 *For this reason, we could reflect on some ways – together with the financial industry – on possible ways to foster behavioural diversity in global markets.*

To safeguard the smooth functioning of the markets, and in particular an efficient pricing mechanism, it would be opportune to protect, and even reinforce, the diversity of behaviour on the markets. This necessary diversity is merely the echo of the different time horizons, strategies and reaction functions of market players. On this point, I would like to explore with you a few possible avenues.

2.2.1 First and overall strengthen the continuing efforts aiming at market transparency:

– Experience shows that uncertainty and incomplete information are determining factors in mimetic behaviour. These shortfalls in market transparency make herd behaviour seem rational to agents, who prefer to follow bigger participants, who are thought to be better informed, rather than develop their own analysis. Strengthening transparency therefore is, more than ever, a priority.

– One of the objectives of transparency is to enable better differentiation of borrower creditworthiness. A key feature of mimetic behaviour is that all borrowers are "tarred with the same brush". So when one emerging economy encounters difficulties, all neighbouring countries, or countries that share common characteristics, are treated in the same way – regardless of their actual economic and financial situation. The same applies to businesses operating in the same economic sector. Transparency has substantially increased since the Asian crisis thanks to a solid global consensus – let us continue and reinforce these efforts-

2.2.2 Take into account the medium and long-term perspective of some market participants:

– Some investors, such as pension funds and insurance companies, have to invest funds in order to enable their customers to build up wealth over the medium and long term, notably in preparation for retirement. Consequently, this type of investor are supposed to behave differently from traders and short-term investors, who are working on a very different time horizon. But at times it seems that they are all pushed to behave in much the same way, on the basis of an overwhelmingly dominant very short-term horizon.

– To preserve, and even restore, their specific investment approach, these particular investors might be more shielded from excessive short-term pressures. This objective raises considerable difficulties, because it touches on the way in which the performances of medium and long-term funds (including pension funds) and life insurance companies are assessed.

2.2.3 Diversify the risk management tools of financial institutions:

– As I mentioned earlier, even the best techniques can have adverse effects. To some degree, this is perhaps what has happened to value-at-risk based techniques, which have been massively adopted by the financial industry. Because they use more or less similar parameters and have the same features – for example, they took inadequate account of market liquidity at the time of the 1998 crisis –, such tools tend to give converging signals to those that use them. They thus encourage the herd behaviour that I discussed previously.

– Of course, the fact that some market participants are more sophisticated than the average is a guarantee that standardisation will remain limited, since they will develop techniques that are little used by others.

– However, supervisors are helping to spread the idea that financial institutions should round out their current range of risk management tools to include extensive use of stress testing. This technique offers a better reflection of the varying situations of institutions and of the diverse perceptions that institutions have of exceptional events. The application of stress testing techniques and their results are thus inherently more diversified than those resulting from methods based on the value-at-risk approach.

These are only examples of options to help improve *the functioning of markets*.

Indisputable progress has already been made: the generalisation of concepts of appropriate transparency since the Asian crisis and the comprehensive use of stress testing are two significant examples. However, I would like to stress one point. There is probably some merit in an overall review of regulatory, accounting and tax rules and regulations, as well as of codes of good conduct and good practices, and of structural developments of market themselves, to identify possible amendments and improvements that could help protect and enhance the behavioural and conceptual diversity of modern financial markets.