Jean-Claude Trichet: Preserving financial stability in an increasingly globalised world

Keynote speech by Mr Jean-Claude Trichet, Governor of the Banque de France, at the European Financial Markets Convention (EFMC 2001), Paris, 15 June 2001.

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Ladies and Gentlemen,

It is a great pleasure for me to participate in this European Financial Markets Convention. The impressively dense program of the Convention illustrates that the integration of financial markets in Europe is a major and multi-dimensional challenge. The Banque de France and the Eurosystem have a strong interest in all these issues. In particular, a safe and efficient functioning of the clearing and settlement systems of the euro area is crucial for the stability and efficiency of the financial system and for the good implementation of monetary policy. The consolidation of the market infrastructure, currently underway, will contribute to reaching these objectives through the fostering of market liquidity and the reduction of transaction costs. There is however no single path for such a consolidation: it will be up to the market to select the way which best fits its needs, while it will be up to regulators and to the Eurosystem to make sure that the resulting infrastructure is adequately safe, efficient and reliable.

I would like now to share with you some views from the broader perspective of financial globalisation. As you know, the globalisation of the world economy and the development of financial markets were driven by two key factors:

- firstly, financial deregulation -reinforced in Europe by the setting up of the single market and subsequently of the Economic and Monetary Union- which liberalised capital flows and enhanced competition among financial sectors;
- and secondly, technical and financial innovation, which simultaneously paved the way for the creation of financial markets that are deep, liquid and interconnected.

What is interesting to stress regarding financial globalisation is that the interaction of free capital movements within interconnected markets, increasing integration of market segments and hedging opportunities provided by new financial instruments have allowed **a better fit between the financing capacities and borrowing requirements** of governments, households and companies. The use of market interest rates, which represent the markets' consensus on the risk incurred at a moment, as a driving force is fully beneficial to an **efficient allocation of capital**.

Lowering the barriers to entering the financial sector, the free circulation of information and fiercer competition have also brought financial markets closer to a situation of **pure and perfect competition**, which is beneficial to all consumers.

Last but not least, the growth of market financing has allowed savings to be channelled directly into investment. Reducing the share of bank financing, and consequently that of money creation, has enabled a **less inflationary** financing of the economy. Thus increased, monetary stability has produced tangible and positive effects and contributed decisively to **a strong and sustainable growth** of the world economy.

However, while globalisation and financial integration have decisively contributed to improving overall economic efficiency, experience also suggests that ***financial asset prices*** have experienced in some circumstances somewhat erratic developments. The rapid emergence of the "new economy" bubble in 1999 and early 2000- followed by a series of sharp corrections- illustrated the potential of markets for providing funding to the real economy, particularly to the most innovative sectors; but it demonstrated again the tendency of markets to over-react, moving from excessive optimism to disproportionate pessimism, with the ensuing negative consequences for the behaviour of firms and households.

Thus financial authorities have been confronted with boom-bust episodes which must be carefully monitored, since they could affect global monetary and financial stability. I would like therefore to consider two issues here:

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

- Second, the authorities might reflect on some ways of fostering more diverse behaviour on the markets.

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

Even though fixed interest rate markets have a tendency to be somewhat contra-cyclical, financial asset price have tended to fluctuate widely and sometimes deviate from economic fundamentals for long periods of time.

Experience suggests that asset price cycles continue to be very substantial

In the last two decades market forces have indeed tended to cause misalignments between equilibrium and actual asset prices. Stock markets in particular have experienced this phenomenon. But in foreign exchange markets as well, prices have also a tendency to diverge substantially from their "equilibrium level", although those divergences have been contained through fruitful G7 co-operation during the last 15 years.

In addition, some markets have seen ***an increase in volatility and frequent volatility peaks***. Although cyclical moves should be clearly distinguished from volatility, the latter may in some circumstances exceed what can be considered optimal, making the price determination mechanism less efficient and thus contributing to misalignments.

Moreover, as demonstrated by a number of financial crises during the last two decades, ***contagion among countries and across financial markets has been frequent***. As a result, investors have faced asset price fluctuations that might be more synchronised than before.

Lastly, the connections between credit, asset price and business cycles have tended to amplify cyclical swings. Credit, in particular, is playing an important role in asset price fluctuations. Observed in particular during the "speculative bubbles" of the 1980s and early 1990s, this trend has persisted. Another example is provided by boom-bust cycles in asset prices which have often been associated with sharp economic contractions.

Several factors are in play when financial asset prices experience amplified moves

I shall give a few examples.

Some market participants have become more inclined to engage in "*short-termism*", that is, they might be 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. Marking-to-market all assets and liabilities has also contributed to this widespread focus on immediate financial performances. This focus on short-term performance can translate into additional volatility in the price discovery process: the shorter the investment horizon of market participants, the bigger the impact of any new information on prices.

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, appears 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 right, or wrong, alone. A striking example of rational mimetic behaviour is the influence that hedge funds enjoyed, a few years ago, as "opinion leaders" and trend makers. By its nature, trend following amplifies the imbalance that may at some point affect a market, potentially leading to vicious circles of price adjustments and liquidation of positions.

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. It can be argued that

index funds distort the price of the targeted indexes and that, as a result, the indices might end up creating rather than measuring performance.

The impact of risk management techniques on market dynamics is particularly enlightening with regard to the question of asset price overshooting. Value-at-risk calculations have become a crucial element of the standards approach used by market participants to evaluate the risk inherent in their market activities and set up exposure limits. 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 homogeneous 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 some adverse consequences. 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 indispensable to the smooth functioning of financial markets.

For this reason, the authorities might reflect on some ways – in conjunction with the financial industry – to foster behavioural diversity in global markets

Monetary policy alone cannot guarantee the stability of financial systems, which may be jeopardised by shocks from both the financial and the real economies. However, it must be stressed that ***an adequate monetary policy is a fundamental prerequisite*** to smooth the financial cycles. An appropriate monetary stance is crucial for banks and monetary participants to base their decisions on solid ground. The objective of price stability lowers economic agents' uncertainty regarding future price developments. In addition, by committing itself to a long-term objective, the central bank reduces market uncertainty, which can be a source of disruption to the financial economy. Interest rates and money supply are less volatile as a result, which is of benefit to the long-term growth of the economy.

However important, a sound monetary policy is not enough. To safeguard the smooth functioning of the markets, and in particular an efficient pricing mechanism, it is essential 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 a few possible avenues for future action.

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 mimetic 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 continues to be 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.

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, these types of investors 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 a very short-term horizon.

To preserve, and even restore, their specific investment approach, these 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. In other words, this objective concerns the accounting standards and practices they use. It implies that some rules and standards would be adapted to the medium and long-term horizon used by these entities. I have no answer at this stage. I am only asking the question.

Diversify the risk management tools of financial institutions

As I mentioned earlier, even the best techniques can have adverse effects when used by too many participants. 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 suffer from the same weaknesses – 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 mimetic behaviour that I discussed previously.

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. In this respect, I must stress that the Basle Committee, as illustrated by the new Capital Accord, is encouraging banks to use more sophisticated and accurate risk measurements techniques.

In addition, supervisors might help –and obviously they are already 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*. 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.

In conclusion, let me stress the important role played by central banks in preserving monetary and financial stability in an increasingly globalised world.

The recent years have shown the benefits of monetary stability in terms of growth in a globalised world. It is of course closely linked to central bank’s independence, which is no longer a matter of debate.

Financial authorities are nevertheless faced with a new challenge, which is to strengthen financial stability in a context of amplified financial cycles. I would like to stress what I feel is the highly complementary nature of price stability and financial stability objectives: price stability is the bedrock on which financial stability is built.

Central banks have a undoubtedly special responsibility due to their position at the heart of financial systems:

- they contribute directly to supplying liquidity to the economy,
- their close and constant contact with credit institutions gives them a thorough understanding of banking systems,
- they contribute to banking supervision,
- last but not least, central banks are responsible for a safe and efficient functioning of payment systems and, at least for some of them, of securities clearing and settlement systems.

I thank you for your attention.