Jean-Claude Trichet: The international financial architecture

Speech by Mr Jean-Claude Trichet, Governor of the Bank of France, to the Foreign Policy Association, New York, 30 September 2002.

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I am delighted to be here in this great city, speaking to this prestigious association. Let me start by paying tribute to the *Foreign Policy Association* and to *its* contribution to the international debate with immense experience.

Let me also say how Banque de France feels very close to the New Yorkers one year after the tragic events of September 11. As the French daily “Le Monde” rightly emphasised: “We are all Americans”.

I am just coming back from the international monetary and financial meetings which take place every year in Washington. I am lucidly and cautiously confident that we will overcome present difficulties. And in my view there is no room either for undue pessimism or for any kind of complacency.

What has happened during the recent period of time?

Some financial markets have experienced sharp corrections and several large corporate firms have failed or been confronted with significant difficulties; meanwhile, a few major emerging market economies have got into deep financial troubles. However, financial systems have been so far resilient and the economic recovery is underway, although more slowly than first anticipated.

Against this background of uncertainty and shocks, and in order to reap all the benefits of the fantastic process of economic and financial globalisation, we are still facing two main challenges:

First, we observe persistent financial instability of which the ICT and equity bubble is a striking example. What are the factors behind such developments and which avenues should we explore in order to mitigate financial instability?

Second, we had to cope with repeated financial crises in emerging market economies since the early 80s. Our challenge is how to prevent such crises and, if they occur, how to ensure that effective and predictable methods for crisis resolution are available, and enforced.

In my view, the new international financial architecture (understood broadly) should provide appropriate policy responses to both types of challenges. Of course, they are interlinked in many ways.

For the sake of clarity, I will address these two types of issues separately.

- First, I would like to show that some by-products of financial integration may have had adverse effects on the stability and efficiency of the financial systems;
- I will then try to put into perspective recent crises in emerging market economies.

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1. Some by-products of financial integration may have had adverse effects on the stability of mature financial systems

1.1. I would like to briefly sketch two main features of this financial instability:

First, while globalisation and financial integration have decisively contributed to improving overall economic efficiency, experience also suggests that <u>financial asset prices have experienced in many occasions somewhat erratic movements</u> resulting in overshooting and misalignments.

This pattern applies to a wide range of markets: exchange rates as well as bond and equity markets in both emerging and mature markets. The very fast ballooning of the "new economy" bubble in 1999 and early 2000 -followed by a series of sharp corrections- illustrates the potential of markets to provide funding to the real economy, particularly to the most innovative sectors; but it also demonstrates again some tendency of markets to over-react, moving from excessive optimism to disproportionate pessimism.

Thus, financial authorities have been confronted with boom-bust episodes which must be carefully monitored and assessed since they have the potential to affect the global monetary and financial stability.

The second feature is a growing tendency towards volatility on financial markets, in the most advanced economies as well as in emerging markets economies.

Since the beginning of the mid-nineties, volatility has become higher on both international stock markets and foreign exchange markets. Volatility per se is not an issue from a financial stability point of view. Not only is volatility inherent to financial markets but it is taken into account in many areas of the operational frameworks of financial markets.

However, the micro effects of volatility, particularly of unwarranted or unexpected volatility, may actually impair the smooth functioning of financial markets, through different channels. For instance: the asset pricing process and the determination of equilibrium prices is being complicated; transaction costs and collateralisation costs increase; the fragility of financial intermediaries' balance sheets increases; the unequal ability of market participants to tackle volatility movements can increase polarisation among participants, and develop risks of an uneven playing field. Ultimately, these effects may unduly raise the costs and bias the allocation of capital, a source of concern from a financial stability point of view.

Such a higher volatility may have a globally negative impact on market efficiency. Indeed, higher volatility may lead to excessive risk aversion among investors and finally to a misallocation of capital, at both the global and sectorial levels. It may also lead to some lack of discrimination between different debtors which can be especially detrimental to growth in countries who need capital most.

1.2. Several factors are at play when financial asset prices experience more amplified and volatile moves.

The first set of factors relate to the behaviour of market participants:

Some market participants have become more inclined to engage in "short-termism", that is, they might be too much concerned with their short-term results, exhibiting market "myopia". This trend might result, in particular, from growing pressure of investors to yield immediate financial results that are not necessarily sustainable, the so-called "tyranny of return on equity". Moreover, the mark-to-market completed by mark to model of a wide range of 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: indeed, the shorter the investment horizon of market participants, the larger the impact on prices of any new information.

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 favoured such "herd 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 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.

The second set of factors relates to new market techniques or financial engineering devices. Here are a few examples of some of these mechanisms:

- The inclusion of contingent or trigger clauses in loan and bond contracts. These clauses provide creditors with a form of insurance since the level of interest rate paid by debtors increases when specific trigger events occurs (typically the downgrading of the debtor by rating agencies). These clauses were designed to help borrowers access financing at lower rates. However, these clauses create a sort of vicious circle. Indeed, rating agencies are expected to help borrowers to make informed decisions for future financing ; still, through these trigger clauses, rating decisions have an impact on the outstanding debt of borrowers, thus aggravating the situation of the debtor.
- The generalisation of credit risk hedging through short selling of stocks. Hedging is a key technique for a smooth functioning of financial markets. However, the use of new financial techniques to hedge has had unexpected consequences. Indeed, financial institutions have

tended to hedge part of their credit exposure on borrowers by short selling stocks of their debtors. Doing so, they have hedged their risks but at the cost of a further deterioration of the overall situation of their debtor associated with the fall of their shares resulting from such sales.

- The marketing of saving instruments with capital protection feature. These instruments are based upon a built-in asymmetry : they offer the full participation in stock market capital gains and the protection against possible capital losses. Either the issuers of such instruments are not hedged, and enormous risks are concentrated on them. Or, more likely, they are hedging their risks and thus they contribute to amplify current trends, be it downward or upward.

I have to be clear: all these techniques and instruments contribute to a better functioning of financial markets. For each and every market participant, they facilitate the management of credit and market risks. As such they are to be welcomed. However, if not fully understood at the micro level and not fully taken into consideration at a macro level, they may imply some unexpected adverse implications in terms of market dynamics.

1.3. Several avenues are being explored to mitigate financial instability

Strengthening the continuing efforts aiming at market transparency is one of the main avenue for future action. Experience shows that uncertainty and incomplete information are determining factors in mimetic behaviour. One of the objectives of transparency is to better differentiate borrower creditworthiness. A key feature of mimetic behaviour is that all borrowers are 'tarred with the same brush'. So when one firm or one business sector face difficulties, neighbouring businesses or sectors are treated in the same way regardless of their actual economic and financial situation. The same may apply between emerging market economies as we shall see later.

A careful examination of financial supervision rules and regulation, accounting standards, codes of good conducts, market practices and financial engineering seems also necessary to better understand their possible impact on market dynamics. There is a major public interest in trying to identify the elements that are pro-cyclical and those which are anti-cyclical. Financial authorities and market participants should commit to mitigate progressively, or possibly suppress, those elements of standards, regulations or financial techniques that are strongly pro-cyclical and, in the meantime, to reinforce the elements that could potentially counter the boom-bust tendencies.

Let me give two examples of what is being done:

- As regard prudential supervision, I would only mention the fantastic work which has been achieved by the Basel Committee under the leadership of Bill McDonough, the President of the Federal Reserve Bank of New York, in the field of banking supervision. I trust that the new accord will permit a better and more appropriate handling of this extremely important domain as regards financial stability. I am also happy that the concept of "dynamic provisioning", which is anticyclical by nature, has been recognised by the Basel Committee as a useful concept.
- As regards accounting standards, it seems to me that we should also inject in the present meditations in the US, in Europe and at a global level the concern for financial stability. Let us beware of changes that would increase the procyclicality of accounting rules. Let us favour changes that would simultaneously help fair accounting and diminish procyclicality. In that regard, it seems important to me to design accounting practices which would try to take into account of the time horizon of institutions and market participants. Otherwise, we would take the risk of driving all financial institutions and market participants to shorten their time horizon down to a day-to-day basis. This could be a recipe to favour inappropriate market functioning and foster herd instinct in time of excessive volatility.

2. The need for an enhanced framework for crisis prevention and management

I do not need to remind you of the long list of financial crises emerging market economies have gone through in the last two decades. Against this background, the international community must, on the one hand, enhance crisis prevention and, on the other hand, design and implement better procedures for crisis resolution.

2.1. Authorities must reflect, in conjunction with the financial industry, on building up a suitable system of surveillance and crisis prevention.

The objective of strengthening crisis prevention is shared by the private sector and by official community given the magnitude of potential losses; indeed, in some cases, restructuring costs for banking crises have reached more than 40 % of GDP.

Building on international standards and codes is instrumental in establishing an appropriate institutional, supervisory and regulatory framework in the financial sectors of all market economies.

The value of international standards is now widely recognised, insofar as they contribute to spreading international best practices and codes of good conduct, very closely linked to the globalisation process and the expansion of international capital flows. Indeed, the conduct of sound national economic and financial policies stands for a primary protection against potential financial contagion.

Much has already been achieved with the design of more than seventy internationally agreed norms. However, I observe that the IMF and the World Bank have completed a limited number of reports of observance of standards and codes (ROSCs) so far on areas such as corporate governance, accounting and auditing which are key in order to assess the financial vulnerabilities of the private sector. Recent corporate failures suggest that a renewed emphasis could be given to these areas.

Private initiatives aiming at disseminating information on standards and codes are also particularly welcomed. The private sector could develop further initiatives to monitor compliance by countries of international standards and codes. This should be carried out in parallel with efforts by the official sector.

How can we promote further the awareness and understanding of the key standards among emerging economies authorities? Encouraging a greater participation by developing and emerging countries in the development of international standards is fundamental. Without genuine ‘ownership’, implementation will not occur, as there is a risk that standards be seen as a new “colonial” system. The concept of ownership should not be restricted to the policies and corrective actions recommended by the IMF / WB in the context of programs, but rather should be understood as implying that all countries should be involved in the decision-making process in international groupings.

Assessing financial sectors strength has also been a top priority of the IMF and the World Bank.

Cases of financial turmoil in emerging countries, which are usually due primarily to inappropriate domestic policies, show that there is room for improving the timely identification and correction of vulnerabilities by International Financial Institutions. In particular, a key point is to improve the analysis of debt sustainability in order to have a more forward-looking assessment of possible cases of insolvency. We can only praise the ongoing work by the IMF on this matter. Unfortunately, enhancing warning signals will probably not be sufficient to protect us against financial crisis.

2.2. Designing effective procedures for handling international financial crisis represents another challenge

First, there is a need for clarifying the financing policy of the IMF, as acknowledged by the G 7 and the recent IMFC communique.

Greater discipline in the provision of official finance is key to ensure a more timely involvement of the private sector in crisis resolution (PSI), and to provide strong incentives for debtors and creditors to start debt negotiations timely and appropriately.

By doing so, the international community will benefit from the so-called « catalytic approach », that was at the core of crisis management in the 1980s and proved quite successful, and that was recently restated by the international community.

A precondition for an orderly crisis management relies upon more predictable decision-making process regarding the use of Fund’s resources. In that regard, the presumption of clear access limits to Fund financing is key. Therefore, we should define ex-ante the exceptional circumstances under which the international community is ready to go beyond the normal lending limits. These conditions should include external debt sustainability, appropriate adjustment policy measures and the perspective of a quick return to financial markets. I also believe that exceptional procedures should be put in place when IMF access limits are to be breached.

Second, procedures should be settled in order to limit the costs implied by unavoidable suspensions of payments. Indeed, these procedures should support the necessary informal dialogue between debtors and creditors prior to payment suspension and avoid the drawbacks of freezing market processes.

Some instruments could help to achieve a timely and orderly process. A co-operative standstill mechanism would help to achieve a more timely and orderly rescheduling or restructuring process. For example, commonly agreed *Guidelines* or *Best practices* by debtors and creditors under the aegis of the IMF could ensure that such standstills be implemented. In addition to the appropriate domestic adjustment policy, such Guidelines could cover rules regarding, *inter alia*, transparency towards creditors, reasonable offers to creditors, comparable treatment of all creditors, seniority for "new money", and a limited duration of the standstill.

Obviously, a more extensive inclusion of collective action clauses (CACs) in debt contracts can greatly facilitate the negotiation of debt restructuring, by promoting agreement among creditors. Industrialised countries could contribute to this strategy by including CACs in their foreign debt issues, a step already made by EU countries. The work undertaken by the G10, benefiting from private sector expertise, is most welcome and important in this regard.

Finally, the IMF's proposal for a Statutory debt restructuring mechanism (SDRM) is another contribution to the debate, in a medium term perspective, given its legal and technical implications.

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To conclude, let me stress three words: cooperation, leadership and stability. Close co-operation between the private financial community and the official sector in order to manage financial globalisation is of the essence. Consolidating this partnership implies that private investors are responsible for sharing part of the financial burden, but also that they can expect a fair treatment by the official sector in times of crisis. Here, the reliability of information provided by national governments and by the corporate sector is essential, as well as the availability of the outcome of the surveillance exercise from international institutions, in particular the IMF.

Leadership: The ideal of Bretton Woods was the promotion of prosperity through global action. We can preserve it in a changing world, provided that some rules are adhered to by all players. For my part, I believe in an important leadership role for the international financial institutions to make the transition toward the new financial architecture a smooth one. The determined action of the international financial community to achieve this objective is in particular more important than ever to avoid any backlash against trade and financial integration in emerging and developing countries.

And last but not least, stability. In a period of excessive volatility and of wide boost-bust episodes, financial and real stability appear to be a very precious asset. Over the last twenty years, we have constructed a new world: technology has permitted instantaneous communication and incredibly powerful real-time computation. Globalisation has created new cultural, conceptual, commercial and financial links between all economies including previously centrally-planned systems; together technology and globalisation are progressively driving us to a unified planet of universal rules and regulations, codes of conduct and practices, market procedures and market instruments, accounting standards, etc. In this new world, phenomena which had traditionally a local or even a national impact may be amplified and become dangerous at the global level: amplification of financial cycles, herd behaviour, global contagion. Analyzing the opportunities and the risks, and understanding the functioning of our system with a view to making it as stable as possible is a very exciting, ambitious and urgent task.

Thank you very much for your attention.