Jean-Claude Trichet: The transformation of the international financial architecture to meet the challenges of globalisation

Arthur Burns Memorial Lecture by Mr Jean-Claude Trichet, President of the European Central Bank, organised by the Atlantik-Brücke e.V., Frankfurt, 20 September 2004.

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It is with great pleasure that I have accepted the invitation of the Atlantik-Brücke to give this year's Arthur Burns Memorial Lecture. This lecture series is not only dedicated to an outstanding central banker but it has also had a history of eminent speakers in past years. Therefore, I would like to thank the Atlantik-Brücke for inviting me, and I also greatly appreciate the hospitality of the Bundesbank.

Tonight, I would like to offer some thoughts on transforming the international financial architecture to meet the challenges of globalisation. I will focus on developments over the last three decades, a period during which the international community has been confronted with tremendous and continual challenges arising from important structural changes in the global economic and financial system. During this period the international community has also learnt key lessons and has launched profound adjustments to what has been termed the international financial architecture, i.e. the policy framework of the global financial system.

Let me first explain what I mean by structural changes in the global economic and financial system. The steady opening-up of goods and capital markets has led to growing integration of different countries around the globe, and we are still witnessing this process today with the opening-up of India and China. On average, trade has grown much more rapidly than GDP over the past decades. Especially from the mid-1980s onwards and during the 1990s, world trade expanded substantially more than world output growth in every year, with the difference reaching as much as 7 percentage points in some years. These different growth rates imply that over the last two decades, real GDP has doubled whereas the volume of world trade has more than tripled. Moreover, trade has increasingly expanded, and now includes the full spectrum of tradable goods from primary commodities to finished products, meaning that many production processes, such as automobiles or computers, today span not only several economies, but also several continents. Financial integration has also increased due to capital market liberalisation, rapid technological change and financial innovation, and we see its strength both in good times and in bad.

This economic and financial globalisation has enormous benefits, but it also poses challenges and entails risks. One of the major benefits of globalisation is that emerging and also developing countries are increasingly involved in the exchange of goods and capital and can benefit from the transfer of know-how and technologies. Especially emerging markets have, over time, become major global trading partners as well as recipients of financial flows. Some of them, especially in Asia, have turned into nearly industrialised countries with decades of growth rates above those of high-income countries, and they have themselves become sources of international capital flows. Over the last four years, these roughly 20 emerging countries in Latin America, eastern Europe and Asia have accounted for about 30% of world exports and received about 20% of gross global foreign direct investment (FDI), a figure which is close to the FDI inflows into the United States.

Greater integration also means greater economic and financial spillover effects from one country or one region to the rest of the world. Some of these effects are positive, while others are less so. The main positive spillover, as I see it, is that the global economy has benefited from the strong growth in many emerging market economies, especially in Asia. China has become one of the main growth engines, not only for the region, but worldwide, contributing to about one-third of world GDP growth on average over 2000-2003 (in PPP-terms). Moreover, capital mobility and financial integration allow savings to be invested on both the national and global scale, thereby increasing economic efficiency and promoting growth.

What about the challenges? Globalisation and capital mobility also makes the international system more vulnerable to changes in investor sentiment. On several occasions we have witnessed contagion effects spreading from one country or one market to others. Some of these crises originated in the public sector, such as the debt crisis during the 1980s, which started with Poland and Mexico and spread to Latin America, Africa, the Middle East and the Soviet Union, the Mexican crisis in 1994, the Asian crisis in 1997/1998, the Russian crisis in 1998, and the more recent crises in Brazil, Argentina and Turkey. Others, by contrast, stemmed mainly from events in the private sector, such as the stock market collapse of 1987, the bond market crash of 1994, the near-failure of the large hedge fund Long-Term Capital Management (LTCM) in 1998, the stock exchange fall and the bursting of the technology bubble in 2000.

Despite their differences in origin, nature and magnitude, all these events had one thing in common: they represented major threats to the stability of the international financial system. The international community has always managed to resolve such crises, but the costs incurred by the respective economies have been significant. In many instances, the level of output fell dramatically, sometimes even in double figures. For example, in Argentina and Turkey real GDP fell by as much as 10-11% in the worst year of their crises.

These events highlighted the potential vulnerabilities of the globalised system and, in that way, underscored the need for systemic changes to the policy framework of the international economic and financial system. Policy-makers had to rethink how best to promote stability and achieve growth in an ever-changing environment characterised by globalisation. An impressive reform agenda was gradually launched to cope with the new challenges. Many of these reforms have focused on how to prevent financial crises from happening and - should they still occur - on how to manage and resolve them.

This ongoing work is influenced considerably by the widespread recognition of two fundamental principles. First, there is general consensus on giving the private sector and markets a central role, while focusing on sound public policies and institutions to provide market participants with an appropriate environment. Given increasingly liberalised financial systems, the private sector is bound to play a key role not only in providing capital but also, and probably more importantly, in disciplining the overall economic policy. Second, increased international cooperation has been considered as key given the mismatch between globalised markets and national policy responsibilities. Indeed, the scope of international cooperation has widened, but also the forms of cooperation have evolved over time.

Let me now expand on some key areas in which important lessons have been learnt and significant adjustments to the international financial architecture have been initiated and implemented. I will first talk about the main changes in the international monetary system and then comment on the institutional set-up of the international system, before touching upon reform efforts in the area of crisis prevention and resolution.

1. International monetary system

Looking at the international monetary system, some say that since the collapse of the Bretton Woods system of fixed exchange rates in the early 1970s, there has basically been no system in place. The current situation of manifold monetary arrangements is sometimes characterised as a "non-system". In my view, this is not true. It is correct that we are living in an increasingly complex world with a multitude of exchange rate regimes - about one-third of IMF countries have their currencies pegged to one major currency or currency basket, while others have various modalities of floating exchange rate systems from pure floating to more or less managed float. The role of the markets in determining exchange rates has become more important. And it had to be learnt - painfully - over the course of several crises that the economic fundamentals and policies of a country do play the decisive role in the development and stability of exchange rates. But a very important role attributed to the markets does not mean that there is no longer any role for exchange rate policy. Let me highlight two aspects.

For one thing, country-specific characteristics have to be used to determine the most suitable regime for a country. While this holds true for every country, it is especially important for emerging market economies. Economies differ widely and evolve over time. The exchange rate regime needs to be compatible with economic fundamentals and the wider policy framework, including regional integration efforts as well as trade and financial links. From this perspective, all regimes are subject to change should the fundamentals evolve and if circumstances so dictate.

It is not long since a consensus emerged that no single exchange rate system can insulate countries from financial crises. A few years ago, there was a widely held view that a move towards corner solutions, in the form of either very hard pegs or free floats, would help prevent crises. However, recent experience has shown that no currency regime is fully crisis-proof. Currency float does not suffice by itself to eliminate difficulties and crises. At the other end of the spectrum, the currency board of Argentina have delayed, but did not prevent, a fully-blown crisis.

Another aspect is that, while the leading currencies are indeed floating, exchange rate developments are certainly not ignored. The preference of the major countries and economic areas for exchange rate flexibility is the natural consequence of their trade openness, their dependence on capital movements and the necessity to pursue an independent monetary policy, geared towards domestic objectives. However, at the international level, there exist some mechanisms for policy cooperation, including on exchange rates. In particular, for the last 20 years the G7/G3 has proved a very effective forum where finance ministers and central bank governors can exchange views on a broad range of policy issues and where they can agree, if appropriate, on specific policy messages, including in foreign exchange markets in the case of exceptional situations. Only to take the most recent examples of such messages I think that the agreed G7 Communiqués of the Boca Raton and the Spring meetings this year were useful.

2. The institutional set-up

The second area of major change that I would like to highlight is the institutional set-up of the international system. Since their establishment in 1944, the Bretton Woods institutions, the IMF and the World Bank, have maintained their central role in the system. But they have been - and still are - subject to profound change. This year's sixtieth anniversary of the Bretton Woods institutions was an occasion for many observers to review the development of the two institutions against the background of a changing environment. The most dramatic change for the IMF was the breakdown of the Bretton Woods system in the early 1970s, which meant that it lost its previous role as guardian of the fixed but adjustable exchange rate system and that it had to fundamentally adapt its mandate.

Moreover, the international debt crises in the 1980s also had a transforming impact on the Fund, as this was the first time that the IMF acted as an international crisis manager - a role that it is still performing today. It is interesting to note that the IMF refused at the time to approve standby arrangements for crisis-hit countries until it received assurances from bank creditors that they would share the burden by providing fresh money. Twenty years later, the involvement of the private sector is still on the agenda for better crisis management. All subsequent crises have reconfirmed the IMF's central role as a crisis manager, in which it tries to coordinate reform policies in the countries concerned and temporary official financing with efforts to restore confidence and financial commitment on the part of private creditors.

New challenges materialised for the IMF and the World Bank with the collapse of communism, which resulted in 20 new members needing specific policy advice for the transition from centrally planned economies. Since the Asian crises in the 1990s, the IMF and the World Bank have again been undergoing considerable changes. They have been pushed to become more transparent, sharpen their respective focus, and reinforce their policy advice and financial support. Discussions are also still ongoing about the appropriate representation of developing and emerging markets in the two institutions.

In addition to the changes to the IMF and the World Bank, two other issues were addressed with significant consequences for the institutional set-up, namely the representation of emerging market economies and cooperation on financial sector issues:

First, with the growing importance of emerging markets, ways had to be found to integrate them better into the international policy dialogue. The creation of the G20 in 1999 constituted in my view a decisive and highly welcome step to reflect adequately the newly globalised economy. The G20 is turning into the international forum for dialogue and consensus-building between all economies that have a systemic influence, whether industrialised or emerging. I am convinced that the discussions in the G20 have facilitated consensus on important elements of the international reform agenda.

Second, equally important is the Financial Stability Forum, which was established in order to improve international cooperation on financial sector issues. The FSF is uniquely positioned to review the global financial system as a system, as it is the only informal forum which addresses issues from a cross-sectoral perspective, with the presence of global associations of banking, insurance and securities supervisors, of pertinent international institutions, IMF World Bank, BIS, and of treasuries and central banks having to deal with major financial market places.

Since 2001, the FSF has also held regional meetings with non-member financial authorities in Latin America, the Asia-Pacific region and central and eastern Europe to broaden the dialogue on financial stability issues.

Conceptually, I think that the Financial Stability Forum represents a major advance because for the first time the international community stresses that issues, challenges and risks must be examined in a comprehensive and complete fashion, through all their systemic implications, whether analysed from the standpoint of the International Financial Institutions, or of supervision authorities, or from the financial stability perspective of central banks. It also explicitly points out that optimising the functioning of each and all particular subcomponents of the global financial system, in their proper spheres, does not suffice. A cross-checking at the level of the overall system remains of the essence. The best banking supervision concept worked out in an isolated manner could have some counterproductive features from a global stability perspective. It would be the same for the best accounting concept or for the most creative and imaginative functioning of securities markets. This sense of the necessity of a global systemic "optimisation" on top of the "sub-optimisation" of each particular subcomponent is a very significant contribution of the Financial Stability Forum, even if a lot remains to be done in effective implementation.

3. Crisis prevention

Having talked about changes to the institutional set-up, I would like to discuss crisis prevention, which is a key area for all reform efforts. Given that crises are costly both for the countries concerned and for the international system, all emphasis must be placed on learning the lessons of the past and implementing those lessons rigorously. I am pleased to note that considerable progress has already been achieved in making countries and the whole system more resilient to shocks. In that context, I would like to highlight transparency and the promotion of best practices, two key elements of crisis prevention. Transparency is a precondition for well-functioning markets, since it facilitates better risk management and leads to strengthened market discipline. It is therefore welcome that significant changes have been introduced in a number of fields. For example, it was not long ago that the IMF itself started to disclose information on its policies and to encourage increased transparency by its member countries.

It is also reassuring that a large number of international standards and codes of good practice have been agreed upon, covering such different fields as transparency in fiscal policy or in monetary and financial polices, banking supervision, corporate governance, accounting and auditing. Transparency in the private sector is also crucial, as recent corporate scandals have again highlighted the crucial role that accounting standards play in this respect.

I consider that the progress made in the field of transparency after the Asian crisis is one of the main reasons for the absence of contagion in Latin America and the emerging world following the Argentine crisis. I believe that enhanced transparency helps investors to differentiate better between countries and that the countries' efforts to adhere to international standards and codes are well reflected in the markets' assessment of these countries.

Transparency and standards and codes are not the only elements that have been implemented to improve domestic policy-making, especially in emerging market economies, and to make them more resilient to shocks. The debates about sustainable exchange rate regimes, prudent and sustainable debt management and well-sequenced capital account liberalisation are just some examples of areas where important lessons have been learnt. In addition, in response to the growing importance of financial markets, there is an increased focus in the policy advice given by the IMF and the World Bank on financial sector policies and on vulnerabilities in domestic financial systems.

To sum up, I believe that the considerable progress made should help to reduce the frequency and severity of crises. However, we are still learning the lessons of the past, and more work will be needed in important areas.

4. Crisis management

Despite all the efforts put in on the prevention side, it would be too optimistic to assume that there will be no further crises. However, experience has shown that timely, efficient and smooth management of financial problems and their underlying causes in a country can help to minimise losses. Therefore, I will now address some issues related to the management of financial crises.

Every single crisis is different. Every case calls for an appropriate balance between domestic adjustment, private sector involvement and official support. Therefore, crisis management in practice has to struggle with the inherent tension between rules and clarity on the one hand and discretion and flexibility on the other. However, we have learnt that the official sector needs to be more predictable and clearer. Only consistent behaviour by the IMF and the international community will provide the right incentives for countries and private sector investors. Some large financial packages granted by the IMF in the past might have led to a misperception that the IMF would always bail out private creditors. This, in turn, might have brought about an element of moral hazard, namely over-borrowing on the part of the countries and lenient risk management on the part of some private investors. Moral hazard concerns and the limited availability of official funds therefore have led to increasing calls for an appropriate involvement of the private sector in crisis management.

In order to make official financing more predictable, specific criteria and procedures were set up last year for exceptional access to IMF resources. We in Europe have been very much in favour of setting such clear rules and clear limits to IMF financing in view of the substantial financing packages provided to countries in the 1990s and the early years of this decade. It is important that these rules are implemented clearly, not least in order to send out the right signals to the markets.

With regard to an appropriate involvement of the private sector in crisis management, different proposals have been launched in the past ten years. In the wake of the Mexican crisis in 1994/95, the G10 recommended the increased use of so-called collective action clauses in sovereign bonds. It was argued that such clauses would help to overcome coordination problems between a sovereign debtor and the numerous bondholders since they enable a qualified majority of creditors to agree on the terms of a restructuring, which is also binding for the dissenting creditors. But more time was needed to convince issuers and market participants of the usefulness of these clauses. And it also needed Mexico to overcome the first-mover problem in February last year.

Since last year, a remarkable convergence of market practice has taken place. In the first six months of this year, practically all bonds issued under New York law included collective action clauses, while worldwide some 83% of all foreign currency sovereign bonds included such clauses. Despite widespread fears, experience so far has not revealed any discernible impact on borrowing costs for the countries concerned.

Given their more limited use in the past, very little experience has so far been gained with the use of collective action clauses in the actual resolution of sovereign debt crises. Ukraine, Moldova and Uruguay used such clauses in the context of bond exchanges in order to bind in the minority of creditors that would otherwise have objected to the bond exchange.

Besides this progress with collective action clauses, I am pleased to note that work is proceeding on the development of a Code of Good Conduct. I have suggested myself some time ago that there should be guidelines for the behaviour of debtor countries and creditors regarding information sharing, dialogue and close cooperation in times of financial distress. Such guidelines embedded in a Code agreed between countries and creditors might help to prevent liquidity problems turning into a deep financial crisis with serious repercussions for all parties involved. They would also improve the handling of debt restructurings, if they become unavoidable. Discussions are currently taking place between emerging market issuers and private sector representatives on the main elements of such a Code. I would like to encourage all parties to be as active and constructive as possible. It is clear that this initiative can only lead to improvements in crisis prevention and resolution if the main stakeholders, i.e. emerging market issuers and private sector representatives, fully “buy into” the process. The official sector would play a catalysing role in that context.

To sum up, important lessons have been learnt and significant changes have been introduced also in the area of crisis management. That being said, implementation of the agreed principles still remains a challenge.

Closing remarks

Ladies and gentlemen, we are living at the beginning of the twenty-first century in a world which has been very profoundly transformed during the last fifty to sixty years since the Bretton Woods institutions were set up. In a way, what we see today is for a large part made of dreams of the second half of the forties and the fifties of the twentieth century becoming reality:

- The falling down of the iron curtain, the European unity marking the end of the dramatic political and conceptual divide has been the emblematic illustration of a world more united at a global level as far as values, principles and economic rules are concerned;

- The very rapid development of emerging countries and of countries in transition permits the catching up towards a better standard of living of a large proportion of the poorest citizens of the world located in China, India, emerging Asia, and Latin America;
- The acceleration of the scientific and technological advances, including - but not exclusively - in the domain of IT - is giving the full body of the global economy a major impulse;

Under these profound philosophical, conceptual, and economic transformations we have been progressively inventing a new fully globalised economic and financial system, in which human resources, goods, services, capital, concepts, ideas are moving around the planet instantaneously or fairly rapidly. This has created, in turn, a wealth of new chances and new opportunities that are, as always, associated with new challenges and new risks. One of our particular responsibilities in the sphere of the central banks is to guard against financial instability, to promote financial stability.

If I had to sum up what we to cope with in the present circumstances, I would say that we have three main challenges: to understand, to tirelessly upgrade institutions and to remain alert.

- To understand, first. Research is more necessary than ever to have a deeper, more profound and more operational understanding of this new global financial system. It has no precedent and its complexities defy previous modelling. We have already done a lot in this direction: we understand why credibility is so important, particularly credibility of authorities like central banks; we understand better the phenomenon of contagion, of herd behaviour in a globalised environment; we understand better why structural flexibility improves resilience. But a lot remains to be done, in particular to understand the dynamics of the system and its potential instability.
- Second, to upgrade tirelessly institutions, the informal groupings, the rules and regulations, the codes of good practices and conduct. A global system must be monitored at a global level with all parties concerned having a systemic influence. The aim of preventing instability must be present in all respective entities concerned. A lot has been done in this domain which is sometimes underestimated. A lot remains to be done.
- And, third, to stand ready to weather economic and financial shocks and open crises if and when they come. There is no time for complacency. We can minimise risks. But economic theory and empirical observations suggest that chances and opportunities of the dimensions magnitude that the global economy presents displays suppose that risk are taken and that we cannot eliminate them totally. This calls for important progress in two areas: augmenting resilience which calls for structural reforms that is particularly necessary in Europe; and preserving the capacity to give fairly rapid response at a global level thanks to intimate and confident cooperation, in particular across the Atlantic between the two major industrialised economies.

It is on that remark that the Atlantik-Brücke is more important than ever that I will conclude this exposition. Thank you for your attention.