Jean-Claude Trichet: Reflections on the international financial system

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Bundesbank Lecture, Berlin, 21 June 2005.

* * *

It is an honour for me to be invited to give this year's Bundesbank lecture and address such a distinguished audience. It is a particular pleasure for me to speak in Berlin, which symbolises more than any other city the historic peaceful re-integration of Europe. I would therefore like to extend my warm gratitude to President Axel Weber and the Board of the Bundesbank for the invitation to Berlin this evening.

In my lecture, I will try to take stock and look ahead at the challenges our economy is facing today, focusing on the challenges from global financial integration for the international financial system, its architecture and its functioning.

In my view, international financial integration and the state of the international financial system are far less abstract topics than one might think at first glance. They reflect one of the most complex, intriguing and powerful aspects of the phenomenon that is generally referred to as globalisation. This phenomenon represents a key issue that policy-makers in Europe and beyond have to deal with. It is therefore of utmost importance that we understand the significance of this issue for our role as economic policy-makers, and it is against this background that I would like to reflect on international financial integration and the international financial system today.

Policy-makers often face very specific concerns about economic uncertainty and the risk of instability, and we need to address these concerns. Monetary policy also has to play its part. We have created a stable currency for 307 million people. We have created confidence in this currency. We have anchored inflation expectations below, but close to, 2%. We have ensured monetary stability on our continent. In the same way, other policies have to contribute to addressing the challenges of the future. They have to boost confidence and ensure that the opening-up of borders turns into something that is ultimately worthwhile in terms of economic development and institutional cooperation.

In my reflections today I will describe the recent developments in the international financial system and how they have shaped the institutional setup of this system in recent years. I will then turn to the current challenges facing both the international community and Europe, and the implications of those challenges.

International financial integration

The clearest example of global economic integration is trade, and this is certainly true for this country. The label "*Made in Germany*" is recognised the world over as standing for high quality. But international trade is not a process in which only one party gains. Each export corresponds to an import, and economies benefit mutually from each other. Many goods that are bought in the euro area are made in other countries, far away from their consumers. Transport costs have decreased, technology has become universal, information is readily available at low cost, and tastes have been converging. During the last three decades tariffs have halved and over 230 trade agreements between various countries have entered into force. All these developments have resulted in a steady opening of markets in Europe and worldwide. In the early 1970s global exports accounted for only one tenth of world GDP, but they have increased to one quarter of world GDP today. This is a reflection of the dramatic deepening of global economic interlinkages in recent years. In my view, it is important to bear in mind that regional trade integration does not hinder global integration, but is in fact one efficient way of fostering it.

There is also a more recent phenomenon that is less visible, but even more dynamic, namely global *financial* integration. By this I mean the integration of local and national financial markets into a more unified international financial market. Only a few decades ago, the realisation of an investment project was largely contingent on the availability of capital in the local economy. Today the opportunities to raise finance as well as to invest capital are truly global. The substantial number of bilateral investment

treaties and the liberalisation of capital accounts have further encouraged cross-border investment.[1] While in the 1970s over 80% of all countries restricted access to foreign capital, today only 60% of developing countries and no industrialised countries have capital accounts which are still more or less closed.[2] In the 1970s, worldwide cross-border holdings of assets amounted to only one tenth of world GDP. Since then, cross-border capital flows have steadily increased, and countries have now accumulated foreign assets in an amount equivalent to the annual GDP of the entire world. In 2003, euro area residents held foreign capital with a total value of 7.6 trillion euro, a figure that is somewhat higher than the euro area's annual GDP.

But financial integration is also intrinsically linked to the real economy. Over the past 30 years, annual foreign direct investment (or FDI) worldwide grew from around 8.5 billion euro (10 billion US dollars) to almost one thousand billion euro (about 1200 billion US dollars). The value of foreign-owned companies around the world - the stock of FDI - is equal to the annual GDP of the euro area. Taken together, these companies would make up an economy approximately one third of the size of the euro area. Each year they produce goods and services of a value equivalent to German GDP and employ one and a half times the German workforce. For Europe, these international linkages are of particular importance. European corporate businesses are among the most dynamic in the world, as they provide half of world FDI. At the same time, half of world FDI is invested in Europe.[3] Foreign-owned companies contribute between 10% and 20% of euro area GDP.[4] As a consequence, the relationship between the euro area and the global economy is today characterised more by financial linkages than by trade. We as policy-makers have to be aware of these linkages because they can be a very powerful and fast transmission mechanism for shocks.

The benefits of this integration are obvious - a greater variety of goods and downward pressure on prices benefiting consumers and households. But the benefits are even more substantial, as production requires both human and financial capital. A skilled workforce cannot unleash its full potential without financial capital. Europe's impressive economic recovery after World War II would have been inconceivable without its integration into the global economy and its concentration on high-quality exports.

Today, many Asian economies are benefiting from global economic integration. Investment in the appropriate technologies enables these countries to compete on the world market and increase welfare substantially. This is by no means a phenomenon which only appears in national accounts. Income disparities across the world have declined significantly.[5] Not surprisingly, the benefits of this financial integration are particularly clear for open economies, which have recorded higher average growth rates in recent years.[6]

How should we assess these recent developments in the international financial system? We realise that the benefits outweigh the costs. But there are costs of adjustment, often front-loaded and concentrated on specific regions and sectors, which need to be taken into consideration. The change in the structure of the global economy also requires structural adjustments to be made in local economies. We know that the ability of a country to benefit from global financial integration very much depends on the quality of its institutional and structural environment. All economies, including advanced ones, such as the euro area, have to adapt to the changing needs of the world economy. The European economy has undergone and will continue to undergo substantial structural changes, which are necessary and beneficial because they will secure Europe's place in the global economy. This structural adjustment has been and will continue to be a major phenomenon in the coming years.

---

[1] According to the United Nations Commission for Trade and Development (UNCTAD) Bilateral Investment Treaties Database, the number of bilateral investment treaties rose during the 1990s from around 500 to over 2000.

[2] See: M. Ayhan Kose and Eswar Prasad: "Liberalizing Capital", International Monetary Fund, Finance and Development, September 2004.

[3] For a thorough report on the role of foreign direct investment in the global economy, see the UNCTAD World Investment Report 2004.

[4] Jos Jensen and Ad Stockman: "Foreign Direct Investment and International Business Cycle Comovement", European Central Bank, Working Paper No 401, 2004.

[5] Xavier Sala-i-Martin: "The Disturbing 'Rise' of Global Income Inequality", National Bureau of Economic Research, Working Paper No 8904, 2002.

[6] Jeffrey Sachs and Andrew Warner: "Fundamental sources of long-run growth", American Economic Review, papers and proceedings, 1997.

As the world's largest exporter, Europe clearly has a major interest in global economic integration and is well placed to benefit from it.

Sceptics are concerned about the sustainability of global financial integration. They argue that financial integration has gone too far, that market turnover has reached levels that are unhealthy. Each day, foreign exchange transactions are carried out to a value equivalent to the annual GDP of France. Financial integration is regarded by some as having the potential to destabilise the global economy.

But there is also an opposing view. This view states that global financial integration not only contributes to higher growth but also reduces the risks to the global economy. It states that the availability of finance and opportunities to invest are crucial for the stabilisation of economic outcomes. Let me give you just two examples.

The preference of investors for investing in local assets rather than diversifying internationally, known in the economic literature as "home bias", has not yet disappeared. In a world without transaction and information costs, all countries should hold the same portfolio. Each country should diversify its investment in all other countries relative to the size of their financial markets. This would provide the best insurance against shocks to any economy in the world, including the economy of the country in question, and at the same time it would increase the returns for all countries. During the last decade countries have indeed been reducing their risk positions through this mechanism. However, the world economy is still far away from a theoretically optimal portfolio and, as yet, there is no strong empirical evidence for economic stabilisation resulting from risk-sharing. This should be taken as an indication that there is still scope for further reduction of risk and stabilisation of income.[7]

The second example relates to the fact that most developing countries cannot yet borrow internationally in their local currencies, and have to resort to foreign currency. Foreign currency debt makes these countries more vulnerable to exchange rate movements. For example, the positive effect of depreciation on international competitiveness may be outweighed by the government's higher debt service on foreign currency bonds and by deteriorating economic conditions.[8] Recent trends in domestic and international financial markets point to developing countries also having improved access to different types of finance. Therefore, further development and integration of financial markets may contribute to a stabilisation of economic outcomes in these countries, which would also benefit the industrial economies as their trading partners.

Overall, I consider the recent developments in international financial integration to be welcome, because they reflect trends towards an efficient allocation of resources and, in this way, support growth and promote welfare in the global economy. They do not only benefit the recipient economies, but also the countries of origin, where they facilitate international risk sharing and participation in returns abroad. However, the rapid integration of financial markets across borders is not without new risks. These risks include adverse market dynamics, unwarranted spillovers, and challenges for international financial stability. And this brings me to the second part of my reflections, which concerns the institutional governance of the international financial system.

The international financial architecture: is it up to the task?

Potential risks stemming from international financial integration should be addressed with firm governance, requiring solid institutional foundations and policies. These institutional foundations, often referred to as the international financial architecture of the system, will help prevent adverse financial pressure and deal with it when it arises.[9] Therefore, the key questions for policy-makers are whether the international financial architecture is at present sufficiently well-equipped to deal with this task, and whether it is adjusting sufficiently fast to the ongoing changes in international financial integration.

---

7 Bent E. Sørensen, Yi-Tsung Wu, Oved Yosha and Yu Zhu: "Home bias and international risk sharing: Twin Puzzles Separated at Birth", 2005.

8 Barry Eichengreen and Ricardo Hausmann: "Other People's Money: Debt Denomination and Financial Instability in Emerging Market Economies", The University of Chicago Press, Chicago, 2005.

9 With regards to the international financial architecture, see for example P. Kenen, The International Financial Architecture: What's new? What's missing?, November 2001.

These are clearly not trivial questions, and definite answers can be given only with the benefit of hindsight. It is easy to count the crises that have occurred, but impossible to count those that have been averted. However, without forgetting the necessary note of caution, I consider the adjustments implemented in the international financial system in the aftermath of the Asian financial crisis altogether sufficiently important that they now constitute a system that is significantly different from the one prevailing before the crisis. Indeed, I would classify some of the changes implemented in the international financial architecture since the Asian crisis as major ones. Let me expand on this hypothesis.

The Asian crisis was indeed severe. It is estimated that 600 billion dollars' worth of national income was lost within the first year of the crisis (1997-98).[10] It is important to realise that significant weaknesses in the various national financial systems and a lack of market orientation were at the roots of the crisis. These weaknesses included balance sheet mismatches, banking sector vulnerabilities, and inadequate supervision. The Asian crisis was triggered by a shift in market sentiment which led to massive reversals of capital flows.[11] This change in market sentiment spread rapidly across the region, and then into other regions, making contagion a major factor in the development of the crisis.

With hindsight it turned out that both national authorities and international institutions were insufficiently aware of the risks and perhaps also insufficiently equipped to deal with them once they had materialised. The subsequent diagnosis of the origins of the crisis exposed three major shortcomings: first, considerable information gaps between the authorities, financial market participants and the international community; second, insufficient attention to financial sector issues in macroeconomic surveillance; and third, the inadequate involvement of emerging countries in international fora. These shortcomings have been addressed in recent years, which has led to important changes in the approach of international financial institutions, national authorities and market participants. The main thrust of these changes has been to strengthen market orientation through an improved international financial architecture. Let me briefly discuss these three sets of changes in turn.

First, concerning the provision of information, the IMF has made large strides towards increased transparency in recent years. The bulk of its bilateral consultation reports are now published and the Fund has pushed for greater dissemination of key economic and financial data. The fact that, nowadays, data on foreign exchange reserves, external debt, and balance of payments flows as well as other key data are reliable and available with little lag has been an important part of the transition towards a more market-led international financial system.[12] It has allowed market participants to price value and risk regarding each particular borrower in a reliable and effective fashion and to help stem spillovers across markets.

National authorities have also made considerable progress in increasing transparency, including in displaying their fiscal policies and data. All major central banks have made great efforts to increase the transparency of their monetary policy frameworks and they consider clear communication essential for effective monetary policy-making. Nowadays, more than 15 of the 20 major central banks publish bulletins or inflation reports, often with detailed explanations of policy decisions and background data. Importantly, many countries that have been hit by a crisis in recent years are now publishing their inflation reports, including Mexico, Korea, Thailand and Brazil. This too leads to a more informed decision-making process in the markets, reducing adverse market dynamics and contagion.

Market participants themselves also embarked on a process aimed at strengthening the international financial system, including through the provision of information. In my view, an important recent milestone has been the agreement between sovereign bond issuers and private market participants on a voluntary code of behaviour to keep channels of communication open in good times and to facilitate collaborative solutions in cases of distress for a sovereign issuer, and a possible restructuring of its debt. I myself launched this idea in a speech in Washington in September 2001. This agreement has resulted in the "Principles for stable capital flows and fair debt restructuring in emerging markets", previously known as the "Code of Conduct", and it was endorsed at the end of last year by the G20

---

[10] Javad K. Shirazi: The East Asian Crisis: Origins, Policy Challenges, and Prospects, June 1998.

[11] In 1997 net private capital flows to Asia declined by almost 100 billion dollars compared with 1996. The 1996-97 swing in flows to the Asian countries represented about 11% of their GDP.

[12] See T. Padoa-Schioppa and F. Saccomanni: Managing a market-led global financial system, in P. Kenen (ed.): Managing the World Economy: Fifty Years After Bretton Woods, 1994.

ministers and governors, when we met here in Berlin.[13] We welcomed the fact that sovereign issuers and market participants have developed a pragmatic and voluntary approach to reinforce the international financial system and have in that way taken ownership of an important strengthening of the present financial system.

The second important change since the Asian crisis concerns the focus of the international community on financial issues, as it was felt that not enough attention was given to financial sector surveillance. In the meantime, the IMF has brought financial sector issues to the forefront of its work, and they are now regularly included in consultations. Global market surveillance has been established, and analytical tools for the understanding of crisis detection have been strengthened. The IMF has also established the so-called Financial Sector Assessment Program, which aims to promote the soundness of financial systems in the IMF's member countries. An important part of the Program is the IMF's assessment of observance of financial sector standards and codes, which have been endorsed by the international community. In fact, the IMF is producing separate reports on Observance of Standards and Codes as a by-product of the Program. The IMF's nearly universal membership makes it well-placed to carry on this important work, and I think the fact that around 120 countries have already participated in the Financial Sector Assessment Program since its launch in 1999, or are planning to participate in it, is clear evidence of this.

In order to further examine the linkages between financial and macroeconomic stability and across sectors of the financial system on a global scale, the Financial Stability Forum was created in 1999. The purpose of the FSF is to promote international financial stability and reduce the risks stemming from the international financial system. The FSF is uniquely positioned to fulfil this task, as its members include, in particular, the major international financial institutions, the international groupings setting standards for accounting and for the regulation and supervision of financial institutions (by which I mean banks, securities firms and insurance companies), the international committees of central bank experts in the fields of financial markets and payment and settlement systems, as well as the executive, monetary and supervisory authorities of the major financial centres. In my view, it has been the first serious attempt to consider the global financial system as a truly single system, an integrated structural entity where it is of major importance for each institution or authority - whether the IMF or the Basel Committee on Banking Supervision or the International Accounting Standards Board, for instance - to be fully aware of the systemic implications of its own orientations and decisions. From that standpoint, I consider the Financial Stability Forum as a global conceptual clearing house, whose role is likely to be more and more important to the extent that the global financial system itself - driven by technology and globalisation - is more and more complex, universal and integrated.

The third shortcoming that was detected in the international financial architecture during the Asian crisis was the inadequate involvement of emerging countries in international fora. During the development of the Asian crisis, emerging market participation was addressed by the setting up of the G20, which saw its inaugural meeting here in Berlin in December 1999. The G20 was established in order to fully reflect the new nature of the global economy, an economy in which emerging economies were playing a very important role from a systemic standpoint. The G20 is a truly global forum. It enhances the dissemination of information by bringing together key industrial and emerging countries in an informal setting with the aim of reaching a consensus on a number of topical issues related to the international financial architecture. Since its establishment in 1999, the G20 has been instrumental in implementing standards and codes that are applied at the global level, as it has led by an example by carrying out the IMF's Financial Sector Assessment Programs and Reports on the Observance of Standards and Codes at an early stage. By now, two thirds of the IMF membership has participated in these reports, assessing their compliance with internationally recognised standards and codes. The G20 also contributed to the identification of 12 major standards, on which global efforts are now concentrating. These major standards include banking supervision, corporate governance, fiscal transparency, monetary and financial policy transparency, and securities regulation. Without the kind of global ownership of new concepts of the best practices, without reinforced transparency and voluntary implementation of the Principles for stable capital flows and fair debt restructuring in emerging markets that the G20 has delivered, our present financial architecture would not be as strong as it is today.

---

[13] See the Institute of International Finance (IIF) et al., Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets, November 2004.

These three major improvements - namely fostering transparency as a major strategic driver, focusing on a more systemic conceptual approach, in particular, through the Financial Stability Forum, and developing improved global ownership, in particular, through the establishment of the G20 - have contributed to an international financial system which is more resilient than before. The international financial system is today better equipped to detect vulnerabilities and deal with shocks than it was in 1997 or 1998. Although the success of crisis prevention can only be assessed with hindsight, the absence of international financial contagion over the past few years is an important observation.

One important lesson from the recent crises has been that the private sector needs to play its role in crisis management. Private sector involvement is needed in order to avoid the moral hazard problem that is inherent in large financial assistance provided by the official sector.[14] Furthermore, the role of the private sector in crisis management is essential because official support is likely to be insufficient to cover the financing needs of a crisis country at a time of increasing capital flows. There have been some concrete achievements in the area of private sector involvement, most notably the increased use of collective action clauses in sovereign bonds.

There remain a number of open issues in the international financial system that need further reflection. One such issue is the role of the official sector in crisis resolution. Here, the international community started to emphasise the importance of clearer rules for official sector support. This was done in order to strengthen incentives for prudent risk management on the part of both policy-makers and private sector investors. The IMF has established a framework, which is called the exceptional access policy, for large financial assistance programmes that sets guidelines in order to make IMF lending more predictable. It is now up to the international community to follow these rules. Another open issue is the lack of clear guidelines for IMF involvement in the process of sovereign debt restructuring in the event of a country facing an unsustainable debt situation. The case of Argentina is an example of a very difficult debt restructuring process, which has taken a long time to complete and which has caused uncertainty for all parties concerned. Argentina's debt restructuring process has shown that the international community still needs a better framework for crisis resolution. Authorities have to cooperate with the IMF and international creditors. The IMF, for its part, has to remain closely involved in the process, and it needs to take an active role in providing information.

The IMF is currently undertaking a strategic review of its activities, which should set a roadmap for the Fund for the coming years. In this strategic review, the IMF is contemplating measures to make its surveillance more effective. I support the recent efforts to put more emphasis on regional surveillance, in order to reflect the strong regional focus of trade patterns that is visible not only in Europe and Asia, but also in other parts of the world. I also support attempts to review the functioning of the international monetary system and the Fund's role in it. Specifically in this context, the IMF is well-placed to analyse issues like reserve accumulation and the evolution of exchange rate regimes in emerging markets, to take due account of their global implication. Finally, it is important to review the financial position of the IMF and the implications of lower lending activities on the Fund's operational budget.

Current macroeconomic challenges

My reflections on the current state of the international financial system would be incomplete without putting them into the context of the current global economic situation. First of all, I have to note that this is no time for complacency and that we currently find ourselves in a challenging situation.

The global economy is expanding at a comfortable pace, but there are large global imbalances, which have actually widened in recent years. These imbalances involve the industrialised countries as a whole, which have a large aggregate current account deficit and amongst them, more particularly, the United States, whose current account deficit has reached levels not seen before. The increase in the current account in recent years has occurred against the background of a decline in national savings, in turn attributable to rising budget deficits and a household savings rate that has fallen to levels not far above zero. The financing of the current account deficit, which calls for inflows of the magnitude of around two billion US dollars every working day, takes place largely through Asia. Central banks in the region have been intervening heavily for various reasons, such as to prevent their currencies from

[14] See "Managing Financial Crises in Emerging Market Economies: Experience with the Involvement of Private Sector Creditors", ECB Occasional Paper 32, 2005, for an overview of the instruments for private sector involvement and of recent experience.

appreciating, and they have become large-scale purchasers of US debt securities in recent years. While the current situation is rationalised by some observers, in particular as it supports strong growth in both regions and smoothes the adjustment path, it clearly raises questions regarding the sustainability of recent developments and associated policies.

Japan and Europe are also in the picture, Japan because it is posting a large current account surplus and is growing slowly, and Europe because, although it has a balanced current account, it should also contribute to increasing global growth - through raising its potential rate of growth - thereby alleviating global imbalances. The orderly and effective correction of global imbalances is one of the major goals for the international community. These imbalances represent a major risk to financial stability around the world and, therefore, to global growth. There is no individual national or continental solution to that issue. I trust that there is an absolute need to embark on a cooperative strategy comprising all four major partners. The United States has to tackle its structural lack of savings both by reducing public dissaving and by increasing household savings. Europe has to augment its growth potential through structural reforms in order to deliver growth, contributing more effectively to global growth. Japan should also increase its growth potential by implementing structural reforms. And, as a fully-fledged member of this collective, cooperative, global endeavour, the emerging Asian economies would need to accept an orderly realignment of their currencies. I would underline that all four partners together would not only have a winning strategy for tackling global imbalances but they would also individually, each of them, do what is in their best interest. This is true for China and emerging Asia, this is true for America, this is true for Japan.

This is also true for Europe. We have to convince people that structural reforms are necessary to revitalise our economies and make them fit for global competition. Moreover, they can enhance resilience to the shocks inherent in open economies. Structural reforms are essential for Europe's ability to respond to the challenges arising from the ongoing deepening in the global division of labour, the rapid pace of technological change, and the ageing of the population. In my view, all the conditions to benefit from such integration are there, and we should make the necessary structural adjustments with full confidence in their long-term benefits for our economy.

Conclusion

In conclusion I would like to stress three points. First, in my view it is remarkable that the current global imbalances have again brought to the fore the importance of monetary and exchange rate issues in the global economy, namely issues of exchange rate configurations, reserve accumulation and global liquidity. This underscores the fact that the focus on financial sector and market institution issues should not be at the expense of macroeconomic and exchange rate surveillance. This is particularly true for IMF surveillance.

Second, the scientific and technological revolution, the phenomenon of globalisation and the structural changes that are ongoing on all continents, not the least in Europe, are calling for utmost vigilance and for a permanent adaptation of the international financial architecture. We must keep a constant check on whether we have taken the systemic interactions between the various pillars of the international financial architecture into consideration in an appropriate manner. Much remains to be done in this regard and, as I already said, this is no time for complacency. The ECB is keen to play its role fully in this respect, not only by participating actively in the G7, the G20 and the Financial Stability Forum, and by being fully dedicated to the G10 group of governors, but also by calling, when necessary, for a larger, more comprehensive, more systemic view in a number of important fields. For instance, we suggested additional considerations of financial stability in the context of the International Accounting Standards Board, and these have now been done to our satisfaction.

Third, further work also remains to be done to achieve full inclusiveness of emerging economies and economies in transition in the international financial architecture. The G20, as I said, is an emblematic illustration of this new feature, which was overdue. In the field of central banking, the global economy meeting gathering central bank governors of systemic industrialised and emerging economies all over the world is another major example of the new inclusive handling of issues that are both systemic and global.

Thank you for your attention.