Jean-Claude Trichet: The International Financial Architecture – where do we stand?

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at a meeting organised by the Council on Foreign Relations, New York, 16 April 2007.

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It is a great pleasure to be back at the Council on Foreign Relations in New York City. My last visit to you was one year ago, and I must say that I always truly enjoy being here as the Council offers the best possible setting to discuss relevant policy issues of an international nature.

In my talk today, I will look at some key features of global economic and financial integration and elaborate on how the key international fora and institutions in charge of international financial cooperation have responded to this process.

The global integration of national economies continues at a significant pace. The scope of goods and services as well as of capital and labour that are being exchanged between economies is rising. A growing number of countries are involved in this exchange and can reap the benefits associated with it. The benefits are indeed tremendous, and the institutional foundations of the global economic system, which are often referred to as the international financial architecture, deserve credit for having ensured that they clearly outweigh the related challenges.

I will start out by sharing with you some thoughts on the major trends in the global economy, looking in particular at global trade and capital flows as well as the emergence of new actors on the global economic stage. Thereafter, I will focus on the current state of the international financial architecture and flesh out how it has been adapting to the changing global economic environment.

1. Major global economic trends – what are the issues?

One important structural feature of today's global economy is the interdependence of countries as they become more and more integrated into the world economy. This growing integration pertains not only to trade in goods and services but also to cross-border movements of labour and capital. Looking at trade data, we observe that global trade openness – measured as world exports and imports of goods and services as share of world GDP – has basically doubled over the last 20 years and now stands at 60 percent. Trade in intermediate goods and services as a result of the rising internationalisation of production processes has been a growing driver in this regard. While these changes are impressive indeed, even more far-reaching developments have taken place in the area of financial integration. If one takes for instance the share of gross international asset holdings in world GDP as a measure of financial openness, one can see a remarkable eightfold increase over the last 25 years to now more than 130 percent. As far as global capital flows are concerned, it is noteworthy that the composition of these flows has changed significantly over recent years. While foreign direct investment and international equity flows were particularly strong in the late 1990s, international transactions in more liquid assets have risen in recent years, making up most of the increase in global capital movements. International risk-sharing and the transfer of net savings across countries are important features of this process of financial globalisation.

Another salient characteristic of today's global economy is the emergence of new important actors on the global economic stage. Emerging market economies are gaining a larger share in the global economy as their product and factor markets become more closely integrated with the rest of the world. The integration of these countries and their participation in international supply chains has clearly affected global demand and supply of a broad range of goods and factors. With regard to capital flows, according to Institute of International Finance data, emerging market economies in 2006, like in the year before, are estimated to have attracted more than USD 500 billion in net private capital flows. Net direct investment has been, and is projected to continue to be, a large component of these flows. Moreover, what bears emphasis is that emerging market economies in most recent years have been providing the rest of the world with net resources in the form of current account surpluses. The drivers of these mainly official flows are in particular limited domestic absorptive capacities and underdeveloped domestic financial systems.

In sum, these significant global economic developments are structural and systemic in nature and have led to tectonic changes in the global economic landscape. They have brought about substantial benefits and entail inevitable challenges to both policymakers and market participants.

The benefits associated with the broadening and deepening of global economic interlinkages are manifold. The ever closer integration into the global economy of a rising number of countries has offered new possibilities to finance investment and consumption and to diversify and share risks globally. Also, the scrutiny by international investors serves as a disciplining device, which enhances the quality of domestic economic policies and thus contributes to improved economic fundamentals. Moreover, the exchange of goods and services, of capital and labour has facilitated the transfer of know-how and technology. All of these effects have led to an increase in global economic prosperity and rising living standards in many countries around the globe.

While these benefits are indeed substantial, there are naturally also risks and challenges that need to be clearly identified. The ever closer integration of national economies and the rise in capital mobility have made the international system more vulnerable to changes in investor sentiment. Furthermore, international trade and financial links intensify the transmission of shocks from one country to another and amplify cross-border spillovers.

A cost-benefit-analysis of the global economic trends clearly shows that the benefits outweigh the costs by far. That said, it would be short-sighted to take this outcome for granted. One should not forget that not long ago a number of severe financial crises posed a major threat to the international financial system: the debt crises during the 1980s, which started in Poland and Mexico and spread to Latin America, Africa, the Middle East and the Soviet Union; the Mexican crisis in 1994; the Asian crisis starting in 1997; the Russian crisis in 1998; and the Argentinean crisis in 2001-02. The international community managed to resolve these crises successfully, with each crisis bringing about a learning process. Each case was different, the underlying reasons were different, and hence the necessary responses had to be adapted to the specifics at that moment.

Past crises shed light on the vulnerabilities of the global economic and financial system and remind us of the importance of never being complacent. The major global economic trends, which I have just sketched out, make it increasingly difficult for policymakers to provide the public good of global economic and financial stability. And consequently, strengthening the resilience of the global system has become an ever more demanding task.

This brings me to look at some key international fora and institutions in charge of international macroeconomic and financial issues and see how they have adapted to a changing global economic environment and evolving policy challenges.

2. The International Financial Architecture – where do we stand?

In response to the global economic and financial trends just outlined, international fora and institutions have undergone major changes both in terms of their structure as well as their focus of activities. I will confine myself to four important areas. First, the involvement of emerging market economies in international fora and institutions. Second, reinforced focus on the multilateral and regional dimension of monitoring and surveillance. Third, development and agreement on global standards and codes. Fourth, increasing attention to the integration of macroeconomic and financial surveillance. Let me address these issues in turn.

Involvement of emerging market economies

The G7 has been instrumental in shaping the international financial architecture as it reacted to the need to better involve emerging market economies. The creation of the Group of Twenty (G20) forum of finance ministers and central bank governors in 1999 was inspired by the necessity to give major emerging market economies their place and have them participate in a dialogue on global macroeconomic and financial issues. This new international forum brings together representatives from 19 industrialized countries and emerging economies as well as the European Union and the Bretton Woods Institutions. As regards the promotion of global economic and financial stability, which is its main aim, the G20 has been a remarkable forum for serious dialogue on a wide range of highly relevant issues such as exchange rate regimes, prudent debt management, domestic financial deepening and international codes and standards. Peer review of members’ policies has been a helpful approach used by the group. The G20 has also played an important role in forging consensus on reforms of the Bretton Woods institutions and has been constructively involved in helping shape mechanisms of crisis prevention and resolution.

The G7 has also responded swiftly to the changing global economic environment by reaching out to the growing number of systemically important countries. It has invited representatives from major emerging market countries, including Brazil, Russia, India, China and South Africa, to parts of its meetings so as to enable an appropriate exchange of views on issues of relevance to global macroeconomic and financial stability. Such outreach activities have also been launched by the BIS as regards meetings at Governors' as well as experts' level.

Finally, the internal governance structure of the IMF is currently under review. The goal of the reform efforts is in particular to ensure a fair and adequate voice for all members of the IMF by aligning the distribution of quotas with countries' relative positions in the world economy.

Multilateral and regional dimension of monitoring and surveillance

A second change pertains to the increased attention paid to the growing integration of national economies into the global economy and the related international linkages.

Here I will highlight some improvements relating to the surveillance activities of the IMF. One important change concerns multilateral surveillance where the goal is to add a more global perspective to IMF surveillance and to place greater focus on international linkages and spillovers. This is clearly desirable given the ever closer integration of national economies. Cross-checking between multilateral and bilateral surveillance helps promote policies that are consistent not only with other domestic policies, but also with global adjustment within the international monetary system. To foster cooperation on issues of systemic relevance, the International Community has launched a new supplementary consultation procedure in a multilateral format. I trust that this multilateral consultation following the Spring 2006 IMFC meeting has been useful. And I have noted with satisfaction that the policy plans, set out by the participants, represent further progress in the implementation of the global strategy that the International Community has endorsed. I also trust that these policy plans which are being implemented will make a significant contribution to reducing imbalances.

Apart from strengthening the multilateral dimension of surveillance, the Fund is also in the process of adjusting its regional surveillance. Experience has already been gained in the conduct of this form of surveillance as regional reports on some monetary unions, including the euro area, have been prepared. That said, I deem it useful that improvements are being considered to place more emphasis on the interaction between surveillance at the regional and the country level. Another area that deserves attention is the treatment of intra-regional linkages and cross-country spillovers. Moreover, and on a more general note, I consider it important for the Fund to take full account of the specific features of the monetary unions that are subject to surveillance.

Finally, a field which is of particular interest to the ECB is the discussion on how the Fund's surveillance over exchange rates and exchange rate policies could be improved. On a general note, I consider that the Fund in its exchange rate analysis should make a clear distinction between exchange rates which are a policy objective and those which are market-determined. As far as exchange rate policies are concerned, it is desirable for the Fund to engage in a regular dialogue with the authorities and to provide a confidential view on the appropriateness of these policies from a country and from a global perspective. In this context, the Fund could play a useful role in assisting systemically important countries to establish market-based policy frameworks. This would help minimise spillover effects in the form of asset price distortions and risks of disruptive market unwinding. For the Fund to be effective, it is of course crucial that members comply with their obligations to surveillance, including as regards the provision of data. When it comes to exchange rates that are determined by market mechanisms, developments of the domestic economy should be reviewed, but communicating publicly on bilateral floating exchange rates should be avoided: it would always entail the risk of interfering with the proper functioning of foreign exchange markets and with the joint messages that the concerned authorities themselves would agree to give together on their own bilateral rates.

Standards and codes

It has been a very important development in the financial architecture that the International Community has strongly supported the generalisation of standards and codes. In this domain also the G20 played an important role. The various standard setting bodies, including the Basel-based committees, the IMF and the World Bank and the Financial Action Task Force, have managed to develop many international standards and codes, which have been agreed upon by a rising number of countries. These standards and codes cover a broad range of fields such as transparency in fiscal, monetary and financial policies, banking supervision, corporate governance, accounting and auditing and reflect the growing interaction between the macroeconomic and the financial sphere. The role of these instruments is highly significant as they help anchor market expectations by effectively constraining macroeconomic and financial policy measures. Moreover, compliance with international standards and codes makes national policies more transparent and mitigates the risks of disruptive developments. All of these effects contribute to the resilience of national economies as well as the global financial system. One of the challenges that the standard-setting bodies are faced with is to ensure that the various standards and codes are mutually consistent and regularly updated so that they keep pace with the changing global financial environment.

Let me mention, as an example, the voluntary “principles” to underpin a sustainable and healthy flow of private capital to emerging markets that I suggested myself a few years ago. Now the “Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets” have been set up thanks to a very active participation of emerging economies and the private sector. The aim of these market-based and voluntary principles is to provide guidelines for the behaviour of sovereign issuers and their private creditors regarding information sharing, dialogue and close cooperation in times of financial distress. To date, over 30 issuing countries have voiced support for the Principles and expressed particular interest in advancing their implementation. On the investor side, an increasing number of financial institutions have backed the Principles.

Integration of macroeconomic and financial surveillance

The fourth important change concerns the increasing attention to financial sectors and markets that the international fora and institutions pay in their monitoring and surveillance of national economies and the global economic and financial system.

A prominent institutional newcomer is the Financial Stability Forum (FSF), which was set up in 1999 to enhance policy coordination among national financial supervisors, the International Financial Institutions, and international standard setters with the aim of promoting international financial stability. Its creation came also as a major response to the financial crises of the late 1990s. They had exposed numerous weaknesses in the interaction of national authorities in charge of supervision and regulation of financial institutions operating in increasingly globalised markets and had underlined the need for improved information-sharing and harmonisation of national rules. Already one year after its creation, the FSF presented important findings and policy recommendations on three key systemically relevant issues, namely risks stemming from large and volatile capital flows, concerns relating to offshore financial centres, and highly leveraged institutions. At the request of the G7, the FSF will soon provide an update of its 2000 report on highly leveraged institutions. Other very important topics that are currently being monitored include credit risk transfer markets and the area of private equity and leveraged buyouts.

International institutions also place increasing emphasis on the interplay between macroeconomic and financial surveillance. The BIS, for instance, has expanded its work on the link of macroeconomic and financial stability. Moreover, the IMF in the context of its strategic review is currently considering, and has in some instances already implemented, changes to its surveillance activities by placing more focus on the integration of macroeconomic and financial surveillance. Given the increasing role that financial sectors and markets play in national economies as well as in the global economy, this is a very welcome development. Among the topics that are worth exploring are the identification of critical links between macroeconomic and financial market issues. Also, the role of the financial sector in triggering disturbances and spillovers from the country to the global level would have to be studied in greater detail. Particularly important tools in this regard are of course the Financial Sector Assessment Programs, which the IMF established some time ago. These Programs as well as the assessments of observance of financial sector standards and codes are important instruments to promote the soundness of financial systems of IMF member countries.

3. Conclusions

The policy challenges associated with growing global economic and financial interlinkages need to be addressed head-on so that the benefits stemming from the rapidly integrating global economy are maximized and the related risks reduced to a minimum. It is for this reason that, as I have set out, the governance of the international monetary and financial system has been upgraded in a number of important ways to remain relevant and effective in the ongoing quest for global financial stability.

The fact that more and more countries have established sound and transparent policy frameworks has led some observers to conclude that policy dialogue at the international level has lost its relevance and that the fora and institutions dealing with global financial issues have become redundant. I would clearly disagree with this view. Of course, keeping one's house in order and putting in place rules-based policy frameworks are decisive contributions to the stability of the global economic system. However, given the rising degree of global integration, these efforts alone do not eliminate the potential for spillovers from one country to another, adversely affecting the stability of the global system.

Therefore, policy cooperation at the international level is vital to strengthen the ability of the global economic system to absorb shocks and hence to deliver the public good of global financial stability. A conditio sine qua non is that the various fora and institutions that form the international financial architecture are designed and constantly upgraded so that they are up to the task. This is an important and ongoing responsibility that policymakers from around the globe are faced with. Living up to this responsibility will ensure that, going forward, global economic integration will lead to further global economic prosperity.