Jean-Claude Trichet: Reflections on the global financial system

Keynote speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the 2007 25th Anniversary IIF Annual Membership Meeting, Washington DC, 20 October 2007.

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I. Introduction

It is a great pleasure to be here on the occasion of the 25th Anniversary IIF Annual Membership Meeting. During the last quarter of a century, the Institute has proved to be both an important coordination forum for the international financial industry and a counterpart to international financial institutions and fora, making many valuable contributions to the international dialogue on the global financial system. Back in 1983 when the Institute was founded – in response to the international debt crisis – one of its key jobs was to provide its members with information about the policies and performance of borrowing countries. As time passed by, the range of the Institute’s activities broadened and it has worked as well on such issues as global financial regulation. Moreover, it played an active role during the last number of years in the debate about the international financial architecture and emerging market policy issues.

Celebrating today’s anniversary brings to mind not only the many policy issues that we discussed over the past 25 years but also the many colleagues and friends from all parts of the world whose professional careers are in various ways linked to the development of the international financial system and to the issues that the Institute has been dealing with. I myself have interacted with the IIF on many occasions, not only back in the 1980s when I was chairman of the Paris Club, but also thereafter in my capacity as governor of the Banque de France and today as President of the European Central Bank.

In my talk today, I will seize the opportunity of the 25th anniversary of the Institute and share with you some thoughts on two broad issues that I deem particularly relevant. First, I will recall the past financial crises that have hit emerging market countries over the last two and a half decades and focus on the progress that has been achieved with regard to devising mechanisms for crisis prevention and crisis containment. Second, I will take a closer look at the recent turmoil in financial markets and provide some preliminary reflections.

II. Emerging market countries and their access to international financial markets

The financial integration of countries into the global economy continues at a high pace. While advanced countries are the most financially integrated, emerging market countries have significantly increased their cross border asset and liabilities positions and hence improve their degree of integration. The tremendous benefits that are associated with this integration process in terms of rising living standards and overall prosperity should not be taken for granted though since globalisation and rising capital mobility require taking into account the possibility of shocks spilling over into different countries. The financial crises that we have witnessed over the last 25 years and that were largely confined to emerging market and developing countries have not been few: The debt crises during the 1980s that started with Poland and Mexico and spread to Latin America, Africa, the Middle East and the Soviet Union; some years later, the Mexican crisis in 1994; the Asian crisis starting in 1997; the Russian crisis in 1998; and the Argentinian crisis in 2001-02.

As is well known, the composition of private capital flows to emerging market and developing countries in the periods before and after the crisis of the 1980s differed substantially. Looking at World Bank Global Development Finance data, from the 1973 oil price shock until the 1982 Mexican crisis bank lending amounted to almost two thirds of overall private capital flows, dwarfing bond financing and equity flows, which stood at below 5 percent and 17 percent respectively. This composition of private capital flows changed dramatically in the 1990s. In the period between 1990 and 1997, while bank lending made up only 12 percent, FDI and portfolio equity flows as well as bond financing combined had risen to an impressive 80 percent of overall private capital inflows. In hindsight, the 1989 Brady Plan of collateralized debt reduction could be seen as paramount in paving the way for these significant changes.

That said, and irrespective of whether the crisis took place in the 1980s or 1990s, all of these crises have in common that they not only imposed major macroeconomic costs on emerging market countries and led to significant financial losses on the part of commercial banks and bond holders in mature economies. These events posed also major threats to the international financial system. What is important to note, though, is that the international community managed to resolve all of these crises. This was so because the international institutions and forums that are charged with crisis resolution were up to their responsibilities. Moreover, measures were taken by sovereigns in emerging market countries and the private sector in mature economies to fight these crises.

Going forward, an important lesson that we have learned from these events is that our efforts aimed to strengthen the global financial architecture need to continue tirelessly to ensure that the resilience of the global financial system is preserved. Updating the effectiveness of this architecture in the areas of crisis prevention and crisis management is an ongoing task, and many crucial steps have been taken, and are being taken, to this end. Over the last number of years, it has of course been the preventive rather than the resolving mechanisms that have been more relevant.

In this respect I would like to focus not so much on the various institutional adjustments of the international financial architecture, but concentrate on a subject that I deem particularly relevant, namely the development and implementation of international financial standards and codes. Such tools, which set out widely accepted good principles, practices, rules and guidelines, determine the interaction between public policy and market functioning. They serve as effective mechanisms for crisis prevention and crisis containment and hence do deserve a closer look.

Following the Asian crisis, the need to strengthen the international financial architecture was widely recognized. A major initiative was clearly the creation of the Financial Stability Forum (FSF) in 1999 and its work on developing and implementing financial standards and codes. Most relevant are the 12 standards that the FSF has designated as key to strengthening and preserving the soundness of financial systems and that cover a broad range of subject areas. These standards pertain to macroeconomic policy and transparency, institutional and market infrastructure as well as financial regulation and supervision.

As far as creation and implementation of these standards is concerned, many international institutions and fora have been involved, including the G20, the Basel-based committees, the Financial Action Task Force on Money Laundering and the International Financial Institutions. The progress that has been made over the last number of years is truly impressive. For example, as of today, three quarters of the Fund membership has completed more than 840 modules of the IMF’s Reports on the Observance of Standards and Codes, the so-called ROSCs. Moreover, more than a third of the IMF’s member countries subscribe to its special standard for dissemination of economic and financial data, the SDDS. Finally, more than 60 percent of the Fund membership has so far completed a Financial Sector Assessment Programme (FSAP). That said, further improvements should be sought in respect of participation rates, including also as regards the reporting to the IMF on the currency composition of countries’ foreign exchange reserves.

Why does the implementation of internationally agreed standards and codes play such an important role when it comes to the prevention of financial crises? There are a number of benefits that bear emphasis. At the national level, these tools do not only help anchor market expectations as they make more predictable future macroeconomic and financial policy measures. They also make institutions, markets, infrastructure and policies more transparent, thus mitigating the risks of disruptive developments. Moreover, international financial stability is promoted and the risks of financial distress are curbed through better-informed lending and investment decisions. In passing, I would also note the more widespread use of market-based policy frameworks in many countries that has been highly conducive to preventing financial crises.

Another consideration that deserves emphasis is that standards and codes do not necessarily have to be set and enforced solely by public authorities. Rather, the private sector in many instances plays an important role, and rightly so. Indeed, there can be no doubt that ensuring transparency and an appropriate flow of information is the responsibility of both the public and the private sector. One example of private sector involvement in the area of international standards relates to accounting and auditing where private sector organisations are the issuing bodies. Another prominent example – one that relates directly to the work of the IIF – are the "Principles for stable capital flows and debt restructuring in emerging markets", on which I will now elaborate in more detail.

The Principles, which have been agreed between sovereign debtors and their private creditors, serve a number of important purposes. They aim to foster transparency and the timely flow of information between debtors and creditors. Moreover, they seek to ensure close debtor-creditor dialogue and cooperation to avoid restructuring. In cases where a debt restructuring becomes inevitable, the Principles request relevant parties to pursue good faith actions and call for fair treatment of affected creditors.

With regard to the creation of the Principles, I remember launching the idea at a luncheon organised by the Bretton Woods Committee in 2001. What was important then, and is of course today, is the clear support that the Principles received from private sector representatives as well as public officials of the issuing countries. Indeed, the work that has been done by the IIF in this area and its backing has been, and continues to be, highly valuable. And I remember that the first mention of the "Principles" in a communiqué of the G20 was made in New Dehli.

When it comes to awareness and implementation of the Principles, I am very pleased to see that further progress has been achieved. A rising number of sovereign debtors and international investors have underlined their backing for the Principles and have already applied them. What is the Principles' formula for success and why is it that commitment to, and compliance with, the Principles is advancing? I believe that the answers to these questions lie in the Principles' design features. The Principles are not a heavy-handed mandatory approach, but a soft mode of governance: they incorporate strictly voluntary, market-based, and flexible guidelines which are applied on a case-by-case basis.

Talking about the market-based approach to avoiding and resolving sovereign debt crises, I should also mention collective action clauses (CACs) that are incorporated into international sovereign bonds. While there was not much enthusiasm for CACs back in 1996 when the G10 Rey report was published, the changing international financial landscape and the experience with the crises of the 1990s led to a fresh look at CACs and ultimately an increasing interest. We all remember well how the Mexican government assumed the role of an icebreaker and in February 2003 announced a bond issue with CACs. Many other countries have followed Mexico's example, and today CACs are a standard provision in international bonds. As a consequence, the share of outstanding emerging market sovereign bonds including CACs has now reached two third. What is worth underlining, and confirmed by empirical evidence, is that, contrary to earlier concerns, CACs have not significantly affected the price of the bonds or the levels of subscription.

In concluding, I would point out that there are many examples of international standards and codes – be they agreed solely by the public sector, jointly by the public and the private sector or by the private sector only – that have proven highly useful as tools for crisis prevention. They are woven into the fabric of the international financial architecture and make an important contribution to strengthening the resilience of the international financial system. Finally, what ought to be stressed is that for standards and codes to retain their relevance, policymakers and standard-setters are faced with the constant challenge to ensure that these instruments are mutually consistent and regularly updated so that they are in line with the fast changing global financial environment.

III. Mature economies and the recent turmoil in financial markets

Let me now move from some lessons of past crises in emerging economies to the situation we are now facing in the global financial system. What has been notable about recent experience is that the epicentre of market turbulence has shifted from the emerging economies. This we saw during the bursting of the "dot com bubble" at the beginning of the decade and now, a financial market liquidity squeeze that simultaneously affected many advanced economies was triggered in late July this year. It began with a loss of confidence in the valuations of credit market securities where the underlying assets are US sub-prime mortgages and it quickly spread, causing disruptions in the asset-backed commercial paper (ABCP) market and eventually, by way of consequence, in the unsecured inter-bank money markets as concerns mounted about counterparty credit risks. Several markets were affected by the turbulence and the spill-over effects were generally characterised by losses of market liquidity and heightened market volatility.

It is important to note that the present significant market correction is not an event that should surprise us. We had been quite clear, since a number of months if not years in stressing a global phenomenon of underpricing of risks which was signaled in particular by a low level of volatility, a low level of spreads, a low level of risk premia across the board in a large array of products and markets.

In many respect the present episode can be interpreted as correcting those anomalies and paving the way – once the turbulences would have dissipated – for a more sustainable structure of global finance. That being said even if the likelihood and even the necessity of a market correction was largely recognised by the public as well as the private sector, the channels that were the vehicles for the propagation of the turbulences were not identified ex ante. Several observations can be made in this respect.

First, despite the fact that over recent years credit risk transfer has facilitated a widespread sharing of risk in the financial system, the recent market turbulence has nevertheless confirmed pre-existing concerns about the risks stemming from a lack of transparency about where credit risks ultimately reside in the financial system. Paradoxically in a large number of cases the credit risk remained in the realm of the commercial banks through the commitment they still had to activate back up lines of conduits or structured investment vehicles.

Second, even if the risks were well dispersed across the system, the recent events have illustrated the importance of adverse selection problems in a crisis situation in that even a suspicion that counterparties could have modest exposures to assets for which no market value can be computed can significantly impair market functioning.

Third, the financial market turmoil has highlighted vulnerabilities created by off-balance sheet special investment vehicles set up mostly by banks. Such vehicles have proven to be more prone to liquidity mismatches than anticipated, which, as a result, caused contingent credit lines to be drawn on banks.

Finally, the fact that the problems were related to the rolling over of secured short-term financing instruments rather than unsecured instruments highlighted the risks created by excessive reliance on ratings in valuing complex assets which are used as collateral in short-term asset-backed commercial paper markets.

Although some signs of normalisation of credit market conditions emerged throughout September and early October, for global financial institutions the turbulence in the financial markets has clearly created some challenges. Many large institutions have been warning that future earnings will be materially affected as a result of both direct and indirect exposures to US sub-prime mortgage securities. Nevertheless, after several years of strong profit growth, capital bases are comfortably in excess of regulatory requirements. As a result, the global financial system – especially the core financial institutions within it – has remained resilient.

Looking forward, the uncertainty as to how market liquidity problems will eventually be resolved clearly complicates the assessment of the medium-term outlook for financial stability, both globally and in the euro area. Given the relative strength of the underlying fundamentals – although pockets of vulnerability do exist – the central scenario is that the impact of the financial turbulence on the intermediation of credit is likely to be relatively contained.

Nevertheless, low probability but plausible and challenging scenarios for financial stability could be triggered by adverse disturbances that affect global market liquidity conditions or if unanticipated credit events were to occur.

Let me draw some further, albeit preliminary, lessons and putting forward tentative suggestions. First, it is important to keep in mind that the recent market liquidity squeeze originated from a surge in defaults by a sub-set of borrowers with particularly weak credit fundamentals. As the global credit cycle advances, one can hope that default rates do not start rising in other parts of the credit markets. We need to monitor the situation closely in order to identify any such adverse spill-over effects.

Second, an important factor holding back market liquidity in the credit and money markets at the current juncture seems to be uncertainties about the ultimate holders of assets and derivatives where credit quality has deteriorated. In such an environment, further voluntary disclosure by both banks and non-regulated entities – including conduits, special purpose vehicles, etc – could work as an important signalling mechanism that would allow investors to re-assess positions and gradually help the market for structured finance to start functioning again.

Third, for financial institutions, the period ahead is likely to provide a first material test of the effects of changing banking business models to one whereby the securitisation of bank assets and the role of non-bank financial institutions have become increasingly important. Although currently profitable and well capitalised, many banks will experience income and credit losses, which may trigger a re-assessment by some of them of the suitability of this so-called “originate-and-distribute” business model. With regard to hedge funds, they have not been at the centre of the turmoil. An important lesson in this regard is that many funds with solid financing structures and/or strategies geared towards distressed asset management are likely to have prospered from recent events, thereby smoothening volatility and mitigating the effects of a financial de-leveraging process.

Finally, certain supervisory and regulatory issues can already be identified as warranting further attention or action. Initiatives are already underway at the European and international level to draw lessons and consider further policy actions. Whilst it is still too early to draw definitive conclusions, there is a common understanding on the need for finding solutions that can be applied consistently at the global level. In this respect, international coordination is of the utmost importance, as any policy action should be applied consistently, thus ensuring a level playing field globally.

Turning to possible lessons from a regulatory and supervisory viewpoint, I would stress first of all the importance of effective implementation of Basel II which, despite the possible need for some revisions in light of the recent financial market developments, provides a sound basis for banking supervision and incentives for improvements in banks’ risk management.

Second, I would mention three key areas that warrant further attention on the part of the international community. First, banks need to further improve their risk management, in particular liquidity risk management. The complexity of structured finance products calls for banks to have in place commensurately sophisticated risk management systems, including liquidity risk stress-testing. Second, the role rating agencies played in the recent events needs to be assessed. In particular, a better insight is needed into the incentive structures, including possible conflicts of interest, to perform proper due diligence. At the same time, the possible lack of incentives for investors to carry out their own credit analysis and due diligence should also be taken into account. Third, certain areas of the regulatory framework may need to be reviewed, such as the treatment of liquidity risk and the securitisation framework, in particular the treatment of liquidity exposures to special purpose vehicles and the assessment of risk transfer, given their significance in the recent financial turbulences.

Let me conclude by stressing that I am confident that from this process, an even stronger financial system will emerge, which will be well able to face the future challenges for the global intermediation of credit.

IV. Concluding remarks

One important lesson that we have learned from past financial crises and that should be applied at the current juncture is that fostering transparency proves to be an effective mechanism for both crisis prevention and crisis containment. This is so because ensuring transparency through the appropriate disclosure of information reduces uncertainties on the part of market participants, thus leading to less disruptive market movements and overshooting. Moreover, transparency helps minimise contagion in all compartments of global finance, not least through its preventive, but also dampening, impact on herd behaviour of market participants. Enabling market participants to differentiate across players and to price risks appropriately is therefore a highly valuable outcome.

As we have seen, the concept of transparency relates to many different areas such as the domain of sovereign risks and the interaction between sovereign borrowers and their private creditors and investors as well as to financial markets of industrialized countries. While I am firmly convinced that more progress ought to be achieved when it comes to introducing transparency in the various areas of the global financial system, I am equally convinced that we do not need heavy-handed public sector regulation to reach our goals. On the contrary, there are many examples of both self-regulation by the financial industry and joint governance involving both the private and the public sector. One promising recent initiative are the benchmarks for best practices that a number of highly leveraged institutions have worked out voluntarily. Another example that has proven highly successful are the Principles for stable capital flows on which I have elaborated before. In sum, I would underline that it is the task of all the stakeholders of the global financial system, regardless of whether they belong to the private or the public sector, to live up to their respective responsibilities and contribute appropriately to the stability of this system. In this context, the IIF has made very significant and valuable contributions during the last 25 years, and I look forward to its future work.