Jean-Claude Trichet: The changing world of global governance

Keynote speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Institute of International Finance, Spring Membership Meeting, Vienna, 10 June 2010.

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Ladies and Gentlemen,

I remember vividly when the Institute of International Finance (IIF) was founded back in 1983 at the time of the international debt crisis. One of its key early tasks was to inform members about fundamentals and policies in borrowing countries. Since then, the range of the Institute's activities has broadened a great deal.

I have continuously interacted with the IIF since its beginning; in the 1980s as chairman of the Paris Club, later as Governor of the Banque de France and over the last years as President of the European Central Bank. And as Co-Chairman of the Group of Trustees of the "Principles", I enjoy the regular events together with distinguished colleagues from the public and private sectors.

I want to thank Charles Dallara, in particular, for his dynamism and constant efforts in fostering dialogue between the private sector and the official sector. The IIF gatherings always provide a fantastic opportunity for stimulating exchanges of views on the international financial system.

When preparing my remarks for tonight, I looked at my text from the 25th Anniversary IIF Membership Meeting in October 2007. At the time, I concluded that "it is the task of all the stakeholders of the global financial system […] to live up to their respective responsibilities and contribute appropriately to the stability of this system."

I trust that all will agree that this statement remains valid today.

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In recent weeks, we have had difficult news not only on the financial system but also the ecosystem – the news that the oil spill in the Gulf of Mexico is spreading ever wider – from the riggers who lost their lives in the explosion to their employers, local communities, environmental agencies and public policy-makers. Similarly, the financial events of the last three years, which began in a seemingly small part of the US housing market, have touched all of our lives and come to test the resilience of our whole system of global economic governance.

The financial crisis has tested the business models and risk management systems of market participants, and the rules and structures of the markets in which they operate. It has tested the preparedness of central banks and governments to take unprecedented support measures to preserve confidence in markets and the economy. And it has tested the ability of the institutions of global governance to restore financial and economic stability.

Just as the Deepwater Horizon oil spill is doing for environmental protection and natural resource management, the financial crisis offers many lessons for management of the global economy – lessons about private sector incentives, lessons about regulation and lessons about global interdependencies and the ever-growing need for effective policy coordination.

Tonight, I would like to share with you a few thoughts on the strengths and weaknesses of our system of global governance.

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But before doing so, let me say a few words on the current situation in Europe.

In recent weeks, the euro area governments and the ECB were once again called upon to demonstrate their ability to take swift and essential action to face up with exceptional circumstances.

In 2008, the ECB decided on unprecedented measures when private financial intermediation was first impaired and then on the verge of collapse, and we restored it to its prime function. On both sides of the Atlantic, we had to cope with impaired money markets. We set the conditions for banks to resume lending to each other and to their customers. We helped reconstruct the market when it had disappeared. And we laid the foundations for the nascent recovery to start and consolidate.

Throughout these actions, the ECB has maintained price stability and the stability of inflation expectations. A month ago, we sprung into action for a second time. It was for the same reasons. Once more, private financial intermediation – often secured by government paper – was threatened. The market for government paper – the basis for the pricing of many financial assets, from fixed-income instruments to equity – was seriously impaired.

We judged – and we continue to judge – that our monetary policy stance was appropriately tuned to the conditions and the prospects of the broader economy. But once more – as in the autumn of 2008 – we could see that the transmission mechanism was not functioning sufficiently well to channel our policy intentions to the broader economy.

Therefore, we intervened. Our Securities Markets Programme is targeted to those segments of the euro area government debt markets that are most dysfunctional. The aim is to restore a precondition to our primary function of accomplishing price stability in the medium term.

At the same time, we have taken note of the commitment of the euro area governments to take all measures needed to meet fiscal targets this year and the years ahead, and that each one of them is ready to take the necessary measures to accelerate fiscal consolidation. And we are in close contact with the Commission and authorities to verify that further convincing and concrete consolidation and reform strategies are prepared and implemented.

The Greek authorities have started to implement the ambitious economic and financial programme that was agreed with International Monetary Fund and the European Commission, in liaison with the ECB. This programme itself is an important achievement. It is based on prudent macroeconomic assumptions. It is frontloaded. It has the potential to correct long-standing flaws, because it entails a very comprehensive structural reform package. This structural reform package to my surprise seems still largely unknown to many. The three institutions will regularly come to Athens to monitor the programme and support the government in its efforts to implement the measures, so as to secure a better future for the Greek people.

We consider that the Greek programme has the appropriate features to succeed. Many policy adjustments that seemed Herculean at the start have succeeded in history. And we have indications that the budget execution in Greece in the first five months of 2010 – despite a painful recession – is on track. The central government cash deficit is more than 40% below the level over the same period last year.

We see encouraging signs in other countries too. Measures are being prepared to credibly advance fiscal consolidation. Those measures are particularly helpful if they focus strongly on the expenditure side, because such measures have in the past proven more effective, and if they address one prime cause of a loss of competitiveness in recent years: the rise of public salaries relative to the rest of the economy.

The view that fiscal consolidation is generally negative for growth is too narrow. Demand-side economics has in the past underestimated the risks of excessive spending, and is now overestimating the risks of consolidation. We have to take into account that today's adjustments are being made in strict association with structural reforms and they enhance confidence. Both elements will increase supply and, along with supply potential, prospective incomes and thus demand. These adjustments are therefore ultimately growth-friendly.

There are very important decisions under way. It is true that Europe's decision-making process is complex. This is because it involves both national and supranational actions. But complexity does not mean ineffectiveness. Europe has been remarkably effective during the 2007/2008 financial crisis. Not a single systemically important institution has failed, not a single recovery programme has been refused by any parliament.

What markets often underestimate is Europe's complete dedication to the degree of integration achieved so far. Decisions were taken recently, which were difficult to foresee by observers and markets only a few months or weeks ago: a negotiated fully-fledged adjustment programme for a member state, a €80 billion support loan by member states for that programme, and a €440 billion financial stability facility, on top of a €60 billion existing facility. This provides Europe with a highly significant endowment of a total of €580 billion (around $700 billion), without even counting the possible additional IMF co-financing.

Let me now turn to the main topic of my remarks: global governance.

1. Global governance and the crisis

Global economic governance embraces supranational institutions – such as the IMF – as well as informal groupings – such as the G7 and the G20. Both are necessary, and both are complementary. Supranational institutions offer a framework for dialogue and formal agreement. Informal fora are invaluable for "softening the ground" in areas where decision-making processes remain largely national – whether in forging a consensus on prudential standards and codes, or facilitating the coordination of economic policies when appropriate.

How did this system of formal and informal elements fare during the crisis? Let me highlight one strength and two areas that are still in need of strengthening.

To my mind, particular resilience was shown by the central banking community – both bilaterally and channelled through the various Basel-based committees. This institutionalised cooperation ensured an unprecedented degree of collaboration in, for instance, the provision of cross-border liquidity – the network of temporary currency swaps or repos set up bilaterally by central banks such as the Fed and the ECB. This cooperation has been reaffirmed and further activated in recent weeks as market conditions have deteriorated, underlining the strong commitment of the central banking community to addressing the global crisis in a co-ordinated way.

Of the areas still in need of strengthening, the first relates to macroeconomic policies that were clearly insufficiently oriented towards medium-term sustainability. This led to the build-up of unsustainable external imbalances between deficit and surplus economies prior to the crisis. No effective mechanism existed to influence macroeconomic and structural policies in key countries where those policies appeared unsustainable from the standpoint of global economic and financial stability.

This must change – and it requires both improvements in the efficiency and legitimacy of international institutions and a broader awareness by national authorities of their global responsibilities. The G20 Mutual Assessment Framework is promising in this regard. Just this last weekend, G20 Ministers and Governors in Korea reviewed this process, which will now be examined by Heads of State in Toronto in early July. The momentum is here, and we fully support this overall process.

The second shortcoming was the insufficient coordination in financial regulation before the crisis, which encouraged regulatory arbitrage. This was the unavoidable result of the disparity between the increasingly *global* financial players, and the largely *national* approach to financial regulation, with only relatively weak coordination at the international level, despite the remarkable efforts of the Basel Committee in respect of the banking sector.

The crisis demonstrated quite clearly that proceeding too far down the road of deregulation is not always conducive to better functioning markets. Rather, markets require an effective regulatory and supervisory infrastructure to function properly. Of course, setting common rules in complex and innovative fields such as finance requires finding the balance between allowing financial innovation and growth, and preserving stability for the good of the real economy. But it should remain foremost in all our minds that the prime purpose of the financial sector is to serve the real economy, not the other way around. Changes to the regulatory environment should reflect that.

Given the current downturn and the volatility of financial markets, it is imperative that the timelines for regulatory reform agreed by the G20 in the autumn of 2008 are met. Policy-makers should remain committed to setting rigorous standards and designing appropriate transition periods that will allow countries and financial institutions to implement the agreed regulatory standards consistently and fully.

In this context, the Basel Committee's reform package, released last December for consultation, forms one of the cornerstones of the financial regulatory reform. It is important, however, that the cumulative impact of the reform package on financial institutions and the real economy is thoroughly assessed. We will carefully consider the impact analysis presented by the IIF in the process of evaluating the multifaceted impact mechanisms of regulatory changes. There may well be differences in views on the most appropriate way of computation as well as on underlying assumptions. We have to deliver a much safer and much more resilient financial system that it to the benefit of the sustainable development of the real economy.

2. The evolution of global governance

Let me now turn to how the system of global governance is evolving in response to the crisis. I see three major trends:

First, the scope of international cooperation is broadening significantly.

Second, the efficiency and legitimacy of global governance is being addressed: the mandates and governance structures of existing international institutions are being strengthened, existing informal fora adjusted and new fora developed.

Third, the system is moving decisively towards a much more inclusive system of global governance, encompassing key emerging economies as well as the industrialised countries. The acknowledgment of the increasing role of emerging economies is a trend that predates the recent crisis. But the crisis has made it even more pressing. Although emerging countries have also been immediately affected, they have rapidly become a source of strength for the world economy. In 2009, the contribution of emerging countries to global growth was 57%. In the same year, they represented roughly one third of world GDP at market exchange rates (31%), and close to a half using PPP rates (46%).

There are several examples where these three trends become apparent:

The emergence of the G20 as the prime group for global economic governance is probably the most prominent example. It provided policy impulse and took decisive actions during the crisis. It is now making the transition from crisis resolution to crisis prevention. This is the purpose of its framework for strong, sustainable and balanced growth. Its primary goal is collectively to implement coherent and medium-term policies to attain a mutually beneficial growth path. Since this process is fully owned by the G20 members, and involves Heads of State and Government, it also confirms the strong commitment at the global level to more multilateralism in economic decision-making.

A second example is the designation of the Global Economy Meeting (GEM) as the prime group for the governance of central bank cooperation. This forum includes central bank governors from all systemic emerging economies. I currently have the privilege of chairing the GEM, and find the candid exchange of views at our bi-monthly meetings of enormous value.

And a third example is the reform and the expansion of the Financial Stability Board (FSB). It now includes all the systemic emerging market economies, largely overlapping with the G20. Its mandate has been enhanced to strengthen the international financial architecture and global financial stability. The FSB assesses vulnerabilities affecting the global financial system and reviews the regulatory, supervisory and related actions needed to address them.

3. Insights from the crisis

Let me draw to a close. Looking ahead, and distilling insights from the financial and economic turbulence of recent years, I would like to stress three points.

First, the crisis has shattered previously held convictions that "keeping one's house in order" and self-regulation are sufficient to ensure global welfare. We have seen that improvements are needed to preserve the safety of the global economic and financial system. These improvements concern rules of the game and procedures, but they also concern attitudes and underlying values. Countries have to recognise the global impact of their policies and financial market players have to accept that the prime purpose of the financial sector is to serve the real economy.

Second, more than in the past, global governance must demonstrate a capacity to coordinate and decide extremely swiftly. A characteristic of the turbulences that intensified in September 2008 was the extreme rapidity in the succession of events as the crisis unfolded. The very high degree of interdependency between all economies calls for a much higher level of cooperation than in the past.

Third, the crisis has rightly accelerated the inclusion of emerging markets into the framework of global governance. But there are two reasons for this change. One is positive: the emerging economies are now economically and financially so important, and systemically so influential, that they must be fully involved in global governance. I hesitate to unveil the other reason that is not flattering for industrialised countries: they did not live up to their responsibilities prior to the crisis. Now, the industrialised countries are called on to contribute to the stability and prosperity of the global economy within the new, more inclusive framework.

Looking ahead, we see that the global recovery has started to proceed at different speeds across regions, with a relatively modest recovery in advanced countries like the United States, Japan and the euro area and a stronger expansion in the emerging economies. And yet, there is no time for complacency as recent tensions in financial markets have amply demonstrated.

Let me stress that it is important that the recovery should be measured in broader terms than the simple resumption of GDP growth and a return to sustainable fiscal positions: it means a full restoration of trust in our financial institutions; it requires the healing of wounds inflicted by the irresponsible behaviour of some financial players on our societies and on the real economy; and it requires renewed confidence that global governance is strong, broad and flexible enough to ensure global economic and financial stability and resilience in the future.

Thank you for your attention.