

Jean-Claude Trichet: Europe's frameworks for macro-prudential oversight and economic governance

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Economic Club of New York, New York, 12 October 2010.

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Ladies and gentlemen,

Stopping over in New York after the IMF meetings has become a tradition I very much cherish.

And it is a particular pleasure for me to speak before the Economic Club of New York today. The last time I spoke here was on 14 October 2008. At that time, we were in the eye of the storm, with fresh and acute challenges to the global financial system arising by the hour. Today we have to remain permanently alert, while we must address all of the challenges associated with the need to ensure long-term financial stability. We must find a way to create a financial system in which a crisis of this magnitude cannot happen again.

If I were to draw one lesson from the IMF meetings which have just taken place in Washington, it would be that the international community is fully aware of the need to remain particularly vigilant in the present period. A lot of hard work has been accomplished since the intensification of the crisis in mid-September 2008. But a lot remains to be done both as regards the resilience of the global financial system and as regards the rebalancing of domestic and external imbalances at a global level within and between the advanced and the emerging economies. More than ever, resolve is of the essence.

Today, I would like to address two issues: Europe's new macro-prudential framework and the planned strengthening of Europe's economic governance.

How Europe is addressing systemic risk

Let me start with the macroprudential framework. Here, I have three basic messages.

First, I am honoured to speak to you not only in my present capacity as President of the European Central Bank, but also – if I may – in my future capacity as Chairman of the European Systemic Risk Board or ESRB. This new European Union (EU) body, established to provide macro-prudential oversight, will become operational in January.

Second, there is a remarkably strong political consensus in Europe in favour of establishing this new body. The European Parliament approved the legislation supporting the functions of the ESRB with an overwhelmingly large majority of around 80%.

Third, the establishment of the ESRB is part of a more comprehensive reform of financial supervision in Europe, which encompasses also the creation of three micro-supervisory European authorities, of a European System of Financial Supervision and an acceleration of structural reforms in the broader financial arena. The breadth and depth of reform in Europe is, in my view, comparable to that recently enacted by the US Congress.

Allow me to elaborate on these issues of macroprudential supervision and broader financial regulation.

Establishing Europe's macro-prudential framework

One of the overarching objectives of the reforms carried out in recent months in Europe and the United States has been the near simultaneous establishment of a new supervisory architecture. On both sides of the Atlantic, new legislation has been enacted with the specific

aim of overseeing systemic risks in the financial sector as a whole. This represents considerable progress towards regulatory convergence across our two economies, which only a few years ago would have been considered impossible.

In the EU, progress is expected to be achieved at all levels of authority. In a third of the Member States, policy-makers have announced or enacted a revision of existing national institutions. I consider it significant that these events are taking place in the context of increasing consensus among European authorities. Only a short while ago it was feared that divided and partial responses by the regulators to the financial crisis had put Europe's single market at risk. Today, I observe with satisfaction that institutions acting in different financial markets – from the City of London to the major financial centres of continental Europe – are increasingly speaking a common language.

At the EU level, reform has involved a comprehensive overhaul of all segments of the financial sector: banks; securities markets; and insurance and occupational pensions. For each of these, the EU has created new European Supervisory Authorities (ESAs), which bring together the competent national institutions, and will draw up guidelines and recommendations to ensure that systemic risks arising from individual institutions are adequately addressed. These institutions will establish a "single rule book for Europe", reducing inconsistencies between national regulations and fostering cooperation across Europe's national borders.

The ESRB for its part will consider financial institutions, markets, products and infrastructures. It will have a horizontal focus, across countries, across sectors and across the boundaries between the financial sector and the real economy. Understanding interlinkages and spillovers will be at the core of its analysis. To fulfil its mandate, the ESRB will perform three main tasks: identifying and prioritising systemic risks; issuing early warnings when significant systemic risks emerge; and making policy recommendations for remedial action in response to the risks it identifies. It will be the ESRB's responsibility to initiate corrective responses to any identified threats to the EU's financial stability.

The institutional framework remains complex in the United States, but it is, for obvious reasons, even more complex in Europe. That complexity requires a unique combination of Europe-wide and national competences, which are attributed to different institutions. Adopting legislation requires, following a proposal by the Commission, both the assent of the Council – a body representing the 27 national governments – and the approval of the European Parliament. Despite this complex decision-making process, Europe has delivered a new framework in around the same time as the United States, a framework which represents a high level of ambition, comparable to the ambition shown by the Dodd-Frank legislation.

The new Europe-wide institutions will also receive substantial new assignments. Many issues are common to Europe and the United States. To mention but a few, Europe is discussing provisions to bring the shadow banking sector into the regulatory system, to reduce risks by bringing transactions into transparent and secure financial infrastructures, and to increase consumer protection against the abuse of market power.

Months of intense work lie ahead of all of us – in all the entities making up the European System of Financial Supervision – to implement these new regulatory powers. The ESRB and the ESAs will need to develop a common set of quantitative and qualitative indicators to identify and measure systemic risk. We will need to understand how to coordinate our functions, in terms of data collection, analysis and communication. All of this will need to be performed within tight deadlines and under pressure to deliver functional arrangements. I understand that our colleagues in Washington face equally demanding assignments with equally tight time frames.

Basel III

There is no question that this is the time for action on our financial system – in Europe, in the United States and globally. This leads me to the most global of regulatory frameworks: that established in Basel.

Since I have the honour of chairing the Committee of Governors and Heads of Supervision that oversees the work of the Basel Committee on Banking Supervision, let me say a few words about the “Basel III” reform package. In my view, this achievement is a cornerstone of the new regulatory system and I would like to pay tribute to all those who have worked on this new framework and succeeded in agreeing on it at a global level.

Basel III represents a decisive improvement in global capital standards. In this context, I find the Long-term Economic Impact study particularly noteworthy. It reminds us of the fact that tighter rules can be beneficial for economic welfare, for the simple reason that they help to avoid the major crises triggering abrupt busts, deep recessions and threats of depression that are so damaging to our societies. The study suggests in particular that if tighter rules were to lower the yearly probability of a major financial crisis by 1 percent, this could correspond, on average, to an annual output gain of 0.6%.

The study also suggests that the increase in capital requirements, which is part of the Basel III consensus, would indeed significantly reduce the probability of a crisis. Of course, the figures need to be interpreted with caution, but the various models applied in the impact study all suggest that the net social benefits of strengthened regulation can be substantial. They also remind us that, in the long run, growth is only meaningful if it is sustainable.

Overall, I consider that the agreement strikes a good balance between the objective of decisively strengthening the resilience of the financial sector in this new permanent regime, and at the same time, establishing a transitional period which is sufficiently well crafted not to hamper the ongoing recovery.

Wider financial reform

But we are far from done on financial reform.

Financial reform at the global level is necessarily complex, and achieving it demands resolve and perseverance. For some comprehensive measures such as the framework to address risks posed by systemically important financial institutions, hard work remains to be done, in particular through the Financial Stability Board, to clarify the concept of systemically important institutions, to investigate the properties of the pertinent tools – additional capital requirements, contingent capital, bail-in instruments, etc. – appropriate to increase the loss absorbency of their capital base and to develop firm-specific recovery and resolution plans. This will require continued resolute coordination and dialogue in order to resolve potential conflicts and avoid regulatory arbitrage.

But there is much more to the financial system than the main regulated banks.

The financial system has grown in scope and dimensions that – since finance is largely an invisible service – are hard to imagine.

There are three figures that I consider it important to note in absolute terms. First, assets of major investment banks have risen from less than USD 2 trillion 20 years ago to USD 22 trillion just before the crisis. That is around 1.5 times US GDP. Second, hedge funds, which had capital under management of less than USD 100 billion in the early 1990s, were estimated to manage around USD 3 trillion in 2007 – 30-fold increase in 17 years – and are probably of this order of magnitude or larger today. And finally, the notional value of all categories of derivatives contract has increased by a factor of 20 over the past two decades to stand at more than USD 600 trillion, ten times world GDP.

These figures give a measure of the structural transformation seen in the global financial markets over the last two decades.

I consider that we are a long way from fully understanding what those dramatic transformations mean in terms of concentration and the spreading of real risks, in terms of the additional unpredictability of the behaviour of the system as a whole and, therefore, in terms of potential systemic financial instability.

There are still many issues on the agendas of the G20 and the FSB that need to be implemented. My message on these is straightforward: these agendas should be implemented fully and equally on both sides of the Atlantic. Rigour and a level playing field are the two key terms in this context.

Apart from the issue of systemically important financial institutions, which will figure high up on the upcoming G20 agenda, there are at least six other items where progress needs to be made in the design and/or implementation of reform. These are: accounting, ratings, short-selling, compensation, OTC derivatives and alternative investment vehicles.

Accounting, ratings and short-selling practices are all issues that need to be addressed in order to lessen the degree of procyclicality in our financial system.

On accounting, the G20 summit in London decided that accounting standard setters should reduce the complexity of standards for financial instruments, achieve clarity and consistency in the application of valuation standards internationally, and make significant progress towards a single set of high-quality global standards.

The announcement made in June 2010 by the IASB and FASB on their convergence strategy is welcome, also because time lags in implementation are considerable. If the SEC decides in 2011 to incorporate IFRS into the US domestic reporting system, this would mean that US issuers would potentially not actually report under these rules until 2015 or 2016.

Moreover, even though many attempts are underway, in key accounting areas there are still divergences to be addressed. For example, the accounting for financial instruments still diverges considerably between the IASB and FASB on the role of market valuation. As regards ratings and the G20's call to engage in decoupling the financial system from external ratings, work is also in progress on both sides of the Atlantic.

For short-selling rules and practices, the key shortcoming prior to the crisis – i.e. the fact that there was no European harmonised framework – will soon be rectified. The Commission has recently made its proposals for a harmonised framework at EU level, which also aims at ensuring consistency with rules prevailing in the US.

Short-termism in the financial system was a key element contributing to the crisis. I note that G20 leaders in Toronto in June this year considered implementation on compensation rules and practices – one of the issues underlying short-termism in finance – to be “far from complete”. Indeed, there is still considerable divergence, and a lot of work remains to be done with supervisors and regulators to ensure that compensation practices do not provide incentives for an excessive focus on short-term returns.

Finally let me stress two issues that concern extending the perimeter of regulation.

First, the creation of infrastructures for OTC derivatives with the decision to clear all standard derivatives products on central infrastructures by end-2012 at the latest. The Commission proposal for a European framework has been designed so as to aim at a level playing field with the approach in the United States. If decided on in due course, timely implementation could be assured.

Second, the G20 also agreed to extend the perimeter of regulation to systemically important financial intermediaries including alternative investment funds. The London G20 summit declaration had stated “to extend regulation and oversight to all systemically important financial institutions. This will include, for the first time, systemically important hedge funds.”

If there is one area where a global level playing field is absolutely necessary and, in particular, a level playing field on both sides of the Atlantic, it is certainly the sector of alternative investment funds.

We are still fully in the process of implementation of financial reform. Given the issues at stake and the complexity of finance as well as the global financial system it is not astonishing that implementing this agenda takes time. What is of the essence, is rigorous and equalised implementation on both sides of the Atlantic, and in the rest of the world.

Strengthening of Europe's economic governance

Let me now turn to the economy and devote the second part of my remarks to Europe's economic situation and planned reforms in the area of economic governance.

Real GDP in the euro area grew by 1%, quarter on quarter, in the second quarter of this year. Growth has been supported mainly by domestic demand, but also reflects some temporary factors. Recent statistical releases and survey evidence generally confirm our expectation of a moderation in the second half of this year in the euro area. Therefore, we do not declare victory and we have to remain cautious and prudent. That being said, the positive but modest underlying momentum of the recovery remains in place. Annual inflation in the euro area is currently 1.8%, and we expect inflation to remain moderate in 2011. Very importantly, we note that inflation expectations over the medium to longer term continue to be firmly anchored in line with our definition of price stability.

As all developed economies, Europe has experienced a period of unprecedented turbulence in the last three years. As regards the policy response of the executive branches, the EU and the euro area do not take decisions in the same way as a fully fledged political federation like the United States. Decision making processes are of a different nature and certainly more difficult to decipher by external observers.

That said, the trend over the last three years has been that, when faced with new challenges, the euro area has found solutions. This was the case in the rescue of the financial sector in 2008, when no systemically important institution failed in Europe and no economic support package was refused by any of the numerous Parliaments. That was also the case earlier this year in the support for Greece and the establishment of the new stability facility. If I were to draw a tentative lesson from this period, it would be that there is a high level of resolve in the euro area to engage in the decisions and the reforms that are necessary to preserve and consolidate the functioning of the Economic and Monetary Union.

Looking ahead, I see two trends that support this view.

Prioritising fiscal sustainability

The first trend is a general recognition among euro area countries of the need to prioritise fiscal sustainability. The governments of all euro area countries have committed to fiscal consolidation, although implementation is more advanced in some cases than in others. In many countries, implementation is already bearing fruit. The IMF currently projects the aggregate fiscal deficit for the euro area next year to be 5.1% of GDP – compared with 9.7% of GDP in the United States, 8.1% of GDP in the United Kingdom and 8.9% of GDP in Japan.

I am confident that this trend towards fiscal sustainability will continue. Euro area countries are demonstrating their commitment to a sustainable path by taking action towards consolidation that is necessary and in their own interests. In the euro area generally, the public debate is mostly supportive of the rationale for fiscal consolidation.

Some have asked why I see fiscal consolidation as a positive trend for the euro area. The well known counter-argument is that consolidation risks dampening the prospects for growth. But I believe that fiscal consolidation is not only positive, but essential – for three reasons.

First, experience suggests that the short-term costs of fiscal consolidation can be contained if the consolidation strategy is effectively designed and includes a comprehensive programme of structural reforms. Conversely, the long-term costs of not consolidating can be non-linear and unpredictable.

Second, the excessive level of fiscal imbalances in many euro area countries puts them in “uncharted waters”, where they can be vulnerable to a rapid deterioration of confidence among firms, households and investors. This makes consolidation imperative.

Third, we are still in uncertain economic times, and it is important that governments retain the capacity to intervene in the face of possible future adverse events, including unforeseeable circumstances such as natural disasters, which can have a significant fiscal dimension. This requires sound public finances and specific strategies tailored to national circumstances.

A new framework of economic governance

The other trend that is encouraging for the euro area, but where there is still a great deal of hard work before us, is the review of the economic governance framework. The European Commission and the Task Force chaired by the President of the European Council, Mr van Rompuy, have been very active in this area. The Commission has come forward with proposals to strengthen economic governance, published on 29 September. A number of these proposals go in the right direction and address some important gaps in the existing governance framework. But let me lay out what I believe to be critical points in the implementation of a new framework.

What we need is a fundamental strengthening of economic governance in the euro area. Economic and Monetary Union rests on two pillars, the economic pillar and the monetary pillar. The monetary pillar is firmly established and the ECB has fully delivered on its mandate to maintain price stability at below and close to 2%, over the medium term. Over the first 11½ years of the euro, the average annual inflation rate has been 1.97%. What is more, inflation expectations are firmly anchored in line with our mandate.

In contrast, the economic pillar of our union remains under construction and there is much work to do. One key area is surveillance of fiscal policies to prevent excessive deficits and unsustainable public debt. It is essential to establish sound procedures to enhance and enforce fiscal surveillance in the euro area. We need shorter deadlines under excessive deficit procedures so that corrective policy action is taken in good time. We need quasi-automaticity in the application of sanctions, based on clearly defined criteria and with less discretion over outcomes. And we need ambitious targets for the reduction of public debt towards the 60% of GDP ceiling.

The crisis has also demonstrated the importance of broader surveillance of macroeconomic policies in the euro area. Given the large spillovers from the macroeconomic policies of one country to other members of the single currency, much needs to be done. I am in favour of the creation of an early warning system to identify unsustainable policies.

A number of the Commission’s proposals point in this direction, but we need to go further still. The framework for the assessment of macroeconomic imbalances within the euro area should focus primarily on countries with vulnerabilities, losses in competitiveness and high debt levels, as these countries face the greatest sustainability challenges.

The framework should also use a limited number of indicators to ensure clarity and consistency. When the indicators reveal potential problems, they should automatically trigger an in-depth analysis of the country concerned, including missions by the Commission in liaison with the ECB and public scrutiny. This process should be backed up by graduated sanctions, which kick in at an early stage, to reinforce compliance with recommendations.

The effectiveness of these enhancements to the governance framework will in part be determined by the quality and independence of the economic analysis that underpins them.

Without reliable statistical data, interpreted and acted on by independent arbiters, we cannot be certain that the governance framework will provide the quantum leap forward that is necessary. It is therefore extremely important that the Commission services charged with conducting macroeconomic and fiscal surveillance for the euro area be sufficiently independent, ideally supported by a body of “wise persons” providing external assessments.

We are now at a stage where we need to remain bold and enact those reforms that we envisaged when the crisis was at its deepest. It was then that we witnessed the clearest manifestation of risks and our judgement was sharpest. It would be a big mistake if, with gradually improving conditions, we fell back into accepting the status quo. I therefore call on all parties to remain as bold in their reforms as they were when we were in the eye of the storm.

Concluding remarks

Let me say in conclusion that I consider it essential to *preserve*, *consolidate* and *reinforce* the remarkable unity demonstrated by the international community in the crisis period.

We were able to agree on the following major points.

First, there was the consensus on the need to increase participation in the informal global governance framework to include all systemic emerging economies. This was illustrated by the G7 passing the baton to the G20 as the primary forum for global economic governance.

Second, there was consensus – spanning both emerging and advanced economies – in confirming, at the very moment the crisis was unfolding, that market economy rules are the most effective and efficient means to create prosperous economies and societies.

Third, there was consensus on working together to reinforce rules, regulations and standards in the financial sector with a view to decisively strengthening its resilience and improving the coordination of fiscal and structural policies within a framework for strong, stable and sustainable growth.

This was no time for complacency. The unity of the international community made a difference. We avoided a depression, and the recovery began in the second half of 2009.

This is still no time for complacency. What we need today is not “wars” of any kind, but a strong and renewed commitment to confident and resolute cooperation.

Together we must say “no” to protectionism and “no” to beggar-thy-neighbour policies. The international community can and must continue to make a difference by being united and showing a strong sense of medium and long-term direction.

I thank you for your attention.