Jean-Claude Trichet: Global economic governance and euro area economic governance

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the World Policy Conference, Marrakech, 16 October 2010.

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Ladies and Gentlemen,

It is a real pleasure to be here in Marrakech – a city which, in its history, is a demonstration of the link between economic success and political events and choices. Morocco is also an important partner for the EU in the context of the Union for the Mediterranean and the Barcelona process. Let me also mention that the ECB and the Bank Al Maghrib have well-established bilateral relations, as well as close contacts in a multilateral framework. For example, the ECB and the other Eurosystem central banks regularly meet with Bank Al Maghrib and the other central banks of the Mediterranean region in the framework of high-level seminars, in which they discuss economic and financial issues of common interest.

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Let me start by saying a few words about the current economic outlook in the euro area.

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.

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In my remarks today, I will focus on global governance and in particular on the lessons that can be drawn from the extraordinary events of the past two years. I will first elaborate on why we need a set of rules, institutions and international relations that we call "global governance". Second, I will analyse how, in hindsight, the existing global governance has fared during the global financial crisis. Third, I will deal with the evolution of the system as a response to the crisis, and in particular I will discuss the rise of new key entities in the world economy such as the G20 and the Financial Stability Board, with a view to the upcoming G20 Leaders meeting in Seoul. Finally, I will touch upon the important institutional changes that are being decided on or implemented in Europe, which should make the EU better equipped to contribute to global stability and prosperity.

Let me point out that economic freedom is not possible without an adequate set of rules and this is valid both within countries as well as in the international realm. This will be the overarching theme in my intervention today.

1. Why do we need global economic governance?

By "global economic governance" we mean, at least in the economic sphere, the set of supra-national institutions and laws as well as the international relations between countries that have an effect on cross-border economic and financial transactions.

Indeed, no market can survive without an institutional infrastructure, i.e. a set of rules and this is particularly true at the international level, where natural barriers to transactions are already formidable. Global governance's primary aims should be that of reducing transaction costs, and that the process of doing so is evolutionary and characterised by continuous change and learning by doing. One therefore needs to maintain a pragmatic approach with respect to what arrangements may work and not work in facilitating trade and keeping transaction costs low, depending on the circumstances.

Moreover, the more complex and durable the goods and services exchanged, the larger the need for a sound institutional infrastructure. In this respect, finance stands out as a field where global rules may be particular beneficial. More generally, the crisis has weakened the arguments of those who think that de-regulation is always and necessarily conducive to a better functioning of markets.

Of course, there are clear limits to what internationally agreed rules can and should achieve.

First, the principle of subsidiarity remains valid, implying that no rule should be imposed at a global level that cannot be more or equally effectively set at the local level. Incidentally, this principle is enshrined in the Lisbon Treaty and is therefore part of primary EU law; the Lisbon Treaty, in particular, has explicitly recognised a role for national Parliaments in monitoring subsidiarity in the EU. This principle might also imply that the "burden of the proof" should rest on those who want to establish global, as opposed to local, rules and institutions.

Second, there is a risk that common rules are not optimal and in particular they are too lax, since they have to be the "common minimum denominator" across many different local positions.

Third, some argue that imposing a common rule also implies limiting the range of national experiences and therefore the potential for learning about the best institutional setting. It would therefore prevent the best rules from emerging from free competition among different systems. Finally, and perhaps most importantly, it is not easy to set common rules in particular in complex and innovative fields like finance.

The global financial crisis has, however, weakened some of these arguments and shattered the previously held conviction that "putting one's house in order" is the only principle that matters to ensure global welfare, and that international spillovers need not be taken into account. We have certainly become more aware of the negative externalities that globalization, in particular financial globalization, can create. This is epitomised in the sentence "the crisis is global, the solutions need to be global". In my view, international interdependencies are too large for purely national or regional rules to be optimal and there is a clear need to strengthen global governance, in particular in the financial field. For example, the crisis has exposed the risk of regulatory arbitrage, shedding a more negative light on the competition among different systems and rules. In addition, the view that local governments are always driven by the welfare of their citizens needs to be qualified, as special interests often matter a great deal. Those special interests are likely to exert less influence if the rules are agreed on at the international level.[1]

2. How has global economic governance fared during the global financial crisis?

Let me now turn to analyse how our global institutions have fared during the global financial crisis.

Global governance in the decades before the financial crisis was characterised by a number of multilateral institutions and relations, in particular three key supra-national institutions, the

[1] Frieden (2009).

IMF, the World Bank and the World Trade Organisation (WTO) were (and still are) in charge of the international monetary system, long-term development and trade respectively, while the G7 was the main informal forum for global strategic governance.

Another distinctive feature of the decade before the financial crisis has been a progressive and largely beneficial trade liberalisation and integration, driven by the WTO. Trade liberalisation has reshaped the world economy, leading to the integration of key emerging economies such as China and India in a market-based system, a trend which has benefited consumers the world over. At the peak of the crisis, there was a legitimate concern that such progresses would be stalled or reversed as countries focused on their own economic growth even at the expense of growth elsewhere. Protectionist and "beggar-thy-neighbour" policies would have certainly aggravated the crisis, as they notoriously did in the 1930s, and yet somehow it could have been expected in such dire circumstances and given the political difficulties associated to them. A good system is one where these self-defeating pressures could be resisted. How has the global system fared in this regard? I will look into five dimensions, namely protectionism, central bank cooperation, regulatory arbitrage, and global imbalances.

2.1 Protectionism

A systematic look at recent trends in global protectionism indicates that there has so far been an only moderate increase in actual protectionist measures to restrict trade through tariff and non-tariff barriers. According to the WTO, a significant outbreak of trade protectionism has been avoided since the start of the crisis. Yet more protectionist pressures might be on the pipeline. First, evidence from surveys shows that public pressure for more economic protection not only has been mounting since the mid-2000s, namely well ahead of the crisis, but has intensified since its start and particularly in the most recent months.

This leads me to conclude that in the trade field, while a repetition of the experience of the 1930s is very fortunately not on the cards, there is certainly no room for complacency and vigilance needs to remain high.

2.2 Central bank cooperation

Another dimension of international cooperation that has worked well during the financial crisis has been that among central banks, channelled through the various Basel and Bank for International Settlements (BIS) committees. This institutionalised cooperation has ensured an unprecedented degree of collaboration and coordination in the provision of cross border liquidity.

Information sharing among central banks has also worked very well, for example on the occasion of the Global Economy meeting of Governors of Central Banks that meets every two months in Basel and where central bank governors from systemic economies have the occasion to discuss issues the global economic outlook, international monetary and financial issues and other issues of mutual interest. Clearly, these fora have turned out to be very useful in times of global financial distress and we should continue to invest on them in the future.

I would also like to mention that the BIS as an institution has been "ahead of the curve" in terms of identifying unsustainable trends in the financial sector and more generally in the global economy – such as the under-appreciation of risk and excessive credit growth – which eventually led to the global financial crisis. It could do so based on a high degree of analytical depth and information sharing at a global level that the BIS and the Basel committees have been able to develop over time. In my opinion, these analytical contributions have played a very significant contribution to form the strong and coordinated policy response that we have witnessed during the financial crisis.

2.3 Where the system has fared less well: regulatory arbitrage and global imbalances

As much as global governance appears to have passed the severe test of the global financial crisis, we should not remain oblivious to the fact that there were significant shortcomings that have contributed to create the conditions for the crisis to happen in the first place. I will mention, in particular, two dimensions: the insufficiencies in terms of financial regulation and international coordination, on the one hand, as well as the constellation of global imbalances, on the other. Let me deal with both in turn.

The lack of integration and coordination in financial regulation was pervasive before the crisis, even though this was not properly appreciated at the time, and has encouraged financial institutions to engage in a large degree of regulatory arbitrage.[2] This was the unavoidable result of the fact that, while finance was becoming more and more global, with some financial institutions having operations in dozens of jurisdictions, financial regulation has remained largely national, with only some form of mild and non-binding coordination at the European and international level. Later, I will discuss how the international community is addressing this problem, in particular, under the leadership of the Financial Stability Board and of the Basel Committee.

As regards global imbalances, the deficiencies of macroeconomic policies as regards economic and financial medium-term stability and sustainability, led to the build-up of unsustainable external imbalances among key deficit and surplus economies prior to the crisis. A number of advanced economies have engaged in macro-policies that are imbalanced and marked by a structural lack of savings. On the other hand, excessive reserve accumulation by emerging countries have contributed to make global imbalances too easy to finance, resulting in compressed global interest rates and ultimately in too high risk taking and leverage in those (advanced) countries that were receiving a large degree of capital inflows, ultimately contributing to pave the way for the financial crisis to unfold. Moreover, there was a distinct perception of a lack of an effective mechanism to influence macroeconomic and structural policies in key countries where those appeared unsustainable from the standpoint of global economic and financial stability. The global public good of international financial stability was, and remains, under-supplied. This is an area where bold and ambitious reform was and is needed.

3. The evolution of the system

Finally, let me now turn to the question of how the financial crisis has moved the direction or the speed at which global governance is moving. Some of these trends are not yet fully clear, nor free of challenges.

3.1 From the G7 to the G20

One distinctive feature of this crisis has been its originating at the centre of the system, differently from past major crises in the previous three decades. Although emerging countries have also been severely affected, they have overall been, at least taken as a group, a source of strength for the world economy. They are also recovering significantly faster than advanced countries at the current juncture. It is therefore not surprising that the crisis has led to an even better recognition of their increased economic importance and to a better integration in global governance. It is notable that emerging markets now represent around half of the world GDP in Purchasing Power Parity (PPP). To be sure, the acknowledgement

[2] See, among others, V. Acharya and M. Richardson (eds) (2009): Restoring Financial Stability: How to Repair a Failed System, Wiley, March.

of the increased role of emerging countries is a trend which precedes the global financial crisis, but that has been made significantly faster, and perceived more pressing, by it.

Global governance – and indeed collective decision making in general –always faces a trade-off between efficiency and legitimacy. With few, homogeneous players around the table, decisions are taken more quickly and perhaps implemented more easily; but they may not be seen as legitimate from those excluded from the same table. Therefore, devising institutions for collective decision making is always a delicate balancing act, even more so at the global level. The international community has agreed that, from now on, the G20 is the main forum for the informal governance of international economic cooperation and it includes 11 emerging economies.

To be sure, the G20 has already been in existence for over a decade. The main innovation is to make it as the key informal forum for strategic global impulse at the level of the Leaders as well as at the level of Ministers and Governors, not only in crisis times but permanently.

3.2 The G20 Framework

An important decision, taken at the G20 Pittsburgh summit in March 2009, has been the G20 Framework on cooperative mutual assessment of members' policies. I consider this a decisive step forward in order to address one of the main shortcomings of the pre-crisis regime, namely the lack of a way to ensure that macroeconomic and structural policies of key countries take into consideration their external spillovers and in particular the risks that they entail for the global financial system. This should not imply that the G20 should enter in macroeconomic decisions on a short term basis or micro-manage economic policies, but rather that a mechanism should be put in place in order to evaluate whether medium to long term policy objectives are mutually compatible, which is the optimal pace for the rebalancing of the current account deficits and surpluses, as well as the domestic demands of the systemic economies.

However, whether this initiative will eventually lead to a significant change in national and global economic decision making is still far from obvious, and only time will tell. Notably, the Framework's predecessor, the IMF's 2007 multilateral surveillance initiative, encountered significant compliance problems, which makes the G20 ownership of the new Framework particularly promising and noteworthy. At the same time, we still cannot be sure that the Framework will be implemented effectively. It is therefore paramount that the international community presses ahead now and fully lives up to the commitments taken in the G20 context; in particular, it is important that the rebalancing efforts are maintained over time even when the recovery will appear to be solidly consolidated at the global level.

3.3 Further strengthening of central bank cooperation

In the area of central bank cooperation, discrete, but decisive steps have been made since the onset of the crisis. A core feature of this crisis has been not only the central importance of domestic liquidity provision by central banks, but also its complementary cross-border dimension, that is, the network of temporary currency swaps or repos set up bilaterally by major central banks such as the ECB and the Federal Reserve, which has involved many other central banks in the world. At the same time, progress has been also made in deepening central bank cooperation and extending its geographical scope.

The main forum of global central bank cooperation is the Global Economy Meeting (GEM) which takes place in Basel. Over the past few years, this forum has been including 34 governors as permanent members plus a number of other governors attending on a revolving basis. The GEM is a very important forum as it assesses global economic and financial conditions, analyses economic and financial policy issues of common interest to central banks. It now exerts governance over the central bank cooperative activities conducted by various Basel-based central bank committees under the auspices of the BIS.

I have the privilege to chair the GEM, and must say that I find the frank and very rich discussions we hold at its bi-monthly meetings of invaluable importance for the central bank community at large.

3.4 The rise of the FSB

Another crucial innovation of the past couple of years has been the expansion of both membership and range of competencies of Financial Stability Board (FSB) chaired by Mario Draghi, the Governor of the Bank of Italy, and in charge, together with the IMF, of strengthening the international financial architecture and of global financial stability. The expanded membership – now largely overlapping with the G20 – and the stronger mandate significantly raises the profile of the FSB. The broad membership of the FSB – where both central banks and regulatory authorities are involved – ensures an unprecedented degree of international cooperation in regulatory matters. The FSB has been working actively on drawing the lessons from the crisis from the standpoint of the global principles for prudential rules regulations and supervision of all financial activities. In any case progress in building a global financial regulation architecture that is broadly agreed and at the same time effective is not easy, and we need a very strong consistent and determined action of all parties involved.

Let me also mention that the ECB is actively involved in the G20 (at the Ministers and Governors level) and the FSB, being a full member of both fora, and participates to their sub-structures at the technical level.

3.5 Summing up

Overall, the system is moving decisively towards an ownership of global governance that is really inclusive and comprehends systemic emerging economies as well as industrialised countries. This very significant transformation of global governance that we are engineering today can be illustrated strikingly by three examples: first, the G20 replaces the G7 as the prime group for global economic and financial governance at the level of Ministers and Governors and at the level of Heads of State or Government. Second, the Global Economy Meeting of central bank governors replaces the G10 group of governors as the prime group for the governance of central bank cooperation. And third, the Financial Stability Board membership is extended far beyond the borders of the G7. Not surprisingly after a global financial crisis, the economic and financial sectors are areas where a new concept of global governance has been decided, and we can expect a number of tests of this new bold concept in the years to come.

4. Putting the EU house in order

Let me mention now the institutional changes that are taking shape in Europe which I could label as “putting the EU house in order”, thereby contributing to global economic and financial stability more generally. I mentioned earlier that putting one’s house in order is not sufficient, but it always remains necessary and now more than ever.

The first is the EU’s new financial supervisory architecture, which has recently been approved by the European Parliament. The new architecture includes the European Systemic Risk Board, established under the aegis of the ECB, and the three EU supervisory authorities (for banking, insurance and securities markets). There are two noteworthy innovations in the new architecture which I would like to emphasise here. The first is that a high-level body is explicitly tasked with the monitoring and prevention of systemic risks to the financial sector, similar to what is happening in other important jurisdictions such as the US. Second, the macroprudential analysis will also be conducted at the EU level, in recognition of the increasing degree of financial integration within the EU. Clearly, many macroprudential issues are global, which implies that the ESRB will have to talk to, and collaborate and share information with, similar bodies outside the EU as well as international institutions such as the IMF and the FSB.

Second, last spring the EU has experienced a sovereign debt crisis in which it was not a bystander, but rather the epicentre. The crisis has had important reverberations at the global level. It is essential that the EU reforms its own institutional infrastructure so that this episode is not repeated – not only in the EU's own interests but also in view of the external effects that instability within it can have on the global economy and finance. As you know, this is a matter that is being still debated in the context of the Task Force chaired by President Van Rompuy and the European Commission has recently published legislative proposals with its views on how to reform EU governance.

The Commission has published on 29 September its proposals to strengthen economic governance.

A number of the Commission's proposals are going in the right direction, but for the euro area more ambitious reforms are needed to ensure the smooth functioning of monetary union.

In short, it is essential to strengthen further the euro area dimension of surveillance and policy adjustment. The euro area dimension must entail even greater automaticity, accelerated timelines and reduced room for discretion in procedures. It must foresee country missions and the possibility of sanctions at earlier stages in the macroeconomic surveillance framework; greater independence and quality controls in underlying analysis; and stronger powers in case of questions over statistics.

This is our assessment in a nutshell. Since the matter is so important for monetary union, I would like to give you also our more detailed assessment, which can be summarised in four points.

First, on *fiscal surveillance*, more is needed to enhance enforcement procedures. Specifically, all deadlines under the excessive deficit procedure should be significantly reduced; sanctions should be applied quasi-automatically on the basis of clearly defined criteria, without scope for discretion through "exceptional circumstances" or waivers; and the debt reduction should in some cases be more ambitious than proposed by the Commission.

Second, on *macroeconomic surveillance*, the procedures need to be straightforward and use a maximum of analytical intelligence. Thus, on top of what the Commission has proposed, it is crucial that the framework focuses on countries with vulnerabilities, competitiveness losses and high debt levels. Vulnerabilities can be detected on the basis of a limited number of indicators; and when the indicators reveal potential problems, they should automatically trigger an in-depth analysis of the country concerned, including missions of the Commission in liaison with the ECB and public scrutiny. Finally, to reinforce compliance, graduated sanctions should come into play at an earlier stage.

Third, the *quality and independence of economic analysis* is essential. Therefore, it would be important that Commission services conducting macroeconomic and fiscal surveillance for the euro area have some independence, for example the same independence as the Commission competition services. A body of "wise persons" should be created to provide external assessments; and the Code of Practice for European statistics should be enshrined in a Regulation, ensuring that weak spots in data collection and reporting are addressed immediately.

Fourth, and as the final point, member States should *anchor the new surveillance framework in national legislation*. Beyond the minimum requirements for budgetary frameworks proposed by the Commission, it is essential to introduce rules-based, medium-term frameworks and establish independent national institutions assessing fiscal policy.

Implementing the most ambitious reforms possible under the current Treaty is in the deepest interest of the euro area countries.

5. Conclusions

Let me conclude. If I were to summarise the key lessons of the global financial crisis that I have been talking about today, I would emphasise three main points:

Firstly, a very profound transformation of economy and finance at the global level has taken place over the last thirty years. The combination of a technological revolution which is still ongoing, particularly, but not exclusively, in the field of information technology, with the fall of the Soviet Empire and the generalisation of market economies at a global level, has contributed to create a new entity, which is the globally integrated economy with its associated global financial system.

We have attained a level of intertwining and interdependencies at the global level which was previously unseen in terms of intensity of the links and also the rapidity of global transmission of shocks. The fact that a sole event, namely Lehman Brothers' bankruptcy, was transmitted in all economies – whether industrialised or emerging – and in all sectors – whether financial or non-financial – in a few half days, was a "première" in the history of economy and finance.

Secondly, the fact that the global financial system and the global economy are now deeply integrated and are pertinent entities of their own, this calls for an equivalent appropriate concept of global governance. In this respect, the crisis has been revealing. Extremely bold changes that seemed unthinkable have been triggered by the intensification of the crisis in mid-September 2008. It is imperative that all institutions, governments, central banks and parties concerned do what they can to make the new constellation of global governance work exemplary.

Thirdly, the central issue for executive branches is that, even if the pertinent entity is the integrated global economic and financial system, major decisions have to be taken at the level of individual countries. Only to speak of the industrialised world, it is necessary to make our public opinions sufficiently aware of the externalities of national decisions, and consequently on the necessity to internalize complex concepts like global economic prosperity and global financial stability.

In our democracies, very fortunately, decisions depend on the sentiment of the people. I consider that one of the most formidable challenges of today is to engage in a deep communication exercise at the level of each of our countries to permit our public opinions to be as enlightened as possible on the very nature of the new globalised world in which we are living.

Thank you for your attention.

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