Jean-Claude Trichet: Global governance today

Keynote address by Mr Jean-Claude Trichet, President of the European Central Bank, at the Council on Foreign Relations, New York, 26 April 2010.

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Ladies and Gentlemen,

It is a real pleasure to be back here at the Council on Foreign Relations.

You will all be familiar with the well-worn French expression "plus ça change, plus c'est la même chose" – and its New York equivalent "same old, same old" – to imply a world-weary feeling that despite the appearance of change, things remain the same.

Well, since my last visit three years ago, I think we will all agree that there have been the most dramatic changes in the world economy. And these are changes that suggest that things will not and should not remain the same.

Back in April 2007, I noted that the ever-closer integration of national economies and the rise in capital mobility had made the international system more vulnerable to changes in investor sentiment. I added that it was vital to strengthen the ability of the global economic system to absorb shocks to preserve global financial stability.

But few then could have imagined the magnitude of what eventually came to pass, starting with the subprime crisis in the summer of 2007, turning into a full-blown global financial crisis in the autumn of the following year with the collapse of Lehman Brothers, and culminating in a devastating impact on trade, production and jobs.

These are not entirely new phenomena – but we have to go a long way back in the history books for a suitable comparison. According to economic historians Barry Eichengreen and Kevin O'Rourke, the initial decline in global production between mid-2008 and mid-2009 was broadly comparable with that at the beginning of the Great Depression. The corresponding correction in global equity prices and the fall in global trade volumes were even larger.

The good news is that the global economy has now turned the corner, largely thanks to the unprecedented support measures taken by both central banks and governments, which have helped to restore confidence. Yet the recovery remains somewhat fragile and not yet sufficiently supported by private demand; therefore, it is not the time for complacency.

I should add that the recovery should be measured in much broader terms than focusing on a resumption of GDP growth. A full recovery also implies a return to sustainable fiscal positions. It means a full restoration of trust in some of our financial institutions. And it requires a healing of the scars that the irresponsible behaviour of some financial players has inflicted on our societies and on the real economy.

In my introductory remarks today, I would like to explore some of the lessons for policy-makers around the world that can be drawn from the extraordinary events of the past three years.

I will *first* elaborate on why we need a set of rules, institutions, informal groupings and cooperation mechanisms that we call "global governance".

Second, I will analyse how, in hindsight, the existing system of global governance has fared during the crisis.

Third, I will examine the evolution of the system in response to the crisis, in particular the rise of new key players in the world economy, such as the G20, the Global Economy Meeting of central bank governors and the Financial Stability Board.

1. Why we need global governance

There are numerous definitions of global governance. In the economic and financial sphere I will propose that global governance comprehends not only the constellation of supranational institutions – including the international financial institutions – but also the informal groupings that have progressively emerged at the global level. Those informal forums (G7, G10, G20, etc.) are key in improving global coordination in all the areas where decision making processes remain national – whether in helping to work out agreed prudential standards and codes or to facilitate where appropriate, the coordination of economic macro-policies.

No market can survive without a set of rules. This is particularly true at the international level, where natural barriers to transactions are formidable. One of the global governance's primary aims should be that of facilitating the proper functioning of cross-border markets and thereby of reducing transaction costs.

The process of doing so is evolutionary and demands a pragmatic approach with respect to what arrangements may and may not work, depending on the circumstances. But the more complex the goods and services exchanged are, the greater the need for a sound institutional infrastructure. In this respect, finance stands out as an arena in which global rules may be particularly beneficial.

More generally, the crisis has weakened the arguments of those who think that deregulation is always conducive to better functioning markets. We have learned once again that markets cannot function properly without an effective regulatory and supervisory infrastructure. Governments, central banks, international institutions and globally agreed prudential standards and codes are the means by which we collectively seek to avail ourselves of the global public good of global economic stability.

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

First, the principle of subsidiarity is essential. This principle, which is a key feature underlying of European Union legislative framework, says that no rule should be imposed at a global or supra-national level that cannot be more or equally effectively set at the national or local level. This principle might also be read as implying that the "burden of proof" should rest on those who want to establish global, as opposed to local, rules and institutions.

Second, it is not straightforward to set common rules in complex and innovative fields such as finance. While financial liberalisation, deregulation and innovation all have the potential to make our economies more productive and more resilient, the financial sector must not forget that its purpose is to serve the real economy, not the other way around. We have painfully witnessed the fallout from excessive complexity of financial instruments in the current crisis.

Finally, there is a risk that common rules are not optimal and in particular that they are too limited, since they have to be the minimum standards across many constituencies. This risk is very real in the area of finance because of significant differences across countries in financial structures, financial instruments and preferences for financial regulation.

Overall, the global financial crisis has shattered previously held convictions that "keeping one's house in order" is the right principle to ensure global welfare. We have certainly become more aware of the negative externalities that financial innovation and financial globalisation can create. Finance in its current form has become a double-edged sword for the real economy.

2. How global governance has fared during the global crisis

Let me now turn to how our institutions of global governance in the financial sphere have fared during the crisis.

Central bank cooperation

One dimension of international cooperation that I consider to have worked particularly well during the financial crisis has been that among central banks – both bilaterally and channelled through the various Basel-based committees. This institutionalised cooperation has 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 major central banks such as the Fed and the European Central Bank.

The Bank of International Settlement (BIS) itself 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 crisis. It could do so based on a high degree of analytical depth and information sharing at a global level that the central banks' global cooperation has been able to develop over time.

These analytical contributions assisted in driving the strong and coordinated policy response when the crisis erupted. We have now scaled back our cross-border operations as markets have recovered, but the spirit of cooperation and the readiness to work together is stronger than ever.

Regulatory arbitrage

But as much as some aspects of global governance appear to have passed the severe test of the global crisis, we should remember the significant shortcomings that may have contributed to creating the conditions for the crisis to happen in the first place.

One is the lack of coordination in financial regulation that was pervasive before the crisis and which encouraged financial institutions to engage in a large degree of regulatory arbitrage. This was the unavoidable result of the fact that while financial players were becoming increasingly global, and despite the remarkable efforts of the Basel Committee in respect of the banking sector, financial regulation remained largely national, with only relatively weak coordination at the international level.

The dramatic under-supply of the global public good of international financial stability is an area where reform is essential.

Global imbalances

Another shortcoming that needs to be addressed for the future was the insufficient orientation of macroeconomic policies towards medium-term stability and sustainability. This led to the build-up of unsustainable external imbalances between deficit and surplus economies prior to the crisis.

Although warnings had been voiced, including by the IMF, about the risks of a disorderly adjustment, there was no effective mechanism 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 the work of international institutions and the cooperation of national authorities.

3. The evolution of global governance

Let me turn to the question of how global governance is evolving after the crisis.

The scope of international cooperation has been significantly broadened. After an initially hesitant response, governments implemented broadly coordinated policies, both within the EU as well as at the global level under the aegis of the G20. And central banks were able to take quick, decisive and coordinated action at short notice.

But the crisis also showed that gaps in the system of global governance – in terms of both efficiency and legitimacy – have to be filled. This can be done – indeed, it is being done – by strengthening the mandate of existing international institutions and adjusting existing or developing new informal forums.

Overall, the system is moving decisively towards genuine global governance that is much more inclusive, encompassing key emerging economies as well as industrialised countries. The significant transformation of global governance that we are engineering today is illustrated by three examples.

First, the emergence of the G20 as the prime group for global economic governance at the level of ministers, governors and heads of state or government. Second, the establishment of the Global Economy Meeting of central bank governors under the auspices of the BIS as the prime group for the governance of central bank cooperation. And third, the extension of Financial Stability Board membership to include all the systemic emerging market economies.

Let me touch on each of these.

The breakthrough of the G20

One distinctive feature of this crisis has been that it erupted at the centre of the system. Although emerging countries have been severely affected, taken as a group, they have rapidly become a source of strength for the world economy. It is therefore not surprising that the crisis has led to a clear recognition of their increased economic importance and to their full integration into the institutions of global governance, notably with the breakthrough of the G20.

The G20 has been effective in addressing the global crisis. We are now at the stage where this forum is making the transition from acting in a crisis resolution mode to contributing to crisis prevention. This is, in particular, the purposes of the G20 framework for strong, sustainable and balanced growth. The primary goal of this framework is to collectively implement coherent and medium-term policy framework to attain a mutually beneficial growth path.

For this purpose a Mutual Assessment Process (MAP) has been set up that will allow to assess whether policies of individual members are collectively consistent with sustainable and balanced growth trajectories. The first steps in this MAP have been presented by the IMF to the G20 Ministers and Governors last week during our spring Washington meetings. Guidance has been given to the IMF on the next steps in the process that will lead to policy recommendations on how to best meet the common goal of strong, sustainable and balanced growth.

Since this process is fully owned by the G20 members, and given that it involves them not only at the level of Ministers and Governors but also at the level of Heads of State and Government, it is confirming the strong commitment at the global level to more multilaterism in economic decision making.

Further strengthening of central bank cooperation

In the area of central bank cooperation, the main forum is the Global Economy Meeting (GEM), which gathers at the BIS headquarter in Basel. Over the past few years, this forum has included 31 governors as permanent members plus a number of other governors attending on a rotating basis. The GEM, in which all systemic emerging economies' Central Bank governors are fully participating, has become the prime group for global governance among central banks.

The GEM has become a very important forum for assessing global economic and financial conditions, for analysing economic and financial policy issues of common interest to central

banks. I have the privilege of chairing the GEM presently, and must say that I find the candid exchange of views of our bi-monthly meetings of enormous value.

Strengthening institutions

Among the new and strengthened forums, I would like to highlight the expansion of the membership in the Financial Stability Board (FSB), whose membership is now largely overlapping that of the G20. The FSB has received an enhanced mandate to strengthen the international financial architecture and global financial stability.

Collaborative efforts between the IMF and the FSB in this context are currently underway, including a joint early warning exercise for the identification of risks to the global economy. The IMF itself has overhauled its lending framework and introduced new instruments to assist countries in financial need, a first step in the broader discussion of its future mandate and internal governance. The meeting of the IMFC, two days ago in Washington, showed a confirmed determination to move ahead in this field.

The crisis has also pointed to the need to enhance the framework for cooperation in financial regulation and supervision in Europe. As a result, micro-prudential supervision will be reinforced with the creation of a European System of Financial Supervisors, including three new European supervisory authorities in banking, insurance and securities.

Moreover, micro-prudential supervision will be complemented by macro-prudential supervision, focusing on the prevention of systemic risk. The financial crisis has been revealing in many respects. It has revealed the scale of the potential fallout from the failure of large financial institutions. It has revealed the fragility of the financial system to features and trends that cut across institutions, markets and infrastructures. And it has illustrated the magnitude of the consequences of adverse feedback loop between the financial system and the real economy.

All three elements I have just described are key features of systemic risk: first, contagion; second, the build-up of financial imbalances and unsustainable trends within and across the various components of the financial system; and third, the close links with the real economy and the potential for strong feedback effects.

In short, the crisis has revealed the fundamental importance of systemic risk. The purpose of macro-prudential supervision is to identify sources of systemic risk and recommend remedial action. In the EU, this will be the task of the European Systemic Risk Board (ESRB). The members of the ECB's General Council will be voting members of the ESRB, together with the three heads of the envisaged European supervisory authorities and a member of the Commission. Moreover, the body will comprise all national supervisory authorities. The ECB, as an institution of the European Union as a whole, as an institution of the 27 EU Member States, has been invited to provide support to the ESRB. The Ecofin Council concluded that the ECB should provide analytical, statistical, administrative and logistical support, in close cooperation with all the national central banks from the 27 states. The ECB is prepared to bring to the benefit of the ESRB, with the participation of all the members of the ECB's General Council, the macroeconomic, financial and monetary expertise of all EU central banks.

The legislative proposals are currently being reviewed by the European Parliament for a decision later this year. I am confident that the ESRB can make a very important contribution for the overall stability and functioning of the EU's financial system.

Conclusions

In conclusion I would like to stress four points.

First, global governance is of the essence to improve decisively the resilience of the global financial system. We avoided a major depression but it was a close call. Governments had to support the financial sector by putting at risk taxpayers' money for the equivalent of around 25 % of GDP on both sides of the Atlantic. This as unprecedented. I am convinced that, if we do not reinforce significantly the resilience of the financial system, our democracies will not accept for a second time such a very large scale of rescue operation.

Second, a characteristic of the recent turbulences is not only that they displayed a high level of unpredictability but also an extreme rapidity in the succession of events characterising the unfolding of the crisis. Global governance today must demonstrate a capacity to coordinate with agility and, where necessary, to decide extremely swiftly. This is also unprecedented.

Third, the crisis has had some paradoxical effects: on the one hand it has unleashed a tendency to reengage in financial nationalism if not mercantilism; on the other hand it had contributed to the recognition that a very high degree of interdependencies between economies called for a much higher level of cooperation. These two opposing forces are presently competing. It is imperative that effective global governance preserve the level playing field which is indispensable to foster global stability and prosperity. It is a major challenge. Both sides of the Atlantic have a very important responsibility in this respect in many domains, in particular in prudential and accounting rules.

And fourth, as we have seen the crisis has driven an historic change in the framework of global governance. In my view this transformation was overdue. But there are two immediate reasons for this change. One is positive: the emerging economies are now economically and financially so important and systemically so influential that they must have a full and proper ownership of global governance. But the second reason is negative: the industrialised countries have proven particularly clumsy in their handling of global finance before the crisis at the time when their responsibility in global governance was obviously overwhelming. There was therefore no reason to confirm their exclusive prime responsibility. This calls for the industrialised countries to be now particularly irreproachable in the delivery of their present and future contribution to the stability and prosperity of the global economy within the new, more inclusive framework.

Thank you for your attention.