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It is a great pleasure to be here in Tokyo and I am greatly honoured to have been invited to the 8th Symposium of the Institute for International Monetary Affairs. I would like to thank you for giving me the opportunity to express my views on the International Financial Architecture.

Rather than trying to predict the international currency system that will prevail in 2020 I would like to focus more cautiously but more realistically on the work under way to adapt the International Monetary and Financial System to the globalisation economy. I will consider especially three important topics which are at the core of the current reflection on the reform of the international financial system :

- the need for reducing volatility of capital flows
- the choice of exchange rate regime
- the governance of the international monetary and financial system

I will add to this review some thoughts on the conditions of the success of the euro which are also conditions for the euro to contribute to a more balanced international monetary system.

1. Reducing volatility in capital flows

Contributing to more stable capital inflows to emerging markets is the objective of a number of recent proposals put forward by the international financial community. Let me just comment on current proposals which I consider as particularly important.

The bulk of these proposals aims at :

- Reducing or eliminating distortions that bias capital flows toward shorter maturities and preventing over-indebtedness
- Promoting more effective risk assessment and pricing by creditors/investors and as a result contributing to a more effective functioning of international capital markets
- Containing moral hazard.

The recent financial crises have brought to the fore the importance of sound debt and liquidity management in helping countries withstand external shocks. These issues have been or are being discussed in a number of fora, especially in the Financial Stability Forum group on capital flows. One proposal in this area is the so called “Guidotti rule”, namely that countries should manage their external assets and liabilities in such a way that they are always able to live without new foreign borrowing for up to one year. Beyond this simple balance-sheet rule, a

“liquidity-at-risk” approach has been suggested by A. Greenspan, involving the calculation of a country’s liquidity position under a range of possible outcomes for relevant financial variables (commodity prices, credit spreads...). The IMF contribution to this effort will be to supply the Guidelines for Good Practices on Transparency in Debt Management Policies. The IMF is also reflecting on debt and reserve related indicators of external financial vulnerability. The World Bank is designing a manual of "best practices in the area of sovereign debt and risk management".

More generally, policies designed to discourage excessive short-term foreign borrowing and based on market mechanisms should be supported. For instance, unremunerated reserve requirements on short-term foreign liabilities should not be discarded; domestic savings should be more systematically mobilised through the development of domestic financial markets. To this regard, the World Bank has begun to produce a manual that will provide practitioners in the government and the private sectors with guidance on the development of domestic debt markets. The BIS based Committee on the Global Financial System has recently produced a useful document identifying general principles and more specific policy recommendations relevant to the promotion of liquid government securities markets.

The design of Deposit Insurance Schemes is another important measure contributing to reducing or eliminating implicit government guarantees limiting moral hazard on the lenders as well as on the borrowers side. A study group has been created under the umbrella of the Financial Stability Forum. It will assess the feasibility of setting out international guidance on deposit insurance.

As to the promotion of a more efficient functioning of global markets, I would like to emphasise two points :

- firstly, one of the most effective recipes for countering herd behaviour that has been observed in the recent financial turmoil, is full transparency of each particular entity, of each particular country, of each particular borrower, of each particular signature. Full and reliable transparency is needed to allow a proper judgement of the merits of each case. More transparency is necessary for proper risk manager and risk pricing. Improvements in the SDDS, notably the adoption of a detailed template for foreign exchange reserves disclosure, more transparency regarding Article IV reports and compliance to internationally agreed standards and codes, as well as transparency of private sector financial institutions, will certainly improve risk assessments.
- Secondly, the decision to introduce a new capital adequacy framework to replace the 1988 Accord is an important step towards a more comprehensive

approach to addressing risks. The new framework should significantly improve the way regulatory capital requirements reflect underlying risks.

Reducing moral hazard is a crucial condition for lenders and borrowers to be more prudent. Recent crises have emphasised the need to improve the approach of the international community to financial crisis prevention and resolution. In particular, there is a need to provide the private sector with a clear framework indicating that it will bear the consequences of its risk taking decisions.

The Cologne G7 framework is a good basis for an effective involvement of the private sector. It is an acceptable compromise between a case-by-case approach and a rules-based one. I think it necessary, in particular, to build a consensus around the following three points :

- first, the principle of equality of treatment should prevail : no one category of private creditors should be regarded as privileged relative to others
- second, there is a need to support the introduction of collective action clauses in emerging market sovereign bonds. Argentine issued both American and European-style bonds. The Argentine experience shows that the market does not penalise emerging market issuers on their European-style bonds. In other words, this provides support to the notion that collective action clauses

represent a rather marginal innovation in terms of cost which is worth implementing

- third, it should be made clear that very large packages should no longer be expected from the official sector

Let me now turn to another very important matter highlighted by the Asian financial crisis : the choice of exchange rate regime.

2. The choice of exchange rate regime

As a first reaction to the financial crises in Asia, Russia and Brazil, many observers took the view that exchange rate pegs are inherently unstable and that either firm fixing or free floating are preferable to any intermediate regime. Against this background I believe there is a need for a more balanced view.

There is no ideal exchange rate regime that can meet the needs for countries that widely differ in terms of economic and financial conditions. Thus, an exchange rate regime should be assessed on the basis of its ability to contribute, in the specific circumstances of a given country, to a stable macro-economic environment by supporting an exchange rate level consistent with underlying fundamentals and expectations.

For developing and emerging countries a wide variety of exchange rate regimes prevail. Corner solutions (free floating or currency boards) are not necessarily the most appropriate choice. Although floating rates may appear suitable for coping with volatile capital flows and asymmetric shocks, they might prove disruptive for the real sector of small open economies, which often lack the size for developing the necessary market infrastructure to cope with exchange rate volatility.

The recent financial crises have highlighted that macroeconomic discipline alone does not suffice to sustain pegs and thus must be accompanied by sound financial systems, good corporate governance, effective regulation and supervision, as well as greater transparency in monetary and financial policies.

Although requirements for sustaining pegs have become very demanding intermediate solutions might still remain a relevant option for a number of countries, notably small open economies with a dominant trading partner that maintains price stability, I have especially in mind the EU accession countries, and less developed economies experiencing high inflation. In such cases, anchoring the currency contributes to monetary and financial stability.

While the choice of exchange rate regime remains the responsibility of national authorities, the IMF has a clear role in advising its members to pursue appropriate exchange rate policies, in view of the systemic implications of such decisions. In this context, the IMF should adopt a cautious attitude in providing its resources in the context of Fund-supported programs, should there be any doubts about the consistency between macroeconomic policies and the exchange rate regime.

3. Role of the international institutions

In promoting more efficient international financial institutions and arrangements, the G-7 has reaffirmed the central role of the IMF and the World Bank in the international economic and financial system and created the Financial Stability Forum to enhance international co-operation and co-ordination in the area of financial market supervision and surveillance. More recently the G-7 has set up the G-20 to foster the dialogue between industrialised and emerging market economies.

The IMF has a central role to play in macroeconomic surveillance which is its main purpose. The conditionality associated with its financial support is essential to give economic agents a clear assessment of the efforts made by Members committed to implement adjustment programmes.

Furthermore, the IMF has a crucial role to play as regards prevention and assessment of compliance to international codes and standards. I have already mentioned actions taken by the IMF in improving Data Dissemination and publication of Article IV reports. The IMF has launched a series of experimental Reports on Observance of Standards and Codes which summarise the extent to which countries observe certain internationally recognised standards, focusing primarily on the areas of direct operational concern to the IMF.

Together with the World Bank the Fund has recently set up a Financial Sector Assessment Programme. As a by-product of this programme, the Financial Stability Assessment Reports should identify the main vulnerabilities affecting financial systems and make recommendations to mitigate these vulnerabilities. This is an important enhancement to the surveillance activity.

The new mechanism for informal dialogue in the framework of the Bretton Woods institutional system, the so-called G-20, aims at building consensus between industrialised countries and emerging market economies on the main issues related to the reform of the global financial architecture, thus facilitating the implementation process.

Given the large number of institutions and fora involved in the efforts aiming at a better global financial architecture, the creation of the Financial Stability Forum reflects an important effort to co-ordinate work in progress and identify issues not yet addressed. The Financial Stability Forum created three working groups dealing respectively with Highly Leveraged Institutions, Capital Flows and Off-Shore Centres. We are looking for the conclusions and recommendations of these groups in March 2000. The FSF established recently a task force on implementation which should explore crucial issues related to promoting the implementation of international standards relevant to strengthening financial systems.

4. The conditions for a complete success of the euro.

The successful introduction of the euro is, in itself, a major reform. For that reform to be a full and complete success a number of conditions have to be met.

I see four main conditions:

-The first condition is the credibility of monetary policy guaranteed by the independence of the European Central Bank, which is enshrined in the Maastricht Treaty and rooted in the independence of each national central bank.

If the euro is to be consolidate its statute of highly credible currency, it must

keep the confidence of the 290 million Europeans in the euro area and also the confidence of non-Europeans with whom we do business. This is, in particular, ensured by resisting any kind of pressure on how the new currency is managed.

The necessary dialogue between monetary policy officials and economic policy officials is fully taking the independence of the ESCB into account and also the objective of price stability which, according to the Treaty, must guide the monetary policy of the euro area. The respect for the independence of the monetary policy is a condition for the success of the euro, in particular in the framework of the "Cologne process"-macroeconomic dialogue for the implementation of the employment Pact-adopted at the last European Council.

Satisfying this first condition related to the credibility and the independence of the monetary policy, will be facilitated by the harmonious functioning of the European monetary team, which is composed of twelve players, the ECB and the national central banks from the eleven founding countries. This is this full, twelve-member monetary team which is playing on the field, with a single team spirit ; and this team spirit is one of the priceless assets of Europe.

-The second condition is compliance with the provisions of the Treaty and the guidelines laid down in the Stability and Growth Pact with regard to fiscal policy. Close coordination of fiscal policies and vigilant peer surveillance within

the informal council of the eleven participating member states - the "Euro Eleven Club"- and by the ministers of finance of the 15 Member States convened in the Ecofin Council is essential to ensure a balanced policy mix throughout the eurozone. The medium-term objective of achieving " public finances that are close to balance or in surplus" -means nobody gets to run a selfish budget deficit. To comply with this objective is indispensable for the union as a whole to weather periods of economic difficulty and for individual countries to withstand possible economic downturns which affect only their own economy.

We have to understand that monetary policy alone cannot ensure price stability without the appropriate fiscal discipline at the overall level of the Economic and Monetary Union.

For my part, I would give **three economic justifications** for the Treaty provisions that gave rise to the Stability and Growth Pact.

- First, by coordinating the fiscal policies of the Member States of Monetary Union, the pact ensures a good policy mix within the euro area. This is essential for monetary policy.

- Then, the pact helps prevent well-run economies from having to bear unjustified risk premia by setting up a system of penalties for excessive deficits.

- Finally, the stability pact allows us to disprove the assertion that the euro area has no automatic stabilizers in the event of asymmetric shocks to a member economy. Indeed, by urging governments to aim for a fiscal position of close to balance or in surplus in the medium term, the pact enables them to let fiscal deficits increase during recessions without exceeding the 3% reference value. In short, it allows them to create a fiscal buffer during normal economic periods that can be drawn on, if an asymmetric shock occurs.

-**The third condition** is that all European countries must resolutely undertake structural reforms. Continental Europe is experiencing too high levels of unemployment, despite the fact that the jobless rate has been declining in most of its economies. According to the IMF and the OECD, around 80% of this unemployment is structural, that is, generated by our own burdensome rules and regulations.

-**The fourth condition** is that all economic leaders in Europe must be clear-sighted with regard to the crucial question of competitiveness. Pre-euro economic policy meant monitoring trade balances, the balance of payments and the foreign exchange and interest-rate markets. Authorities thus received

constant feedback on key indicators affecting national economic performance and could react accordingly. These indicators were sensible, multiple and very reactive.

Most of these indicators have disappeared at the national level or have seen their significance weakened, with the advent of the euro. But, of course, they remain on the euro-wide level. This is why the coordination of fiscal and economic policy provided for by the Treaty is so important.

Nevertheless, the rules of a market economy, especially competition, continue to apply to each economy. Jobs are created by consumers when they choose the goods and services they feel are the best value for money. Businessmen allocate these jobs to various possible locations in various countries according to the relative competitiveness of these locations. It is therefore necessary to monitor competitiveness even more closely than before through indicators such as unit production costs, and the tax and regulatory framework.

Contrary to the pre-euro period, loss of competitiveness will not show up so quickly on radar screens like exchange markets, interest rates markets or external accounts, so economic managers must be even more vigilant in watching pertinent competitiveness indicators. The sanctions for economic

policy errors might come more slowly and insidiously via rising unemployment and weak growth.

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In conclusion, let me stress three points:

1/ Firstly, the global economy is doing much better than a year ago, which is perhaps the best proof of an appropriate handling of the difficult situation in which we were in 1998. World output growing at a pace of 3% in 1999 and 3.5% in 2000 is pretty encouraging. Particularly encouraging for me, being in Asia, is the fact that the newly industrialized Asian economies are likely to grow at a pace of a little more than 5%, both in 1999 and in 2000.

This calls for two “coup de chapeau”: one to the Asian economies themselves which have demonstrated a remarkable capacity to adjust in a very short span of time. The second to the international community and the IFIs, in particular the IMF and the World Bank, which have demonstrated in the most difficult circumstances of the last 24 months lucidity, determination and courage. I know that saying that is not necessarily fashionable. But it is precisely because it might not be fashionable that it is worth saying it.

2/ Secondly, this is not the time for complacency. The global economy is in much better shape but remains fragile, taking into account the risks and the challenges that exist, facing the international community. It is very important to take advantage of the present good state of the global economy and global finance to proceed in the direction of reforms. Being complacent in relatively quiet times would be a big mistake. Let us actively set up and generalize the good practice principles and the codes of good conduct for the public as well as the private sectors. Let us actively reinforce cooperation amongst all parties concerned including within the framework of the Financial Stability Forum and the G20 which will meet in Berlin very soon.

Let me also say that I regret the lack of consensus that has been observed in Seattle on trade issues. Global trade is a win-win game and it is a pity that it is so often presented as a zero sum game, which is not the case. A good agreement in the trade area is in the interest of all – developing countries, emerging economies, countries in transition, industrial countries – and above all, in the interest of global prosperity and economic and financial stability.

3/ And thirdly, I would like to stress the tripolar nature of the present international monetary system. The three major economies and the three major currencies have to contribute to the stability and prosperity of the industrialized world. Being an European in Japan let me point out three points that are of importance in my eyes:

- First, I entirely subscribe to the G7 communique published in September, in Washington as regards the yen in its relation vis-à-vis the other major currencies, namely the dollar and the euro. I add that the three currencies are shaping up a global triangle and that it is important to consider the dollar and the euro on the same footing as regards their relationship with the yen.

- Second, as Wim Duisenberg has said in the name of the Board of Governors, we are, in the Eurosystem, pursuing a policy of solid, strong, credible Euro and the Euro has an important potential for appreciation.

- and Third, here in Tokyo, I will say – as the US put it over the last seven years, namely “a strong dollar is in the interest of the US” – that I strongly believe that “a strong Euro is in the interest of Europe”.