

## Overview

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*Jean-Claude Trichet*

Let me present some remarks on the concepts and ideas that have been so pertinently put forth, especially from the standpoint of a central banker. First, I'll comment on the concept of financial stability, and then on the idea of how to ensure financial stability in a global perspective.

On the concept of financial stability, I have four observations. First, it goes without saying that I agree with the fact that financial stability means stability of financial institutions and stability of markets. I don't have a problem with defining stability of financial institutions as the institution's having the ability to meet all its commitments on a sustainable basis, then, as Eddie George stated, as protecting depositors and the economy as a whole from possible damages and losses.

But the stability of markets is a much more challenging concept. And I have learned a lot from what has been said here. One has to admit that fluctuations and volatility are of the essence when you are dealing with markets. The real time liquidity of the market calls for ups and downs. Therefore, you might have successively ups and downs of great magnitude and it is hard to identify who should be the judge as to when appropriate market prices are in line with fundamentals. This capacity of the market to display at times a large array of prices out of pretty close fundamentals is challenging, and

in a way, intriguing. Nevertheless, there is a case where it is absolutely clear that we could have a crisis and that we have to prevent that crisis or correct it actively when it has unfortunately occurred: that is when markets are illiquid. Illiquidity of markets is the ultimate crisis we have to prevent. Fluctuations and volatility are of another nature. I want to make that point because I am not sure that it was made as candidly as I think it should have been made.

My second remark in the area of financial stability is that we have not said much on the cascading effect. It has been made very clear in a lot of very interesting interventions. Contagion is another story. Contagion is a phenomenon that is associated with human nature. And even if we make a lot of progress in the transparency of information, and therefore, on having the capacity to treat each particular risk according to its specific fundamentals, I think, nevertheless, we will still have to deal with contagion. Human history is driven by contagion. From time to time, it has been driven by contagion for the worse but in more recent times, it has been driven by contagion for the better. Recently, contagion has led to an embarking on appropriate democratic and market economic concepts the world over. Of course, we must try to prevent catastrophic contagion threats by appropriate means, full transparency probably being the best tool to do it. But we have to accept the idea that unless human nature changes, we will probably always live in a world where the threat of contagion exists.

My third remark, which I think is strongly in agreement with remarks made by a number of other speakers, is that we have to accept the idea that in certain cases, and maybe in more cases than we suspect, there can be multiple equilibria. And that, of course, explains the fact that it is so difficult to assess a particular situation a priori when it is so easy to justify what has been observed a posteriori. Maybe a handful of us who are in this room are in the category of persons and institutions being absolutely sure of their assessments a priori, and particularly, being absolutely sure that the various markets they are observing are or are not in line with fundamentals. I suspect that they are not very numerous! A posteriori, it is much easier to explain why we are observing a new market

equilibrium. This is part of the difficulty for responsible institutions and central banks, and I would like very much for academics to reflect on this concept of possible multiple dynamic equilibria.

I have one last remark on the concept of financial stability. I think there is consensus in this room that the major preventive action for financial stability is price stability. I would say price stability is emblematic of macroeconomic stability-oriented policies. And again, that's part of the positive side of contagion I have mentioned. The price stability contagion has worked very well the world over. I totally agree with the remarks of Martin Feldstein and Eddie George in this panel.

Now, let me turn to the global perspective. How do we ensure financial stability in a global perspective? Again, I have four main observations on this topic.

First, and I think there is a consensus in this room on this, we must rely heavily on market participant professionalism when we devise any kind of regulation. In my opinion, there is the driving force. I completely agree that our present financial sphere is driven by technology—technology not only defined as information technology and computerization, but also invention of new financial products and concepts by market participants. We have to accept the fact that market participants know a lot, and that their creativity has to be disciplined on the one hand, but also fully accepted as a major asset on the other hand. Institutions responsible for surveillance have to understand that. They have to be ready to rely heavily on the technical wisdom of market participants. New risks have been identified. The first approach to regulatory capital requirements was credit risk. That approach appears too simple today, even though we have done a lot to improve the efficiency of our own regulations and market risks are now taken into account. There are other risks besides credit risks and market risks. Andrew Crockett made the point very clear yesterday. There are operational risks, legal risks, and many other risks. I think, therefore, we are in a process of improving our regulatory capital requirements, accepting the idea that we have to rely profoundly on market participants' knowledge.

But, of course, central bankers retain the right to determine at which level to place capital requirements, taking into account the assessment of their own risks by market participants, but setting the level of capital requirements according to their own assessment of the systemic risks, which market participants cannot assess themselves. There lies the key concept: central bankers have the responsibility to make as accurate as possible their judgment on the underlying systemic risks and therefore, on the appropriate preventive requirements.

My second observation deals with the question of transparency and full disclosure of information. I have already mentioned that. It is a very complex issue. I think that human nature, again, is driving people to hide the facts and figures that could be harmful for them. So we have to ensure that information is going as high as possible in any particular entity. This is necessary not just for financial institutions, but also for the countries themselves—information going as high as possible in institutions, meaning up to the top management; information going as high as possible in the case of country economies, meaning to go up to the global market and participants. This is extremely important. Transparency of information is of the essence, both in terms of institutions' stability and in terms of global stability. However, I don't think this will eliminate all potential problems by ensuring full disclosure of information.

That leads me to my third remark, which is the early warning by international institutions or regulators. Even in a transparent world, the market is not necessarily taking fully into account all messages it is receiving. I was struck to see the extent to which the market accepted in the past big imbalances in external accounts in Asia, Latin America, and in other parts of the world. I have personally always thought that big current account deficits are a reliable indicator of potential instability. On this point also, I totally agree with Martin Feldstein. Nevertheless, the market has been quite relaxed, with market participants inventing a lot of good reasons for explaining and therefore, accepting, these big deficits.

Now, put yourself in the place of international financial institutions regulators, and take, for example, the question of the sovereign

risks. What shall the international financial institutions do when the difficulty of the country case has been underestimated by the markets? I think that one has to accept that an international institution is not a rating agency. Rating agencies have their own responsibilities. International institutions have a different perspective. Not only do they have to assess the situation of a particular economy, but they also have to see whether or not they can manage to get out of the potential mess, which is not yet recognized by market participants. So they have to embark on a very complex dual assessment, where first they have to determine whether the situation is a potential mess, and second, whether it is possible to get smoothly out of it. I was very interested by Urban Bäckström's explanations of what has happened in Sweden. One of the necessary conditions to get out, without dramatic shocks, of a very difficult situation is to achieve a social and political consensus with all parties concerned. It is absolutely clear that a major element in the assessment of such country cases is whether or not there is an organized way out—not only economically, financially, or monetarily, but also socially and politically. And this is the responsibility of the international institutions, to work out this overall synthetic assessment of a particular case. One of my major conclusions is that we are dealing with a decision-making process that is an art and not a science. I don't think we can escape this. We must rely on wisdom, enlightened multiple criteria analysis, and also, decisive intellectual leadership from the international financial institutions.

Last, I think it is important to improve our multinational close cooperation in all appropriate fields. In particular, I agree with the remarks that Gerald Corrigan made on the need for a well-functioning payments and settlement system, not only in the United States and the G-10, but also in the rest of the world. A lot of non-G-10 economies now might have a systemic impact on the rest of the world. The concept for globalizing is also to be applied to prudential standards. In this respect, the "core principles" that have been discussed between regulators of G-10 countries and regulators of non-G-10 economies are very important. I agree with Jeff Sachs that a major improvement is that the G-10 and the BIS are now enlarging and sharing core principles with other pertinent entities in the world.

I think this is a major achievement over the recent period that is completely in line with the overall trend that has been accepted by central banks and other pertinent authorities. I also think that we have to ensure appropriate coordination of supervisors globally, as we have done with the Basle Committee and IOSCO. We should also include insurance supervisors if we want to be sure that we are addressing all potential problems as far as financial stability is concerned. These are immense challenges. When you look at the various national traditions, you better understand the difficulty in having close cooperation between various regulators in various fields. I notice that Gerald Corrigan is nodding in agreement. So not only do you have to pave the way for the appropriate links nationally, but you must also plug in all those national institutions globally. I think that we still have an immense series of workshops ahead of us. I think we need a great deal of effort by including, of course, all central bankers to ensure that we go as rapidly as possible in the right direction.

In conclusion, I would only say that central banks and regulators have to be as closely coordinated as possible. I have a preference, and Edward George can understand that, for close institutional links between central bankers and supervisors. In my case, the link is established in the following fashion. We have an independent central bank and an independent banking commission, which is a college of six members. Two members are appointed by the two highest courts in France. We have one representative from the central bank, one from the state, and two wise persons. The link with the central bank is close, but all decisions are made collegially by the six members. The governor of the central bank chairs the college, but he has only one voice. The central bank does play an important role in implementing what has been decided, but has only one voice. This provides an example of establishing a close link without mixing up the responsibilities of the central bank and the responsibility of the supervisor.

As a last word, I would like to reiterate that we are, in the central banking community, exerting an art and not a science. What we need above all is a lot of good judgment based on multiple criteria analysis, experience, and a candid approach to situations that are

always complex. I don't think that either scientific theories or mechanistic approaches will relieve us from the permanent challenge of delivering good and wise judgment we all have to cope with. Sometimes, hopefully, as frequently as possible, we are right, and sometimes we might unfortunately be wrong. In dealing with financial instability, I think we are all in the same boat. The boards of directors in the private institutions making their judgments on their overall risk strategy and on their particular risk-taking decisions, the regulators assessing the best level of capital requirements and making out "core principles" for prudentials, the central bankers ensuring price stability and assessing appropriate requirements for systemic financial stability—all have to make decisions in a global perspective that is extremely demanding in terms of judgment because globalization creates extraordinary new opportunities together with new risks and therefore, we all have to improve navigation in promising but uncharted waters.

