SPEECH

Governance at a turning point

Speech by Christine Lagarde, President of the ECB, à l'Académie des sciences morales et politiques, Paris

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I am honoured to speak to you today as part of your prestigious academic programme on the many aspects of good governance – a crucial issue in these uncertain and challenging times.

I feel particularly honoured to be speaking to such bright and capable minds, in this iconic meeting place for the scientific, literary and artistic elite of our nation.

The Institut de France is often aptly referred to as a parliament of the learned world. By guaranteeing the independence of knowledge, it offers an open space where all kinds of knowledge intersect, allowing scientific, literary and artistic work to take place freely. In this way, the Institute stands for the protection of liberties and the need for integration[1], two aspects of good governance.

In my view, these aspects also apply to governance in a broader sense, particularly regarding individuals and governments. And they are especially important for supranational governance, as there is often a tension between the need for closer integration – which is likely to advance prosperity – and the wish for greater protection of liberties.

In fact, it's this tension that leads to rules-based systems and institutions emerging as countries work together voluntarily to forge supranational governance structures. And as international cooperation becomes stronger and more complex, supranational governance must also be strengthened to support it.

But in recent decades we have also seen an imbalance emerge between the authority delegated to supranational governance and its legitimacy in the eyes of citizens. That is partly because supranational governance, by promoting the expansion of economic integration, has also contributed to weakening its own legitimacy.

Today, this lack of legitimacy brings us to a turning point where we must either deepen supranational governance or accept its decline. However, I am confident that we can find a way forward by meeting three essential conditions.

First, by aligning governance with, and focusing it on, people's priorities. This is what I will call the function.

Next, by using the right forms of governance to effectively respond to people's concerns. I will refer to this as the form.

And finally, by striving to fulfil that function and serve the public, with what I will describe as courageous and accountable leadership.

The development of global governance

When countries have objectives that they cannot achieve on their own, or face challenges that go beyond their individual capabilities, they are motivated to cooperate internationally. This leads them to voluntarily accept some limits to their autonomy. It could, for example, involve reciprocal market access to promote international trade or a concerted ban on certain products or practices in order to protect the global commons.

But the more countries cooperate internationally, the greater the associated risks. Countries are exposed to unfair competition from trading partners, to spillover effects from other countries' financial markets and to non-compliance with agreements on protecting the global commons, such as treaties on the environment. That is why supranational governance is needed to mitigate these risks and achieve fair outcomes for all involved. In this sense, governance resides in setting the "rules of the game" in advance and then ensuring that they are fairly adhered to.

This type of governance can take different forms, ranging from creating international institutions to setting global rules and establishing standardisation bodies, or even more informal standards. But crucially, governments agree to this governance, submitting to certain constraints in return for a better response to a need they are unable to meet on their own.

However, there is an inherent correlation between the complexity of interactions among governments − particularly in terms of economic integration – and the authority that needs to be delegated to supranational governance to ensure that outcomes remain fair.

When international cooperation efforts remain fairly straightforward, the authority granted to global governance is often limited. After the Second World War, for example, the Bretton Woods agreements were signed globally, while the common market was set up in Europe. However, these governance arrangements focused mainly on promoting a stable environment for trade in intermediate goods. This reflected the limited scope of economic integration at that time, characterised by capital controls, fixed exchange rates, and high tariff and non-tariff barriers for services.

As interactions become more complex, however, there is a need for that governance to deepen. Look at the EU, for example. To promote economic growth, the countries decided in the late 1980s to transform the common market into a single market, covering capital and services. But a single market is inherently riskier. It exposes people to greater risks from harmful products or to unfair sales practices in jurisdictions that are less well-regulated, as well as to anti-competitive behaviours such as subsidies. And the risks of financial spillovers increase, too.

So the powers of competition authorities and financial regulators had to be strengthened. That's why in Europe we delegated authority for competition and external trade to the European Commission. Much later, and at the cost of suffering the consequences of not having it in place at the time of the financial crisis, we did the same thing for banking supervision. And we of course also launched a common currency to prevent the Single Market from being undermined by competitive devaluations.

Research has shown that the capacity of supranational governance to issue guidelines and interpret standards increased by around 50% over this period.[2] This triggered a self-fulfilling process, whereby greater economic integration led to deeper governance, which then led to greater economic integration – that is what we know as globalisation.

There have been multiple benefits: across a sample of 147 countries, a one-point increase in globalisation measures was associated with a 0.3% increase in the growth rate in those countries over five years, with lower and middle income countries benefiting even more.[3] Hundreds of millions of people in emerging markets have been lifted out of poverty. Europe has benefited from globalisation too. Between 2000 and 2017, jobs related to exports to the rest of the world increased by two-thirds to 36 million.[4]

Tensions inherent to global governance

But at the time we were not fully aware of the tension inherent in this process. Michael Zürn, an expert on international relations understood it clearly, however, and he developed a conceptual framework in which the growing powers of global governance lead to a lack of legitimacy, followed by a descent into conflict.[5]

All forms of governance need legitimacy. In other words, people need to feel that authority is being exercised wisely. But supranational governance cannot draw its legitimacy from the same sources as national authorities, such as elections or referendums. In practice, it must obtain its legitimacy through expertise and impartiality.

Expertise can confer legitimacy provided that supranational bodies are seen not only as competent, but also as uniquely able to build a framework for sustainable prosperity by virtue of having a supranational perspective that national governments lack.

Similarly, impartiality can confer legitimacy if supranational governance is seen as a way of ensuring that all parties respect the rules of the game and of adjudicating decisions fairly among all members, strong or weak – something that national governments cannot do either.

In this way, there may be long periods in which supranational governance is perceived as legitimate. After the Second World War, for example, public support for supranational governance was very strong, fuelled by the painful memories of the costs of non-cooperation.

A survey conducted in 1952 asked: “In general, are you for or against efforts to unify Western Europe?” The results revealed that 82% of West Germans embraced the idea, as did 78% of British respondents and 63% in France.[6]

But compared with sources of democratic legitimacy, expertise and impartiality are rather fragile, as they can be weakened by major crises or shifts in power dynamics. By enabling deeper economic integration, supranational governance increases the likelihood of that weakness – as we have seen over the past 15 years.

First, we witnessed the great financial crisis, followed by the euro crisis, both of which led to volatile cross-border capital flows. These episodes undermined faith in the idea that free markets regulated by supranational bodies were essential for sustained prosperity. This mistrust was famously summed up in the declaration by UK government minister Michael Gove that people “have had enough of experts”.

These crises caused the credit bubble that had fuelled growth in the early 2000s to burst, revealing the growing inequalities created by globalisation. Over the past 50 years the income gap between OECD

countries has risen to unprecedented levels,[7] exposing the limitations of resorting to debt to mask such disparities. This realisation was a further blow to the notion of legitimacy founded on expertise.

Global governance has also been a victim of its own success: the impressive increase in wealth and the growth in the international influence of emerging countries. These new powers, especially China, have legitimately demanded fair representation, becoming less inclined to submit to the governance of others.

This has led to the impartial nature of global governance being questioned on two fronts. On the one hand, emerging powers considered that global bodies overly favoured the interests of their main stakeholders and were too resistant to change. On the other hand, the former powers considered that the newer powers had no intention of playing fair. They therefore considered the rules, institutions and standards of global governance to be inadequate.

And as the global economy expanded, climate change was accelerating behind the scenes, with various international agreements barely making a dent in global carbon emissions. This suggests that even in areas of clear common interest, supranational governance was falling short.

So supranational governance is under threat from all sides, as various groups seek to bend it to their own interests. This is a sign of our times: fragmentation of the global order, gridlock in many international fora, the emergence of populist parties and groups of states coming together to forge new agreements better suited to their interests.

Is there a way of countering this trend?

It is vital that we strive to do so, because global governance is a necessary condition for maintaining international cooperation. We will not be able to preserve its many benefits if we let all that we have achieved go into retreat.

But global governance has to address its legitimacy deficit. And since it cannot draw on democratic legitimacy, the only way of restoring it is to tackle the challenges – such as economic insecurity, climate insecurity and geopolitical tensions – to which it has partly contributed, and that have undermined its claims to expertise and impartiality.

To do this, let me describe three possible ways of responding: function, form and leadership.

Three conditions for strengthening global governance

Function

Let’s start with the function of global governance. In order to thrive, global governance must offer solutions in the areas in which people feel most at risk today. If it doesn’t, the logical response would be to erect new barriers and reverse international cooperation.

In Europe, we have already seen this process unfold. For example, when the global financial crisis and the euro crisis exposed vulnerabilities in the banking sector, some wanted to dial back on integration. But we instead collectively responded by making the EU responsible for banking supervision and by addressing the issues that had come to light.

Similarly, when Europe found itself facing another external shock in the form of a pandemic, we reacted by putting in place the European recovery plan and recovery fund (Next Generation EU).

These helped to avert the threat that the virus would have a deeply unequal impact on European economies – especially those most dependent on tourism – which could have caused a new rift in our Union.

In both cases, rather than reversing economic and financial integration, we strengthened our governance to make integration more secure. We made sure that the competences of the EU matched what Europeans expect of it. In doing so, we clearly bolstered the legitimacy of the EU. Today, support for the euro and for the EU stands at 79% and 65% respectively.[8]

Can this be done with today's challenges? The good news is that many of the issues citizens feel most insecure about are precisely the ones where they want stronger European governance.

Around two-thirds of Europeans are convinced that the European Union represents a bastion of stability in a world in crisis. Almost nine in ten Europeans agree that tackling climate change can help improve their health and well-being, and the same proportion expresses support for the environmental objectives of the European Green Deal.[9]

Citizens realise that, although some of these problems result partly from a more globalised world, the answer does not lie in turning in on ourselves, but in taking action at a level that best allows us to deal with the issues effectively. And this means deepening integration.

In the future, it will be crucial to harness this spirit of collaboration to confront new challenges in areas of common interest such as security, defence, climate or mass migration.

Form

After function comes form. The form should mould itself to the function, creating the conditions for supranational governance to deliver on the issues prioritised by citizens.

This means great care should be taken when choosing an appropriate governance method.

We can build multilateral governance using either decentralised rules or centralised institutions. Although the first approach might appear to be the more attractive option owing to easy acceptance and because it keeps power at national level, it actually makes it more difficult to achieve governance objectives.

This is because rules are subject to a trade-off between credibility and flexibility. They are either rigid in order to be credible or vary according to circumstances in order to be flexible. But it is almost impossible to create a rule that successfully reconciles the two. All too often, attempts to find middle ground end up achieving neither.

Take the exchange rate mechanism as an example. It was created in the 1970s to stabilise exchange rates between European countries, initially operating according to strict rules that allowed a maximum fluctuation of 2.25% from the central rates. This system was severely tested in the 1980s, however, by increased capital flows and speculation. And it had to be made more flexible as a result.

But the system had to be relaxed to such an extent that it lost all credibility as a reference point for exchange rates, with fluctuation margins reaching 15% in 1993. This failure clearly showed the benefits of taking an institutional approach to European monetary integration, which then led to the adoption of the euro.

These benefits stemmed from the fact that institutions are not faced with that trade-off. When they have a clearly defined mandate and deliver on it, they become more credible. And when they have operational independence, they can be flexible and adapt to changing circumstances as they arise.

Let me illustrate this with the example of the ECB, which your President knows well and skilfully helped to develop.

Since it was created, the ECB has faced unforeseen challenges as it has carried out its mandate. But the Treaty combines our price stability mandate with discretion over the tools we can use to fulfil that mandate. This enabled us to use unconventional policy tools during the financial crisis, the recession and the pandemic to ensure that inflation remained in line with our target. Managing these complex situations would have been difficult if we had strictly adhered to fixed rules or had been limited to using conventional tools.

However, I am not naive as to the difficulties in moving from a rules-based to an institutional approach. I recognise that creating or changing institutions requires considerable political capital. This poses a challenge in specific political circumstances or situations where progress has stalled. But that cannot be used to justify inaction, because political courage can sometimes prevail over resignation and because there are other forms of governance, such as informal institutions, that can help us address the global challenges we are facing.

As COP28 is under way as I speak, let me take climate finance as an example. Numerous initiatives have emerged in this area under the aegis of the G20, providing a powerful channel for collective action in the wake of the crisis. Initiatives such as the Task Force on Climate-related Financial Disclosures have been set up, creating a framework encouraging companies to disclose information on the climate change-related financial risks in their economic and financial activities. Similarly, the Glasgow Financial Alliance for Net Zero, a global coalition of leading financial institutions, has committed to accelerating the decarbonisation of the economy. And the Network for Greening the Financial System, a coalition of central banks keen to align their actions with the pressing need to tackle climate change, circulates scenarios and analyses among all its members.

Although these are voluntary actions, their widespread adoption by thousands of organisations can create powerful incentives to address the challenges we face, bringing benefits such as speed, efficiency and adaptability.

It is crucial that such initiatives are led by players with a genuine concern for the common good, because if they are not, other entities motivated by profit gains or market share could quickly fill the void, sometimes with less clear motives.

Leadership

The third and final condition that I would like to mention is leadership. Even if we give governance the right function and implement it in the right form, this does not mean that the outcome will be the right one. Institutions need courageous and accountable leadership in order to take the right decisions.

Faced with complex and uncertain global challenges, the “courage to act”[10], as Ben Bernanke said, is essential. Leaders must show an unwavering determination to use all of the tools available to them, in line with their mandate, to achieve their goals.

This is a truth I have experienced throughout my entire career: as Finance Minister in France, as IMF Managing Director, and now at the helm of the ECB. Crises are insidious and unpredictable in nature, and every crisis is different. There is no textbook setting out the perfect approach to take. But time is always in short supply and risks inevitably have to be taken, while the outcome is inherently uncertain.

More recently, we faced an unprecedented crisis with the pandemic. These were extraordinary times, and the creation of the €1.85 trillion pandemic emergency purchase programme (PEPP) to shield the economy from the impact of the pandemic was an extraordinary response. But it was necessary to combat the deflation we could have seen if we had not acted.

Effective leaders must therefore give their institutions the resources they need to act, all the while being accountable for their actions. When taking decisions that break with precedent, leaders must always keep in mind that they will have to account for those decisions. This keeps them within the limits of their mandate and focused on the public interest, and it prevents them from being tempted to go too far.

We saw this again in the case of the PEPP, as we meticulously prepared for the implementation of the programme with this in mind. We strictly complied with the requirements and safeguards considered necessary by the Court of Justice of the European Union in its judgments on our past actions, thereby ensuring that our measures were fully compatible with the Treaty.

So in striving for effective leadership, courage and accountability must go hand in hand.

Conclusion

Let me conclude.

International cooperation is a powerful force that has shaped our recent history. It has brought indisputable benefits, propelling the world towards unprecedented development, creating wealth, providing access to scientific and technical progress in an increasing number of countries and building multilateral institutions that have defined the post-war era.

But it would be a mistake to disregard the challenges that have arisen on this path. Inequalities, unresolved global crises and the loss of institutions' legitimacy have sown doubt in the minds of our fellow citizens.

This mistrust has materialised as protectionism, withdrawal, retreat and populist tendencies, eroding the foundations of supranational governance, leading to political movements seeking to regain control, and to our world fragmenting into competing blocs.

Today, the supranational governance that underpins international cooperation is at a critical turning point: either it is strengthened or it goes into decline. The choice is between a world that seeks to reconcile differences and create prosperity for all, or retreat into a world without cooperation, perhaps even one of confrontation.

I do, however, see a way forward. If supranational governance can be aligned with and focused on citizens' priorities, take the most effective form to achieve those priorities, and be led with courage while being held accountable, then it will be able to rise to the challenge it is facing.

But we should also remember that all supranational governance structures have emerged from an era shaped by the devastating consequences of a failure to cooperate and open conflicts between countries, while deep-rooted fears were taking hold.

In these decisive moments, I am inspired by the legacy of an eminent member of the Académie française and a pioneer in the fight for women's rights, Simone Veil.

She chose to have her ceremonial sword engraved with the number 78651, representing her deportation to Auschwitz, alongside Europe's motto: "United in diversity".

Let us not forget our past. Let's work together for a fairer, more sustainable and more prosperous world. The choice before us must be guided by a shared vision of unity, cooperation and mutual respect, which our future generations deserve.

Thank you.

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