STRENGTHENING THE ARCHITECTURE OF THE INTERNATIONAL MONETARY SYSTEM:

THE RESPONSE OF THE PRIVATE SECTOR

New York City
Union League Club
38 East 37th Street
January 26-27, 1999

Tuesday, January 26, 1999

8:15 am Breakfast & Registration

8:45 am Introduction

9:00 am Panel 1 - Preventing Financial Crises

Chair: ***Ed Altman, Vice Director, Salomon Center, New York University***
• John Hicklin, Assistant Director, Policy Development & Review Department, IMF
• Tom Bernes, Executive Director for Canada, IMF
• Mustapha Nabli, Senior Economic Adviser, Development Prospects Group, the World Bank
• Clifford Dammers, Secretary General, International Primary Markets Association

10:45 am Coffee Break

11:00 am Discussion - Roundtable: The Response of the Private Sector

• Carlos Asilis, Managing Director, Vector Investment Advisors
• Liliana Rojas-Suarez, Chief Economist, Latin America, Deutsche Bank Securities
• Peter Geraghty, Managing Director, Darby Overseas Investments

1:00 pm Lunch and Keynote Address By Dr. Heiner Flassbeck, State Secretary of Finance, German Ministry of Finance

2:30 pm Panel 2 - The Resolution of Financial Crises

Chair: ***Andres Solimano, Director, The World Bank***
• Karin Lissakers, US Executive Director, IMF
• Daniel Jackson, General Director, Nomura International
• Timothy DeSieno, Hebb & Gitlin
• Paul Leake, Partner, Weil, Gotshal & Manges

3:30 pm **Coffee Break**

3:45 pm **Discussion - The Response of the Private Sector**

<u>Chair</u>: Andres Solimano, Director, The World Bank
• George Vojta, Vice-Chairman of the Board, Bankers Trust
• Mary Podesta, Senior Counsel, Investment Company Institute
• Ernest Patrikis, Special Advisor to the Chairman, AIG
• Jeffrey Shafer, Vice Chairman, Salomon Smith Barney

5:30 pm **End of the First Day**

Wednesday, January 27, 1999

8:30 am **Breakfast**

9:15 am **Panel 3 - Strengthening International Monetary Cooperation: The Euro in the International Monetary System**

<u>Chair:</u> Marc Uzan, Executive Director, The Reinventing Bretton Woods Committee
• Hervé Carré, Director for Economy of the euro zone and of the European Union, European Commission
• Paul Kimball, Global Head, Foreign Exchange, Morgan Stanley
• Yukio Yoshimura, Executive Director for Japan, IMF
• Heins Juergen Scheid, Senior Officer, International Relations Department, European Central Bank
• Dick Ware, Manager, Regulatory Affairs, The World Gold Council

11:00 am **Coffee Break**

11:15 am **Discussion**

12:30 pm **Lunch**

2.00 pm **Panel 4 - Exchange Rate Regimes For Emerging Economies: What's left?**

<u>Chair:</u> Nicolás Eyzaguirre, Executive Director for Chile, IMF
• Rogelio Ramirez de la O, President, Ecanal SA.
• Carlos Asilis, Managing Director, Vector Investment Advisors
• Joyce Chang, Managing Director, Merrill Lynch
• Bernard Delbecque, Adviser to the Minister of Finance of Belgium

3:30 pm **Discussion**

4:15 pm **Conclusion**

TRANSCRIPT

INTRODUCTION

Marc Uzan, Executive Director, The Reinventing Bretton Woods Committee

Marc Uzan: As some of you might know, we met a year ago in New York, in fact last year at the same date, to discuss the Asian financial crisis. One year later, the world economy is facing two other crises. We have the Russian default, the Brazilian currency crisis. There have been a lot of discussions on the new international financial architecture for maybe a new Bretton Woods. So, what we wanted to do today is really to try to engage a dialogue between the private sector and the international institutions. And I was very pleased by the response that we had from the International Monetary Fund, and specifically from the Executive Board of the IMF. Most of the constituencies from the Executive Board are attending the conference and we are very pleased to welcome you today at this meeting. We will discuss the best way to prevent and resolve financial crises today, asking what should be the role of the private sector, how the private sector should be involved, and as well, how the euro will fit in that new architecture.

The first panel will deal with preventing financial crises. We'll have the views of public officials and then ask what should be the response of the private sector. So without delay, I would like to ask Professor Ed Altman to chair the first panel.

PANEL 1 Preventing Financial Crises

Chair: Edward Altman, Vice-Director, NYU Salomon Center

Ed Altman: Good morning. Marc, your comments were a little to brief because I was still finishing my breakfast, and I hadn't anticipated being on so quickly. I am going to stand for just a moment. It is a lot easier when you are my height to stand than to sit next to a lot of tall people and important people. I am a bit of an outsider with respect to this first panel. Actually I was asked by Marc to talk a little bit about the euro and its relevance to world economic progress and crises, etc., which is on Day 2 as it turns out. But unfortunately, I have teaching engagements tomorrow all day, and so I wont be able to talk about the subject which I think is quite important, and that is the impact of the euro. However, I was looking for some reason to participate today on subjects that are obviously quite critical and important. The first session at first didn't look like the right spot, preventing financial crises, when I would guess that the emphasis is on financial crises at the macro aggregate level when most of my work in the area of crisis analysis and management has been at the micro level dealing with the corporations for the most part rather than the countries. And then I realized that there was some recent work done by the World Bank, is Michael Pomerleano here?, well good, he's not here! So I can say a little bit about what he said and he can't correct me if I am wrong.

In my introductory remarks then, before I introduce the panel, let me just say very quickly that although I think we are going to hear primarily about macroeconomic crises and, hopefully, ways to prevent them, it is very hard to prevent something that you don't predict in some fashion before hand to marshal your resources in the areas that need the most attention. What Michael did at the World Bank, and he showed me this just a few months ago, was to look at some very basic indicators: financial performance, not of the economy in, but of the entities that comprise the economy, at least the corporate entities. And I refer you to a study in case you have not seen it published by the World Bank, I know we are going to have a number of talks today from people from the IMF and related institutions, I believe the World Bank will be here as well. He published a study called "Corporate Finance Lessons from East Asian Crises". This was published in 1998. Note Number 155, if anyone would like to get a copy from the World Bank. Basically what he did is look at some basic financial indicators: debt/equity ratios, profitability ratios, and the like, and in addition, he looked at a ratio or a model that I built more than 30 years ago, believe it or not, I was seven at the time when we built this model, called the z-scores** model which some of you may be familiar with, which is a model to predict financial distress of companies. And what he did is he aggregated the z-scores, in some meaningful way I believe, of countries in East Asia as of the end of 1996. Then he looked at which countries aggregated appeared to be in the most financial distress. The z-score ratio is a conglomerate of five financial indicators with perimeters that are determined to predict financial distress for companies. And right at the bottom, was South Korea, Thailand and Indonesia I believe. This was prior to the crisis that we all know very much about today. Now, I am not saying that somebody should have used this model and say immediately, let's go to those areas and these are the areas that need the most assistance. But here was an objective model that was built for a different purpose that showed without any question that South Korean corporates were vulnerable to distress in a big way, as well as Thailand, Indonesia, and a few developed countries by the way which also seemed to have low aggregate z-scores. So, perhaps one reason for me being involved in this first session is to talk about preventing financial crises by predicting those areas that perhaps would have the most vulnerability.

Having said that, let me move now to our panel. We'll take about fifteen-twenty minutes for each and then open up for questions, hopefully there will be a good deal of time for that. You have the outline and the agenda in front of you. I am very pleased and privileged to introduce these gentlemen to you: John Hicklin is our first speaker. He is the Assistant Director in the Policy Development and Review Department of the IMF. Without further adieu, John Hicklin.

John Hicklin, Assistant Director, Policy Development & Review Department, IMF

John Hicklin: Thank you very much indeed, and thank you very much for being invited to this panel today. I am very happy to try to give some perspectives from the Fund's staff. I would say at the beginning that these are my personal views. I have to say that particularly today since I noticed that half the Executive Board of the IMF is here. And I have to be particularly careful of what I say. With that, I have three introductory remarks. I will try then in the course of the presentation to explain some of the scope for this world architecture. It is a misuse of the world but it still has become useful because it is a short term now for a wide variety of topics. I would like to begin with three introductory remarks.

The first is the nature of the challenges that are being addressed. It is clear as everyone knows that part of the challenge now being faced is a result of increased globalization which is in itself a desirable and indeed inevitable event. Not all of the problems that we see are the result of contagion. In almost every country there are elements of problems or policies that need to be changed to some extent, even if not dramatically. And there are different sorts of economic problems that are now being addressed, usually to deal with stock imbalances in the financial sector, so not the usual flow imbalances which were the stuff of earlier sets of crises. This is all well-known and documented. I would just like to add one other aspect of the challenges which I think is more important or more interesting to address at the same time. And that is that in many of the countries that are now facing difficulties or have done in the last round, there is a juxtaposition between two relatively happy events: one is the increasing move towards globalization, and the other is an opening up of those countries and a move towards democracy. The juxtaposition of two happy events, nonetheless, leads to many challenges. One of them is that it is much slower for an open and more democratic government and policy makers, including parliaments, to respond to crisis, to build consensus to get the policies in place than it is for financial markets to give their signals and to implement those signals. So we are faced with a set of issues, a set of challenges which have a much broader base than the traditional macroeconomic, and indeed microeconomic, issues just noted. That is my first introductory remark.

And secondly, I cant help but comment in a group which is discussing the Bretton Woods institutions to say well, I won't touch upon many of the discussions or many of the debates that are going on at the moment about the appropriate fora for advancing the agenda, only to say that there have, of course, been many, many groups in the last year, just about every G you could imagine, the G-7, the G-10, the G-22, which is now either G-26 or G-32 or the G-24, and a wide number of private groups and so on that have been contributing to the debate. I would just make two observations on this. The first one is I did participate in part of the G-22 process which as you know is a group of countries initially started by the US, as the G-7 plus 15 crucial emerging market countries. That G-22 process had a couple of characteristics which I think are important. One is that it did involve policy makers who had been through the various crises and could speak from personal experience. So, it brought to the discussions a building consensus, adding to the depth of discussions, an analysis and a framework of perspectives that were very useful. So, that I think was a very positive aspect and I think we should see some elements of that spreading of the discussions in different ways in the future. I am not exactly sure how that would evolve. But the other comment I would make on that sort of process of widening the discussions is that there is a problem of how to bring back the recommendations that come from those groups into the policy making decision structures which exist, and that is another set of issues which will have to be addressed and which is being considered. But I don't want to talk about those today.

The third introductory remark is simply that there have been many, many proposals now that have been put out in public. Some of them grand schemes which can change the world, others small adjustments. And although there is great consensus on the analysis on what the problems are and what the issues are, it is really time now to move to how to implement specific reforms, specific issues and move them forward. And that is the big challenge. It is much more difficult to do that than to have another group or another forum which essentially restates the same issues. Getting to the next step is the crucial challenge.

So, with that, I would like to touch briefly on five areas which come under the broad heading of architecture: transparency and accountability, strengthening financial systems, improving the sequencing of capital account liberalization, involving the private sector in crisis prevention -- I think this afternoon the discussions will move more on to crisis resolution, although they are intimately connected -- and fifth, I would mention though it is not usually included within architecture of the international financial system, an important element which is the social dimension to all the changes. So, on these five broad areas, were are we? I would say that I only intend to give a few examples. There are many issues that are included within these five broad topics, which I cannot possibly discuss or even mention this morning. One example is the exchange regimes, which is obviously an important issue that is going to receive a lot of attention. But I don't intent to touch on that or a number of other topics.

The first area, transparency and accountability. There have been many proposals at the Fund, G-22 and a lot of the other groups on how to make progress in this area. The first aspect is the development of standards. And when one should develop standards in a number of areas, how to develop them, disseminate them and monitor them? Those three elements of the standards issue are distinct and quite complex. There are three particular standards which the Fund has taken a lead in developing, and therefore, will also be considering how to disseminate and monitor them. There is the Special Data Dissemination Standard, there is the code of conduct for transparency of fiscal policies, and a code of conduct that is being developed at the moment on monetary and financial policies. These three issues are close to the heart of the Fund's mandate, and therefore, it is not difficult to see the work proceed within the context of the Fund. The SDDS, as you know, was set up post Mexico. And there is one very important aspect of that, and quite apart from many of the technical details, and that was the recognition, getting back to the theme I mentioned at the beginning, that if you are tackling much more complex problems, you can less easily rely on traditional channels of public institutions, international and financial institutions, coming to a country, advising and saying: your policy is off track, this is what you should do. There was a clear desire to broaden the debate and to get private markets and other private commentators to bring to bear their influence, their views on the national authorities. One way of doing that is to make data available to the markets in such a way that they could channel them and comment back to national authorities. That is a crucial aspect of the thinking behind the SDDS as it developed after Mexico. If such a standard for data dissemination was being developed, why didn't it fully succeed? Of course, it is only one part of the story, and indeed, one of the aspects that we are trying to do at the moment is to strengthen the initial specification of the SDDS to enhance the provision of data for reserves and external debt. Both the definition of reserves and debt, which is extremely complex when you come to look at it, but also the availability of the actual data as opposed to the definition of the data which the subscribing countries should use. So that is one clear area. It seems to be a very straightforward aspect, but almost everyone could agree to. When you actually come to implement these things, it is much more complicated to define the issue and to get international consensus to do it. But that still is high on the agenda. On the second standard I mentioned on fiscal policy, that is being made public the first draft, and there are important principles of transparency of fiscal management which are being promoted. I would be interested in views of the private markets, the extent to which they have been aware that this is made public and the ability to comment on the draft manual which is being developed now. So, we have these standards. As you move away from the Fund's core standards to accounting , to bankruptcy, to corporate governance, obviously the World Bank, the OECD, the BIS, all of these other institutions involved as well as national authorities, it becomes a much more difficult issue to develop the standards, never mind to disseminate and to monitor them. There is one specific proposal incorporated in the G-22 Report on transparency reports, that is the IMF in the context of its Article IV consultation should each year produce a report that indicated the extent to which national authorities do monitor particular financial standards. This is an issue which we are now examining, and we'll come with proposals to the IMF's Executive Board, but it gives some indication of the desire of the international community to present more data on the extent to which countries are adhering to various standards and trying to find a channel where this information could be made available to the markets. Aside from the standards, tether is also the strong pressure for the international community to be more transparent itself. The IMF is trying hard to move on this. We have introduced these public information notices, which come after Board meeting on Article IV consultations, putting pressure on countries to release their letters of intent and policy framework papers after a program has been agreed, trying to get more of the policy documents out, that are being discussed at the IMF's Board. This is a process which is continuing and we can certainly hope, gathers momentum. But again, the reaction from the private markets, their response to this kind of initiative would be certainly appreciated. We would like to get feedback on that.

The second item on strengthening financial systems: there is obviously a lot of work that is being done within the context of the Basle Committee and all the other groups that meet in Basle. There is also developments following what is crudely called hedge funds, but is actually a much broader range of institutional investors, both in the national authorities of the US, the UK and others, as well as the Basle Group, to come up with improved prudential and supervisory frameworks. So, that is an area which obviously is continuing, and again, it is not difficult to agree in general to that principle, that it should be developed. It is very much more difficult to come up with specific proposals on how improvement should be made. On our own part, we have tried to respond to proposals last year on collaborating with the banks and financial sector's work to make sure there is no overlap, and to make sure the existing work is well coordinated. So, I won't discuss that area anymore now.

The third is capital account liberalization and here I will just make one or two comments. A lot of the criticisms which have come on capital account liberalization really criticized the whole process rather than trying to criticize the individual things that have gone wrong. In some countries, it was clear it wasn't just the fact that there were open capital markets. It was crucially important, in the case of Russia for example, the fiscal policy was way off track. SO, which do you blame: the fiscal policy or the fact that markets are open and allowed people to hold of government debt? In a number of countries of course, Korea would be one, there are all sorts of aspects that promoted short-term debt instead of long-term debt, that made it difficult for it to be foreign equity participation, and all of this contributed to difficulties. And the response to that has sometimes been a broad criticism of liberalization rather than attacking the specific problems. So, in developing any new proposals of a more appropriate sequencing of capital account liberalization, we have to look at what the particular problems were, not be too sweeping.

Fourth area: the role of the private sector. There have been many, many bold ideas that have been put forward, but it is indeed a very complex area. I think it is fair to say that although many of the issues have been laid out, a road map to involve the private sector more in crisis prevention, never mind about resolution, is not agreed to yet. This is perhaps the most difficult, the most challenging area to get agreement. But there have been lots of proposals. Most obvious, improving macro policies should go without saying and implications for fixed rates for promoting short-term flows, implicit guarantees, that is one area. And also the many proposals that are being put to strengthen prudential supervision, and Mr. Greenspan's idea on how you are trying to change the rules for inter-bank lending, and so on. There is also the Mexico/Argentina proposals for credit or swap facilities which can be triggered in the event of problems developing. Proposals for contingent credit lines from the official sector backed up by the private sector, modification of sovereign bond contracts to introduce sharing clauses and so forth, and creditor councils to involve the private sector with the national authorities in advance of crises to exchange information. In this area, I would just like to add one point to something that is often raised: clearly problems raised in this context of the problems of selectivity, how do you select the private sector members that would be participating in meetings between them and national authorities, and how do you deal with the problem of privileged access to information that can take place in those meetings? I would be interested in people's views on the extent to which the provision of more information from the Fund on the discussions on macro policies could assist that process. But there are many other proposals which are going on at the moment, you have the monetary haircuts, and then you move on towards the issues of moratorium and mandatory stays, which I think will be discussed more later on today. But the implications for any changes in the regime on private sector's behavior in the period before a crisis as established is one of the very important aspects that needs to be discussed as those items move on. I will not get into the issue that will be discussed this afternoon on the many controversies over some of those issues.

Let me finally come back to the fifth area, on the social aspects. there is clearly the need for more forward-looking work on the implications of potential difficulties for social structure, for social safety nets. This work cannot be done in the midst of a crisis. It was obvious in the case of Korea and Indonesia, to name just two, that the very difficult social problems that developed involve trying to create institutions and modalities after the event. More forward-planning is clearly important, and obviously the World Bank would be taking a lead role in this area, but the Fund would obviously be involved.

So, in general, these are the five areas. I think there is an awful lot of work going on, and who is going to do this work? The IMF's staff and Board will be pursuing a lot of these issues and can do a lot, and indeed will be doing a lot over the period ahead. But a lot of these other issues cannot be done by the Fund. They have to be done by other parts of the international community, and that is the challenge for the period ahead. Thank you.

Ed Altman: Thank you very much, John. Our next speaker is Tom Bernes, who is Executive Director for Canada at the IMF. He will be talking next about his views on preventing crises.

Thomas Bernes, Executive Director for Canada, International Monetary Fund

Tom Bernes: Thank you. It was just a year ago that Marc had invited me to participate in this conference on preventing financial crises. I think this year I will have even more questions and less answers than I had a year ago. I would also say that I also represent some Caribbean countries at the Fund. I was in Jamaica last week, but as I pointed out to some of my Board colleagues who sometimes are envious, that the week before I was in Ottawa and the temperature in one place was minus 30 and the other was plus 30 Celsius. So, on average, during my two trips, the average temperature was zero. To my Board colleagues who have heard my views on these questions, I apologize, but I think the fact that there is such a large representation here demonstrates that there is a great deal of searching going on to try to answer some questions.

The 1990's will be remembered as the decade of currency and financial crises. The list begins more or less in September 1992 when the exchange rate mechanism of the European Monetary System came under attack and a number of countries were forced either to abandon the mechanism or to devalue. This was followed by the Mexican crisis of December 94. The Asian crisis began in the second half of 1997, intensified in 1998 for some countries in the region. Then in August 98, Russia's defense of the ruble collapsed and the debt default that was declared shortly thereafter created severe and unprecedented turmoil in global financial markets, including in some of the deepest and most liquid markets. More recently, of course, we have witnessed Brazil's battle on the financial markets over the value of its currency, the real. The enormity of the direct economic and social costs that will be borne by many of those emerging market countries hit by a financial crisis cannot be overstated. However, financial crisis in individual countries also imposed costs, both directly and indirectly, on the global economy. In my view, the primary responsibility for crisis prevention has to begin with individual countries. The policy makers in the international community also have a role to play through surveillance and appropriate advice to countries and through improvements in the working of international financial system designed to avoid financial crises, or at least reduce their severity and frequency of occurrence. Unfortunately, the increase in the frequency with which crises have occurred over the 1990's clearly requires that we have to intensify our efforts in developing effective preventive mechanisms. Following the Mexican crisis, discussions at the Halifax Summit in 1995 resulted in a number of proposals, including a call for reform of the IFIs. Experience since then obviously shows that the list of solutions was incomplete. Indeed, from our perspective up today, more questions than answers remain. For instance, do we need to fundamentally rethink the structure of the international financial system, given the effects on international capital markets of the development of new financial instruments and advances in technology? Questions are also being asked about the governance of and coordination between the international financial institutions. Are they sufficiently transparent and accountable? Do we require new forms of strengthened coordination between the IMF, the World Bank, the BIS and regulators? The informal clue which the G-7 and G-10 have provided in the past in terms of identifying gaps between institutions and their workings and identifying priorities has had to be expanded to bring in new countries, the G-22, which John just mentioned. Do we need to go further in this area? To begin to address such questions, discussions are once again under way in various fora to improve our understanding of the causes of financial crises and the architecture of the international financial system, and to offer new preventive solutions. In addition, we are undertaking a hard and critical review both from within and outside the IMF of the appropriate macroeconomic and regulatory policies that are required for individual countries to avoid crises.

I would like to begin with some comments on the issue of international capital flows. The prominent role played in the financial crises of the 1990's by massive and fast-moving international flows of capital has naturally raised concerns over their net economic value. Surges in short-term capital flows and their sudden reversal have played similar roles in triggering all of the major financial crises in the 1990's. Calls have thus risen for the imposition of capital controls, with the most benign calling for tighter regulation of short-term flows but allowing for the encouragement of long-term capital flows. In my opinion, countries, especially emerging market countries, should focus on implementing policies that attract and maintain long-term capital. We cannot and should not try to turn back the clock on capital mobility. The imposition of capital controls, such as those adopted by Malaysia last year, are counter-productive and create more pitfalls than possibilities for growth and employment. However, a broad view of capital mobility has to be taken. Clearly, the integration and liberalization of international capital markets has ushered in an era where international savings are allocated more efficiently to global investment opportunities than never before. Both emerging market and developed countries have benefited from this. At the same time, it needs to be recognized that enhanced capital mobility has also increasingly subjected countries to the scrutiny, discipline, and sometimes the fickleness, of global financial markets. It has also increased the incidence of cross-border contagion through the propagation of shocks from one country to another. Because surges in capital flows are likely to remain a permanent feature of capital markets, countries have to insure that capital account liberalization is sequenced appropriately. Preconditions such as resilient financial systems, strong regulatory regimes, and sound macroeconomic policies, have to be in place before hand. Issues also need to be addressed from the creditor side. For example, are the current capital adequacy ratios sufficient? Is enough reliable information available to creditors, and to creditors regulators about their activities? Is risk management adequate? Has technology made the amount of leverage in the international financial system too large? Such issues speak directly to the heart of the discussions on improving the set of principles and institutional arrangements that promote the stability of the international economy.

In an environment where mobile and sometimes volatile capital flows carry the potential for contagion, an obvious starting point for the prevention of financial and currency crises is to design and implement policies to strengthen national and international financial systems to make them more resilient to shocks and to promote transparency with respect to data provision and national policy making. While herding behavior can occur in financial markets, markets can and do differentiate among countries. And the impact of contagion can be mitigated if transparent and credible policies are pursued, and if sufficient and reliable information is provided to allow both borrowers and lenders to improve their management of risk. As I noted earlier, recommendations in these areas are already been formulated under the banner of improving the architecture. John has reviewed a number of these specific proposals, and I won't repeat them. While such proposals should not encounter serious opposition in principle, they will require effort and time to implement. Among other things, international agreements will have to be arranged with respects to definition of standards, the roles of the IFIs will have to be delineated and coordinated and input from the private sector will have to be secured, especially with respect to their involvement in crisis prevention, point which I will return in a moment. More controversial proposals have been advanced. Nowhere is the controversy more apparent than with respect to the appropriate role for the IMF in encouraging orderly and sustainable capital account liberalization. While there is general agreement that the IMF has a mandate to encourage orderly capital account liberalization, there are range of views on how this should be done. IMF management and the governments of some countries believe that this can best be done by extending the Fund's jurisdiction to include both the payments and transfers associated with capital account transactions, as well as the transactions themselves. they argue this would be the most effective way of insuring that countries liberalize their capital accounts, in such a way that minimizes risk to the international financial system. The other school of thought, with which I associate myself, is fully supportive of the IMF encouraging liberalization efforts through its advice, technical assistance and efforts to help establish the conditions necessary for a successful capital account liberalization. However, it sees no need for the extension of formal jurisdiction to capital transactions. We need to walk before we can run. Our understanding in this area is still far from perfect, even in hindsight, as much as it would seem imprudent to give even a highly respected institution such as the IMF the unilateral authority for setting liberalization obligations for individual countries. This is particularly true given that the costs of mistakes are potentially high and are borne heavily by the citizens of the country in question.

Ultimately, proposals such as those I have just mentioned are unlikely to prevent financial crises unless individual countries implement appropriate macroeconomic policies to insure domestic stability and structural soundness at home. In most instances, this means following policies that permit continuous responses to economic and financial pressures so that the economy can adapt more smoothly and quickly to shocks. Key in this respect is the adoption of more flexible exchange rate regimes. Indeed, pegged exchange rates have been closely linked to the source of many of the crises that have occurred over the course of the 1990's because they often come to be seen as an implicit guarantee, thereby distorting the incentives of borrowers and lenders. Unfortunately, when the credibility of an exchange rate peg comes into question, owing for example to an unforeseen shock, a rush for exits can ensue, including by residents trying to protect the value of their savings. This is precisely what happened in Asia. In Brazil's case, despite securing a sizable international financial aid package, doubts about the authorities' ability to maintain the exchange rate peg began to intensify as concerns mounted over the capacity of the government to implement its fiscal austerity program. Moreover, it became increasingly apparent that the authorities were unwilling to increase interest rates to defend the exchange rate peg. The decline in credibility of the peg accelerated outflows of foreign capital. Eventually, and I believe correctly, the authorities have decided to allow the real to float. Similar and even more striking episodes have been played out in Russia and Asia where massive capital outflows and lower levels of international reserves resulted in significantly more dramatic currency collapses. In light of these experiences, it has been increasingly recognized that pegged exchange rate regimes are not the best choice for most economies over the longer term. I am not claiming that flexible exchange rates are a substitute for sound fiscal and structural policies. There are not a panacea. Indeed, very strict regimes such as currency boards work extremely well for some countries. However, for less strict regimes, such as simple pegging regimes, too often crises have developed because of an unwillingness on behalf of the authorities to recognize that the peg was no longer untenable, and the opportunity for smooth exit had passed. If market participants have difficulty in identifying an equilibrium exchange rate, then so do policy makers. And the evidence of financial crises in the 1990's clearly shows that policy makers wait too long to be convinced that their choice of exchange rate peg is untenable, the ensuing adjustment can be abrupt and extremely disruptive.

This leads me to some final thoughts by recent suggestions to have the IMF evolve in the role of lender of last resort to the international financial system, and about ideas to more effectively involve the private sector in crisis prevention. An international lender of last resort can help to minimize the impact of contagion on countries that are affected by financial crises elsewhere, but that otherwise have adopted and implemented appropriate macroeconomic policies, that is to say, countries with liquidity but not solvency problems. However, aside from the difficulties associated with the feasibility of such an effort, I think more has to be done to examine such proposal. We cannot ignore the argument that the mere existence of such a lender may bias the actions of investors towards more risky investments. Such a development would clearly move in the wrong direction. Problems have to be solved, not continually financed. Perhaps more promising are some novel ideas that have been put forward with respect to private sector's involvement in crisis prevention and management. Many of the ideas are still very much in their infancy and in order to be accepted and effective, private sector participants will have to be actively and responsively involved in the debate over their desired implementation. Proposals such as the use of collective action clauses in sovereign bond contracts, the introduction of options into inter-bank lending to oversee debt standstills in the event of a financial crisis may hold some of the answers.

In conclusion, I would submit that while more clearly needs to be done, progress is nevertheless being made in understanding what is required to prevent or at least minimize the frequency and severity of financial crises. Agreement is being reached on certain issues with respect to strengthening the architecture of the international financial system, and both the benefits and limitations of the massive financial assistance packages are being revealed. Most importantly, individual countries appreciate more profoundly now than never before the importance of fostering strong financial systems and pursuing appropriate macro and exchange rate policies.

Ed Altman: Thank you very much, Tom. Our next speaker, I am very pleased to introduce, is Mustapha Nabli, who is the Senior Economic Adviser at the Development Prospects Group at the World Bank, and prior to coming to the World Bank, Dr. Nabli had a distinguished career, both in the private sector so to speak in the Tunisian Stock Exchange, and as an Adviser and a Minister for the Tunisian government in Economic Development. Finally, we have something in common, we both did our graduate work at UCLA.

Mustapha Nabli, Senior Economic Adviser, Development Prospects Group, The World Bank

Mustapha Nabli: Thank you. Like a true professor, I cannot speak well sitting, so I have to stand up. I would like to talk about preventing crises but from the domestic point of view. I think the discussion has been about the international architecture, and I did not realize that the main theme is the international architecture preventing crisis aspect. But I think my discussion is highly relevant, and I'll try to explain why the domestic issues that I am going to discuss are highly relevant for the international architecture and their many implications. The main issue I would like to discuss is that preventing crises from the domestic point of view is really an issue of the art of the possible, and I will try to explain what this means. What I am trying to say is that preventing crises is not a matter of really knowing what is needed to do, but it is a matter of making what is needed feasible and doable. And making what is needed doable and feasible lies essentially in the domain of the public policies and institutions. But the domain of public policies and institutions is determined in the domain of politics. I would like to develop the central idea of the role of the political institutions in preventing crises and I would like to do that by developing essentially four points. Those points can be to a large extent found in the last World Bank Report, the GEP Report published in December.

The first point is to argue that crisis prevention, and it has been argued by the previous speakers, is now key in developing countries, but then, it is difficult because there are many, many types of crises and then what to do about them is not a simple matter. I would like to go and really argue that the root cause of a crisis lies in the management of the trade-offs that are implicit in public policies and institutions and the conflict of interests that are inherent to them. Then I would like to illustrate this by a few examples from the various issues that are discussed in financial crises.

The first simple idea is that crisis prevention is now key in developing countries, which follows from the increased frequency in financial crises. It has been referred to by Mr. Bernes earlier in the 1990's, but in fact when you look at the numbers, financial crises and their frequency have increased significantly since the 1980's. When you see that in the 1970's, the frequency was very low and then there was an upsurge of crises obviously with the debt crises of the 80's, and then the early 90's with the European exchange rate system crisis, and then by the end of the 90's. So, financial crises have become very frequent in developing countries, and developed countries also, but the largest numbers are in developing countries. I don't have time to talk about the costs of these financial crises, but the costs are horrendous. The East Asian crisis has shown that very clearly. So, this means that the development process is not a smooth process. It is not what we thought about in the 60's. When we thought about development in the 60's, we thought it was smooth, you were looking at 20 years ahead, 15 years ahead, it is not so smooth. It is a very discontinuous process. And you have crises happening all the time. This means that crisis prevention has to become a central concern by policy makers in developing countries. It is not something that you have to deal with when it happens and then wait for it to happen.

Having said that, where do you go from there? The first difficulty, the first problem you have is that there is not one single type of crisis. There are a variety of crises. I don't have time to discuss all of them, but when you talk about it, you talk about the old type of crisis where public sector management, excessive borrowing and so on are the major problems, and then we call new type of crisis where we have private sector exposure, private capital flows central to the process, we talk about currency crises, banking crises, crises due to fundamentals weaknesses in the country, and crises that are triggered by contagion from other countries. We talk about vulnerabilities and unpredictability of crises and so on. So, the problem is that we don't have one type of crisis we are dealing with, and what is even worse is that future crises will probably be different from what we have seen, and will have at their source other phenomena that we really don't know today. This makes it very difficult, and it makes crises essentially unpredictable. Despite what the chairman said about developing indicators of distress at the micro level, I don't think we'll ever have really good techniques to be able to predict crises in any meaningful way.

The unpredictability and variety of crises I think, and that is my main point, reflect the centrality of the political process to initiate and implement appropriate public policies and institutions: public policies and institutions that are required, one on hand, to produce prudent risk management by the private sector and also by the public sector, and on the other hand, produce inconsistent policies, which are often the cause of the crisis. So, how and why does the political process produce these inconsistent policies and induce prudent risk management? And that really is the issue. In fact, what I would like to say is that the capability of the political process to deliver such policies and institutions which have inconsistent policies and induce prudent risk management are hampered by the presence of trade-offs in policies, and are hampered by the existence of conflicts of interests in the public policy domain. When you think about it, you could see that Brazil had been in trouble for a very long time, since the end of 1997 or mid-97, but then Brazil was not able to take the decision that were required to prevent the crisis from happening. Essentially it is because of these conflicts of interests, the political system was unable to deliver the appropriate policies. The trade-offs and the conflicts of interests are many. I know that the answer to saying there are trade-offs and conflicts of interests is: so what? what are the implications? That is the major point. What I would like to emphasize is that designing policies and institutions to and taking into account these failures in governments and political failures has to be part of the design of the policies and reforms itself. We cannot say that we know what is the best policy, and what is the best institutions for a country. If you don't take into account the inherent limitations of the political process in designing the policies and institutions, you may run into trouble. This is the link, I would say, with the international financial architecture. Designing the international financial architecture as if political institutions inside the countries are perfect and are going to deliver as we think they should deliver is not going to be enough. In fact, in my assessment, the international financial architecture should be thought of and designed as an institutional mechanism to give incentives for better performance of the domestic political institutions. And when we talk about transparency, about reforming the financial system, etc., the real way is to induce the domestic political institutions to better manage the trade-offs and conflicts of interests.

That is what it is by the end of the day. Let me illustrate this very quickly by a couple of examples. I think that the increased risks of financial crises are due to the interaction of many factors. We cannot say there is one factor of financial crisis. When we go back to look at any one of the crises, especially the recent ones, it is really coming from the interaction of many factors, from the interaction between the macro management and the domestic financial system, the regulation and supervision of the domestic system, capital flows, capital account liberalization, and so on. So, the fact that there are these interactions makes the trade-offs and the conflicts even more intricate and more complex for the policy makers and the political system to deal with. The discussion about the capital account liberalization is not simple because it is not the capital account liberalization itself, or capital flows themselves, which are the cause of any crisis. I don't think anybody can argue that capital flows themselves, or capital account liberalization itself, is the cause of a crisis. It is really how capital account liberalization and capital flows interact with macroeconomic management, interact with domestic financial systems to make the situation unsustainable and then create a crisis. So, the presence of these interactions is really crucial. And when they are there, and for some policy makers, they are new, they have not been dealt with before, it makes the trade-offs and the management much more difficult.

Let me take one example or two on the macro policies. The trade-offs in macro policies are known. You can take any of the issues, exchange rate regime, fiscal policy or monetary policy, and they are all trade-offs. Choose any policy, you will find out it is a trade-off. Exchange rate regimes: if you choose a fixed-exchange rate regime, we know the benefits. You will have a nominal anchor, you will reduce volatility of the nominal exchange rate, which is supposed to be good for predictability of the exchange rate for trade. So, we know its benefits, but we also know that there are costs and risks: expansion of domestic money supply if your reserves increase very quickly with surges of capital inflows, cost of reserve accumulation that you have to bear, you might create domestic booms, which might weaken the domestic financial system, you might lose competitiveness if your real exchange rate appreciates, you'll have reduced perception of risk on the exchange rate, and then excessive borrowing, and so on. So you have to deal with these trade-offs, and then decide what is most important. And each one of these trade-offs has behind it some conflict of interests with groups of people: exporters versus domestic producers, rural versus urban... All these interest groups are behind those effects which are really competing for the favors of the policy makers to choose the policy that they prefer. I just want to show you this graph which shows the frequency of financial crises under different exchange rate regimes during the period 75-81, or 82-99. It is just a simple ratio of the number of financial crises divided by the number of countries which had such an exchange rate regime. Then what you might see is that there is no regime that is really superior to the other. What it means is that crises happen as often under a fixed-exchange rate regime as under a flexible exchange rate regime. So, there is no one regime that is going to solve the problem for you, because it is not the exchange rate regime itself that is the problem. It is really how you manage the conflicts and the trade-offs behind this regime. So, there is no one exchange rate regime that is generally superior, even though we think that flexible exchange rate regimes, as was discussed a little bit earlier, have less chance, other things being equal, to produce crises. I can go on and discuss the trade-offs for fiscal policy, for monetary policy. The important thing is that all the decision making has to deal with these trade-offs, and these trade-offs have behind them major political interests, and that what makes the political system really unable to deal with them very often, and why inconsistency prevails for a long time, which produces crisis.

Let me illustrate this with another example and then I will stop. Domestic financial liberalization. We know that it is desirable. And we know that it has significant long-term benefits. Some work at the World Bank shows that going from financial repression system from financial liberalization can give you as much as 1% of growth gained in terms of GDP growth in the long run. So, these are major benefits. Yet, on the other hand, we know that domestic financial system has often led to crisis just after the liberalization. This is some work at the World Bank which shows the increase in the probability of a crisis after financial liberalization, this interest rate liberalization. And the fact that this probability goes up, and in many of these cases there were actually crises after the interest rate liberalization, and the threshold point is this green line 5%. What this means is that when you liberalize interest rates, or you liberalize the domestic financial system, there are many things that start going on which make the domestic financial system vulnerable, whether it is excessive competition, higher interest rates or more risktaking by the banks, more borrowing abroad and more exposure... The fact of the matter is that often financial liberalization has led to financial crises.

So, how do you deal with these trade-offs? We know that you need adequate regulations, that you need good supervision on the domestic financial system, but the problem is that domestic regulations and good supervision take time to develop. You can't just create them right away. They take time. And in addition to that, regulation itself has implicitly its own trade-offs and conflicts of interests. Some groups don't like it, some powerful groups may not like it because it constraints their ability to use the domestic financial system for their own interest. If you have a strong and large public sector, large state-owned enterprise sector, for instance, any regulation to limit the exposure of the banks to some sectors or some groups you will have to confront their limitation and the way you can use domestic financial systems to finance public enterprises. And the government has to deal with that. And so on. The point is not to say that you should not liberalize. Liberalization is beneficial and we have to do it. But the crucial issue of how to do it in terms of process, in terms of timing, where do you start, when do you have the regulation and supervision, how do you develop it, when do you think it is enough to allow you to liberalize? And this is much more complicated if you add the capital account liberalization issue. That is where the international financial architecture comes in because I think it is all about creating incentives for domestic political systems to deliver the good policies and institutions that we think are needed and required to prevent financial crises.

Ed Altman: Thank you very much, Mustapha. Our final panelist this morning in the first session is Clifford Dammers. You can see in his biography that Cliff Dammers is the Secretary General of the International Primary Markets Association. This Association represents 80 primary markets underwriters and international banks. I have always been intrigued by the title Secretary General. It sounds that it is either someone who does all the work or someone who directs all the work, or maybe both. Maybe, Cliff, you are going to tell me exactly what you do for that organization and, indeed, how that organization relates to this question of preventing financial crises.

Clifford Dammers, Secretary General, International Primary Markets Association

Clifford Dammers: When I got off the plane last night at 10 pm, it felt like I was doing all the work myself. We are based in London, although our members come from all over the world. We are a trade association, we are not a regulatory organization. We are a trade association that represents the interests of our members who are the underwriters, managers of international debt equity issues. We are obviously concerned to protect the interest of our members, but in the long run, the best interests of our members is to have a flourishing capital market which provides good investment opportunities for investors and attractive financing for issuers. Obviously, one of the things that we have seen in the last ten years has been a rise of emerging markets issuers in the capital markets, as opposed to the credit markets. Most of our members are also lenders or were until they got out of the lending business. But my focus, my association's focus is on the capital markets side.

I agree with most of what the previous three speakers said, and I am very honored and pleased to be here, especially to be the first spokesman for the private sector. I was struck how some things don't change. The first instance we have of restructuring sovereign debt was the Greek City States had a default and a restructuring of some of the states in the 4th or 5th century BC. So, there are some things that never change. And all down through the Middle Ages, the 19th century with Latin American debt crises, down through as recently as the Brazilian crisis, we keep seeing this. Today, we have a big change in that most of the money on the private sector side is coming from the bond market, most of the new money from the bond market and to a lesser extent, the equity market. But this is not all that new. In the 19th century, all of the foreign investment that came in, whether it was to the United States which was an emerging market or to Latin America, or later in the century into Turkey and Russia, that was in the form of bonds, bonds arranged by merchant banks in France and Germany and London. It was not in the form of loans. Banks did not get into the business of lending their own money to emerging markets in the big way until they were overwhelmed with the flood of petrodollars in the 1970's. One of the major reasons that the banks are so active in emerging markets is that plain old lending is not very attractive any more. When you are lending to general Motors at 10 basis points over libor, or below prime, nobody is going to get rich. Banks are looking for other ways of making money and this drives them to go further out along the credit risk.

But some things have changed. I was very struck listening to the previous speaker about some of those things. In 1973-74, I was practicing law and I was part of a team that was advising an Indonesian oil company. AT that time, the amount of borrowing by the oil company, a state-owned oil company, by the Indonesian government, or by other agencies guaranteed, was a state secret. Every bank had its own list of what it thought was the outstanding borrowing. None of those lists, we learnt afterwards, was accurate. The numbers were much, much bigger. And if a bank had ever publicly disclose how much it thought the country had borrowed, it would have been immediately struck off the list of relationship banks. In 1980-81, I acted for the Sudan in the first round of its restructuring. We were told by the Paris Club that the London Club negotiations could not result in terms more favorable for Sudan than had been agreed six months earlier by the Paris Club. But the IMF, the

World Bank and the government would not tell us what those terms were. And we come a long way since then. But I think we still have more to go, particularly in terms of transparency.

I want to talk about some very concrete proposals that have been made for the changing terms documentation for bond markets. I do this partly because it is of enormous concern for my members, and I think important for the access emerging market borrowers, both sovereign and private sector, want to have. I also do it because while we all know what the problems are, I for one don't have very many ideas about how we want to get from where we are today to where we want to be trying to moderate or prevent international economic crises. I am going to speak frankly about some subjects that aren't usually discussed in public, and I do that on my own account. What I am saying, except with regard to qualified majority clauses, are my own views and not the views of my Board of Directors or my market practices and legal committees.

Some of our problems are that private capital today is providing, at least until the Asian crisis, much more money to emerging market countries than the official agencies or the bilateral aid. And whatever solutions we come up with should structured so as not to dry up that flow of capital. As I mentioned, bonds have replaced bank debt. The lessons that we learned form the 1980's in the bank credit market are not all appropriate for what we have today. A large part of what we were doing in the 1980's, part of the reasons why it took so long to work out the problem, is that the problem was perceived, rightly or wrongly, as how to save the major money center banks, and not how to improve the financial system or protect the borrowers. We could not have seen American and European banks', but particularly American banks, who had lent more than their entire capital to one country, seen those bank loans be written off a hundred percent because it would have brought down the banks, and the financial system would be at risk. So, much of what we were doing was trying to find ways to disguise the problem and come up with solutions to allow the banks and the countries to work their way out of the problem, not too dissimilar from what is going in Japan right now in a purely domestic area.

Domestic bond and money markets have risen in these countries and are terribly important. This is new. in 1973, there was no domestic money market in Indonesia and interest rates were extortionist. If you were a small business and you wanted to borrow, you were borrowing at incredibly high real interest rates. So, it has been a good thing to create competitive deregulated domestic money markets, but it exposes us to the possibility of enormous short-term flows. I think, and I am sure not all of my members agree with me, that we have to do something about controlling short-term capital flows. I hesitate to use the word capital as much as this money speculative and slashes about like water in a bathtub, and it causes enormous problems including problems of contagion. I am very much opposed to long-term capital flows because of the risk of discouraging this vast flood of private sector investment. Prior to the Asian crisis, a year and a half ago, we saw an enormous amount of money going into the Asia, high local savings rates, but it wasn't being very well invested. We know a lot of the reasons: crony capitalism, banks that were being directed by governments as to where they should lend, and just some very silly mistakes, everybody wanted to have a national automobile company, everybody anted to have microchip factories even though there is a worldwide blot in microchips, etc. And one of the problems, speaking frankly, is wide scale corruption. Corruption that is ignored or colluded in by the private sector lenders and investors, and corruption which, until recently, has been tolerated by the international and supranational lending and development agencies. Efforts are being made to address that but it is a fundamental problem that is not going to go away, and it takes a long time. I don't know what to do about it. We don't want to increase the moral hazard that comes from a lender of last resort, whether it is formalized as is sometimes proposed for the IMF, or whether it is assumed by the private sector. recently, many of the investors of the private sector were highly leveraged. We all know about hedge funds and their exposure in Russia and elsewhere. But many of the investment banks, the most reputable investment banks, are just as highly leveraged, and in some ways, are nearly hedge funds with a stock market listing. There has been enormous deleveraging and a flight to liquid investments and a flight to quality. Whether that deleveraging will be a permanent change, or whether as the markets slow down and volatility decreases, investors will be prepare to releverage themselves and will go to another cycle again is very hard to tell.

The G-10 issued a report on the "Resolution of Sovereign Liquidity Crises" in May 1996 after the Mexican crisis. It made numerous proposals. The specific ones that I want to talk about address the question of the bond market. The Report clearly identified the fact that bond markets are now replacing bank credit markets, but that bond markets in the past, in the 1980's, had not shared in the pain that the banks had suffered, and obviously, had not been required to put up additional money. Ideas were flooded to insure, or make it easier, that next time the bond markets would be in the same position as the banks had been in the 1980's. In the 1980's, I think the bond markets were pretty much ignored although Costa Rica did default on its Swiss Franc Bonds, and there was some litigation over that. Bond markets were spared because the numbers were not large enough to justify the hassle that Mexico or Brazil or Argentina would have had to go through if they were trying to restructure bonds. Mexico had almost 100 billion dollars in debt, 5 billion of that was bonds. It was more important to focus on the 95 billion and all the problems they had negotiating with the bank Steering Committee than it was to worry about 5 billion dollars. Today, the ratios are almost reversed and there would be enormous pressure on bond holders next time around, and of course, we saw that in Russia. We have had some bond defaults in South-East Asia, and we will see increased litigation.

The G-10 Report proposed three changes. One that there should be provisions for collective representation. There should be some way that the bondholders could be represented so that there would be someone the issuers could negotiate or restructure with. One of the suggestions is that bondholders should be represented by a trustee who would have authority to speak forward and represent the bondholders. Secondly, it was proposed that new bond issues should provide for qualified majority voting clause so that if issuers faced a liquidity crisis, and I emphasize that the G-10 proposal was in the context of the Mexican liquidity crisis, it wasn't thought to be a problem that issuers just could not pay but merely would be under a temporary liquidity crisis, so a standstill and affirmative interest restructuring of maturities were the proposals that people were talking about. And in many bond issues of course that is practically impossible. It requires a consent, under German law for instance, of every single bondholder, very high majorities in the United States. You cant change the payment terms without the consent of the individual bondholder. And thirdly, it was suggested that the sharing clauses that we see in bank syndicated credit agreements be included in bond issues, so the sharing clause says that if any one bank in the syndicate recovers more than its pro rata share, it has to share that with the other members of the syndicate. This is to insure that all the banks are treated equally and that the issuer, the borrower does not prefer one bank over another. the Report also calls on debtors to provide information, to engage in early dialog with the bondholders and to make timely adjustments in macroeconomic policies to avoid getting into the sever difficulties in the first place. The Institute for International Finance picked up on this and its report on the Mexican crisis in August of 1996 "Resolving Sovereign Financial Crises" endorsed all three recommendations, but emphasized the importance that this be done on a voluntary basis for new bond issues, and not be forced on borrowers. The G-22 Report that was published in October also repeated these recommendations and continued to say that this should be done on a voluntary basis and be market-driven. The Institute for International Finance is planning to publish today its Report on "Financial Crises in Emerging Markets" and it repeats its endorsement of this approach.

I would like to say a few words about each of these provisions. I think that the idea of collective representation is a good one. There is a fundamental problem in dealing with bondholders of how you get a hold on them. Let me just say right now that bondholders are not all Long-Term Capital Management. Bondholders may be your pension fund, may be the University. It may be individuals. A lot of the Russian bonds, Russia has 16 billion dollars, eurobonds are outstanding. A lot of the Deutsche market nominated bonds were placed through retail investors in Germany. And when we talk about writing down bonds and rescheduling, reducing interest rates, pushing up the maturity rates, we are talking about individual people bearing a great deal of pain. A trustee is a great improvement upon having a fiscal agent or a paying agent, but it is not a panacea for all the issues. I have talked to the banks who are active in being trustees for those issues that have trustees, and they are not prepare to take on the enormous risks involved in trying to represent bondholders. The trustee can perhaps facilitate negotiations and act as a channel for communications, but at the end of the day, the bondholders are going to have to make a decision. No trustee is going to agree on reducing interest rates, extending maturities or moratoria without the active consent of the bondholders it represents. IPMA supports the use of trustees. There is a fundamental problem, however, and that is that sovereign borrowers traditionally have not appointed trustees. There is even a specific exemption in the United States Law to allow sovereign issuers to issue without a trustee, and they all, to my knowledge, take an advantage of it. So, it would be a major prestige question to try to convince emerging market borrowers' public sector to use trustees.

I think the sharing clause idea is just plain misguided and foolish. Banks can share because they used to in the old days before banks credits were traded and credit risks was divided up, you knew who your other banks were. Bondholders are just not in the same position. In fact, it is all a bit hypocritical, because we all know that those sharing clauses were honored in the breach, and emerging markets borrowers in the 80's and the early 90's favored some banks over others, banks who, a couple years earlier, signed a sharing clause promptly went out and acting as agents for the banks secretly bought up loans and then Brady bonds at deep discounts. The point of the sharing clause in the bond issue sector is to make it possible for a bondholder to sue because more modern sharing clauses say that if you recover any money by litigation, you have to share it, who is going to litigate if they don't get to keep the proceed? This is stated very clearly in an article that Lee Buchheit, Partner at Cleary, Gottlieb, Steen & Hamilton, wrote in last summer's issue of International Financial Law Review. He said it is clearly designed to discourage and probably make impossible effective litigation against issuers. It would make it more difficult to reach an agreement. In practice, we don't have much litigation. Bondholders have been curiously to my mind reluctant to sue, especially in Europe, and I don't think sharing clause helps very much, it is not very practical.

The most controversial of all the clauses proposed has been the qualified majority voting clause. Now, I speak as a Representative of IPMA and my members. I think the majority of my members would be prepared to see a qualified majority voting clause as a good thing if it were designed so that one or two rogue investors could not hold up a rational adjustment of outstanding debt. When talking about not a simple majority, but something considerably greater than that, some sort of super-majority. The numbers that have been thrown out frequently have been 2 thirds or 75% of bondholders. I think that something a little bit north of that, not too far north would probably be acceptable to the bond market. the big question is what would that do to the pricing of bonds. In the short-term, I think it would increase the price of all bond issuers who put in such a clause. It raises the question of whether a bond issuer which is unlikely to default should subsidize or should have to pay a cost that is really designed to protect those countries which are more likely to default. Believe me we know the countries that are likely to default, they are the same ones, in some cases, for centuries. I don't know how many basis points we are talking about, but obviously an increase after we had the first instance when the clause was actually used. The G-22, the IIF and the G-10 reports speculate about how much the clauses would cost. Some legal systems have such clauses in one form or another. Investors don't seem to charge a premium for that. A large part of it is because they haven't focused on it. If we had defaults and the clauses were used, in the short run at least, investors would focus on it and would charge a hefty premium. But one of the things that does not change is that if bankers are faced with a great deal of competition and a very short memory, perhaps in the long run, it would not be all that expensive. Thank you.

Ed Altman: Thank you. Thanks to the entire panel for keeping on the schedule. We have some time now for questions put to any of our panelists and for comments from our panelists to each other as well. Could we see if there are some questions from the audience? Sir,

Unknown: I have two questions, one for Mr. Hicklin, the other for Mr. Bernes. Mr. Hicklin correctly emphasized the importance of disclosure of information by the international community itself, including the IMF, and I fully agree. But the IMF has many missions to member countries, and the key purpose of these missions is to collect and get the important, but confidential information. If the IMF discloses this information, that will be very much appreciated by market participants for example, but at the same time, member countries might become more reluctant to provide data or information in the future. There is a dilemma. How do you address such a dilemma regarding disclosure? And secondly, Mr. Bernes mentioned that in the context of exchange rate regimes, pegged system is not necessarily appropriate in the medium term, and that currency boards are successful in some countries. Recently, Argentina was reported to study dollarization more seriously. How do you assess the concept of dollarization?

John Hicklin: If I could address the first question, clearly there are pros and cons to almost all of these proposals and you have exactly stated the trade-off here that many authorities would be reluctant to provide information to the Fund's missions if they thought this was immediately going to be passed on to the markets. So, there have to be some safeguards put into place. Let me say that this is a key feature of the debate which goes on in the Fund every time this proposal comes up. I would characterize in the following way: we are edging towards finding ways in which information can be made public but does not impeach on the concern of having frank discussions with the authorities. Let me give one example of how we do that, and one problem that would arise if you don't release information that you have, even if you can cause some embarrassment. As you know, we now have these public information notices, and there is a provision that if there is highly sensitive information which is discussed that there are ways in which some of that can be edited out from the one that goes to the public. There are mechanisms put in place to insure that the information that goes out should not cause undue problems. On the other hand, you don't want to be in the position that everything that comes out is so bland that you don't expressed the genuine discussions that are taking place. Therefore, the way this has happened so far is that the information has been voluntarily disclosed. the authorities have to agree to their publication. The same issue arises in the context of staff reports. They, for the most part, have not been published until now. they are Board's documents and the Board doesn't want them published for the reason you have stated. One could imagine ways of trying to move forward and that the voluntary nature of release by the country would allow those documents to come out, but that is still not agreed and it is not immediately obvious how you can proceed. The trade-off is clear. But let me put the other side. What happens if the Fund's staff or the Board is aware of problems in a national authority's policy framework or crucial data which it does not reveal to the markets, then there is some illusion that you are going along with policies over a period of time, and you are not sending a signal. There is a danger that way too. It is not easy to balance those different concerns, although I would say that we are moving in the direction of disclosing more.

Tom Bernes: Just to hang on to that first question that John responded to, there is a very fine line between being transparent and putting out misleading information, information which in itself might affect markets unduly. On the question of data, I think ultimately, it has to be the country that puts out the data. One of the difficulties the Fund faces is that while we are doing a lot of work with respect to standards for data requirements, a large part of the compliance was whether governments are putting that data out and not just go to the quality of the data per se. There is no agreement in many cases among practitioners in terms of, having said you put a number out, how you precisely measure that number, and secondly for the Fund to get into that game would require a tremendous amount of resources which I don't see the Board being prepared to make available in terms of increasing staff, and secondly, would move the Fund towards the direction of a rating agency, which at the end of the day I don't think it is where the Fund should be. On the question of transparency of the Fund's and the Board's view, clearly the Fund has been moving to become much more transparent, along with governments. The trick is to find a way to express views and not just come up with a bland formula or IMF speech which nobody really understands, and at the same time, destroying a policy dialog which you may have with a member government. It is a high wire act which we have been walking, and which, I guess, we will continue to walk.

On the second question, I don't think I want to respond directly because I am not sure there is a direct proposal, but I will just go back to what I said that while currency boards can work in particular circumstances, what they do is to essentially take the flexibility out of one of the major instruments of adjustment, and countries have to consider whether their trading patterns and economic relationships really create environments in which the cost of doing that can be minimized. I think we have seen that one of the difficulties with fixed exchange rate regimes is that it is very difficult to devise an exit strategy. We went through this debate in the Board with respect to Thailand which is a very good example. The Fund's staff and Board recognized that Thailand needed to move to a more flexible regime and, indeed, the Thai authorities accepted that overtime they needed to but the time was not quite right, they just had to solve some other problems before they did that. And that is in part always and very often the critical issue that in good times, the pressure is not there to move and people are reluctant to make some very tough decisions, and when you try it in a time of crisis, it is very difficult to do it in a manner which maintains stability in markets.

Unknown: Question to Mr. Dammers about voluntary the approach

Clifford Dammers: I think the voluntary approach is working. It is the market that does not want it and is turning it down. I don't think that the G-10 and the G-22 agree with me. They would say that it is not working. I know that there are people in central banks and governments do feel very strongly that these clauses would be helpful and would like to see them. I expect that they would be given a test because banks are very competitive and they are prepared to win a mandate by promising a borrower that they will try to bring an issue with such clause. The borrower thinks that it would be helpful. So far, we haven't seen very much of that. We have seen the use of trustees in some bond issues that were done in the last two years by sovereigns, including Brazil and Argentina, that had redenomination and consolidation clauses in preparation for the euro. It was felt by certainly JP Morgan who did those issues that they were enough uncertainties in the mechanics of consolidation and redenomination that you needed a trustee who would have power to make some decisions on behalf of the bondholders. And JP Morgan was right, there have been problems with bond issues that did not have trustees, and it may be that this example will encourage investors and issuers to use the trustee recommendation in the G-22 and G-10 reports. That is a very technical area where the trustee has the power to make the decision itself, as opposed to merely acting as a representative and as an information transmission mechanism. It was a development that we were glad to see. We are probably going to publish a recommendation, it is only a recommendation, that for sub-investment grade issuers that the lead manager attempt to convince the issuer to appoint a trustee. If we do that, it will be in the next couple of months. And we will see whether issuers are prepared to take the recommendation of the lead managers.

Ed Altman: Why do you just limit it to the sub-investment grade? I know that they have a higher likelihood of default, but...

Clifford Dammers: because there is no way I could get the Republic of Italy to agree to put a trustee, I mean not any more than the United States. The United States government issues bonds and does not have a trustee, has never had a trustee. But sub-investment grade is a polite way to say emerging markets, to be very frank about it. You say emerging markets and every emerging market country is going to object to it. When you say sub-investment grade, then it applies to private sector issuers.

Ed Altman: But you would not have had a trustee in Korea then, in this case.

Clifford Dammers: No. Korea, I remind you, has paid in its bond.

Ed Altman: Are there any other questions? Well, thank you very much, and we'll take a break and move to the second session. Thank you.

DISCUSSION The Response Of The Private Sector

Chair: Carlos Asilis, Managing Director, Vector Investment Advisors

Carlos Asilis: Let's get started. The title of this session is Preventing Financial Crises, the response of the Private Sector. As one of the speakers in the first session mentioned, the full-proof prevention of financial crises is clearly an impossibility. I think that is key to acknowledge, to recognize at the outset because I think the aim here of our discussion should be in terms of suggesting, from the angle of the private sector, the introduction of credible mechanisms to mitigate the size, the magnitude of financial crises, particularly in emerging markets, which of course is essential because large scale financial crises have two major implications. The first one is the contagion issue which brings in the realm of systemic risk. And secondly, the drying up of primary market activity which clearly has been a fact in 1998, and clearly also in 1999. So, having mentioned that, today we have three panelists: Liliana Rojas-Suarez who is the Chief Economist for Latin America at Deutsche Bank, Peter Geraghty who is the Managing Director at Darby Overseas Investments, and myself filling in for Arminio Fraga who is unable to join us this morning. He will join us this afternoon. So, Liliana Rojas-Suarez is, as I mentioned, the Chief Economist for Latin America at Deutsche Bank. Prior to joining Deutsche Bank, she spent over a decade working at IFIs, at the Inter-American Development Bank where she was a Principal Adviser in the office of the Chief Economist, and prior to that at the IMF where we were colleagues and she made major contributions in the Capital Markets Division. AT the time she left the IMF, she was Deputy Division Chief of the Capital Markets Group. Liliana,

Liliana Rojas-Suarez, Chief Economist for Latin America, Deutsche Bank

Liliana Rojas-Suarez: Thank you very much. I have been asked to talk about the response of the private sector to prevent financial crises. After ten years or a decade, as Carlos said, of experience at both the IMF and the IDB, what I learned is that the role of the private sector was to impose discipline on government behavior, that markets need to be promoted to prevent abuses from those with access to power, and most importantly, to prevent misallocation of resources that would cost dearly to society by creating inefficiencies and by deterring economic growth. Market development therefore, through its benefits in developing competition is worth enhancing. By containing inefficiencies, markets can actually be the driving force to prevent financial crises. I believed in this then, and I believe in this now. But then what has been going wrong? Why what we are observing now is the simultaneous development of markets and crises? It is as if we have more markets developing, we have more crises emerging. There has to be something wrong in that, but there is nothing wrong in the paradigm that I have just described. It is both in its interpretation and its implementation where things go wrong. I believe that the fundamental reason why things go wrong is that the concept of markets is ill-developed and that little markets could do more harm than no markets at all. And that speculative attacks arise when investors perceived that this approach to market development suffers from important imperfections. There are examples that I can give you of what I am talking about now. It is perhaps embedded in the concept of financial liberalization. I am not going to talk about supervision, I am just going to talk about markets.

What is the idea behind financial liberalization? The idea was, and still is in many countries, that promoting financial liberalization basically promotes more competition by letting more institutions operate. True, but most people who have actually been promoting financial liberalization forget that the true definition of market competition implies not only free entry, it also implies free exit. Competition is entry and exit. Well, we have not observed, in most emerging markets especially, that both entry and exit policies were implemented at the same time. more institutions were allowed to perform and to work within the system, but there was no political will or no sufficient capacity to let those institutions fail and leave the market. What happens in a situation where you have more institutions that come in and a kind of implicit guarantee that the bulk will not go out? The natural thing to follow is market competition, but not competition that will improve efficiency, it is competition for market share. And we all know what happens after that. Bad allocation of credit, etc. I don't want to get into that. The point that I want to make is that, if I am on the government and I am dealing with the multilaterals and I am saying that I am liberalizing my markets, I can actually give, with the support of the multilateral organizations, the idea of more market competition and I am not. This is just one example, but actually, I could give you a large number of examples. Let me just go through three more.

Something else that markets do is when they don't like transactions in any particular currency, they move out of it. That is what markets do. In many countries, the markets' push has been for dollarization. Only a few countries and a few governments allow dollarization to take place, but the markets want the economy to dollarize. Perhaps one of the best example is Mexico. After the 82 crisis, if the government had not prevented, basically prohibited, dollarization, Mexico would be a dollarized economy right now. But market force would not allow it to work. Another example is the reform of the pension systems. We know how bad pay-as-you-go systems are. So, I can easily sell you an idea, I am a government discussing my project with a multilateral, and tell you that I am going to move from a pay-as-you-go system to a private pension fund, a market-oriented move. The truth, however, is that the reason why I, the government, am developing these new forms of systems is because I need somebody to buy my debt. And to be sure that is actually what is going to happen, I put a lot of constraints in the investments that the pension funds can make. With the excuse that I want to develop the domestic capital market, I don't allow you to invest in foreign securities. You don't develop the domestic capital market by prohibiting competition. What you do is you create a forced source of purchase for your own securities. And the number of examples when this has happened is very large. It includes Brazil of course. Another example in a totally different area: decentralization. Once again, decentralization from a central government to the state level or municipal level is a good idea too. It seems as if it is a movement towards limiting the power of the central government. That is the idea. But without appropriate market mechanisms to control government expenditure at the province or state levels, it doesn't work. An appropriate market mechanism of course can only be measured if there is some kind of instrument that reflects what the risk of that particular state is taking. That is not what has been happening in most emerging markets. Decentralization takes place again on one side of the two parts of the scissors in competition. If you develop only one of them without developing the other, that is a call for a crisis, not a call for improved efficiency.

So, from my point of view, market forces can prevent financial crises but selling the idea of a market, when one really is not there, actually exacerbates crises. Do we have examples where markets have actually contained crises, or at least, helped to minimize it? Yes. For emerging markets, perhaps the best market discipline instrument there is is the Brady bond market. The reason for that is that, regardless of the actions that are taken domestically, if there is a perception of increased country risk by foreigners, those countries that have Brady bonds at the present moment will experience a decline in the Brady bond, that of course translates into an increase in the implicit yield paid by those bonds. Because of insufficient development of arbitrage between on-sight and off-sight markets, what happens is that there is no way that any government can afford to see the price of the Brady bonds come down without adjusting further up their domestic interest rates. If they don't do it, they will experience capital outflows. It is almost a rule. It has been observed in any country. If you do not adjust the on-shore, off-shore rates, you close the arbitrage and you have capital outflows. That is called market discipline. I can choose to fight against it, of course. But I will not succeed. Market discipline actually allowed Mexico to make a very smart decision. Mexico cannot have fixed exchange rates. It would be an illusion to think that Mexico can have fixed exchange rates. Why am I so sure about that? Mexico has learned this from very tough experience. The reason is that Mexico still has a very weak banking system. We all know very well what the implications are on the banking system when the interest rates have to increase. Well, over and over again, Mexico has experienced shocks, domestic or external it doesn't matter, that has led to defend a fixed exchange rate system by increasing the interest rates. With a weak banking system, large increases in interest rates give the final stock of death to the banking system. So, as long as you have, this is the most important rule, when people have all these discussions about the different exchange rate regimes, they forget one basic rule: you cannot have fixed exchange rate systems with weak banking systems. That is just out of the question. The inconsistency is so evident, so obvious that markets will perceive it very promptly and, of course, will know that if you have to choose between giving up your exchange rate system or your banking system, you always choose to give up your exchange rate system because, obviously, giving up the banking system is too costly for the government. In the end of course, governments take the decision too late, so in the end, you have both an exchange rate crisis and a banking crisis, but the fight to prevent it is always to let the exchange rate system go first. that is why many people think that currency crises cause banking crises when that is not really true. What happens, most of the time and in a large number of experiences that we have studied all over the place, including at the IMF, the IDB, in the Universities, is that actually the problems were there before, and the only thing that happens is that the pressure on the exchange rates exposes those fragilities. But the crisis was there. So, in the international financial system, it is kind of an illusion to think that what we need is a revolution of the whole existent system, that what we basically have to do now is to reconstruct the apparatus because it has not been working.

The message I want to deliver to you today is that first the system was not working because there is no way that you can have a little bit of a market domestically and a big sound market working in the global economy of the industrial countries. You either go all the way trying to converse towards a much more market-oriented, in the real meaning of the word, approach or you just don't play the game. But you just cannot blame it on the international arrangement of things. What about the multilateral organizations? Is there something else that can be done? Obviously, yes. Of course, there is something else that can be done, and there will always be something else that can be done. If there is any truth in what I have just told you before, something that needs to be absolutely recognized by the multilateral organizations, and especially by the IMF, is that macroeconomics and finance these days cannot be treated as different elements. It is the same thing. In emerging markets, everything is short-term. What is the most liquid market in emerging markets? It is the exchange rate markets. The counter-part of it is the money market. There is no long-term bonds, there is no long-term paper. The stock markets are totally under-developed. Financial markets and exchange rate markets just go hand by hand together. If you just try to understand the problems of a country just looking at macro variables, such as what is happening in fiscal policy, you are going to miss part of the picture because in almost all emerging markets, when the fiscal is properly measured, the banking system is a contingent liability of the government. Have you seen any crisis in the emerging market world where at the end the resolution of the banking crisis does not go back to the government? So, basically, a proper accounting of the fiscal situation would take into account the probability of problems in the banking system. Basically, it sounds simple, it sounds straight-forward, but it is actually very difficult to implement because a crisis, especially in the financial system, do not manifest itself very easily. Let me just give you one example that we are observing right now. Is the Brazilian banking system safe? If you look at the accounts, at the numbers right now, the end of the year report shows an enormous amount of profits. So, you might think that the banking system in Brazil is very safe, but think twice. What is the banking system in Brazil formed of? If you look at the asset side, 50% is loans, and the other 50% is government paper. Think about, and I don't need numbers, I only need logic for this, the loan component, the portfolio part of the Brazilian banking system, have you seen any country in the world, and I mean any country in the world including Japan, the US and of course the Norway countries, where high interest rates in a recession don't hurt the loan portfolio of the banking system? I haven't. That is the 50%. Now think about the other 50%, is it really possible for Brazil to have long-term debt? I don't think so because imagine for a second that the banks were not holding short-term debt, but long-term debt, as you know, increases in interest rates reduce the value of the debt, then the banks would have to be reporting capital losses. The reason why banks report capital gains is that the debt is very short-term. So, with 50% of the asset being government paper, you have to think that if what they hold is the riskier paper in the country, the banks are at risk. Thank you.

Carlos Asilis: Thank you Liliana. Now, we move over to Peter Geraghty. He is a Managing Director at Darby Overseas Investments. Prior to joining Darby, Peter was at the ING Group where he served in London as a member of the Executive Committee, and equally interesting was his experience in the mid-80's where he worked for the NMB Bank which played a leading role in developing debt for debt and debt for equity transactions that helped to recapitalize Latin American debt.

Peter Geraghty, Managing Director, Darby Overseas Investment

Peter Geraghty: Thank you. I have watched the emerging markets develop over the years from a very thinly traded loan market in the 80's into a full fledge securities market in the 90's, and most of the developments in between. Those included any number of hiccup as we all know, but I think that during that time, we were able to create an increased atmosphere of transparency in these markets. A lot of that has come from an increase in fiscal responsibility, certainly on the behalf of many of the countries whose instruments we have traded. And I think also, from an industry perspective, years ago a number of us set up the Emerging Markets Traders Association. We moved to screentrading. We created standard documentation and we created a lot of the basics that you need to get a full-fledged capital market up and running. On the other hand, we have seen our market blow up now twice in the last four years: the Tequila crisis in the end of 1994 and now sort of the continuing on slump we have seen ever since the Thai Baht devalued in the late spring of 1997.

What I would like to talk about today is really what I know, which is the specifics of the bond trading markets and how perhaps some changes or a continuing evolution in those markets might in fact help to dampen systemic risk to some extent. I think the most important thing that strikes me in the last couple of years, having been in a big Wall Street type of firms, is that there is a convergence among non-investment grade credit asset classes, in other words, the mortgage markets and non-investment grade mortgage markets, but particularly the US and European high yield market, and the emerging markets. Prior to the most recent crisis which began two years ago, I think we were starting to see some convergence, particularly between high yield and emerging markets. In that, whenever the country overlay, from a macro perspective, is less important, there is clearly much more focus on what is happening in the corporate sector and we are better able to compare a paper company in Indonesia with a paper company in Chile with a paper company in the United States. As we know from the most recent crisis, when the country overlay becomes as important as it has been, i.e. you have a default in Russia or you now see the currency devaluation in Brazil, no company to my knowledge can really overcome the difficulties when a country runs into a serious credit problem. That has really been one of the reasons that the whole convergence argument, while I still believe in it today, has really had an inability to take hold. It is reflected very simply in the prices that we pay for these fixed income securities. If you go back to 1994, and you look at the MB, the JP Morgan Emerging Markets Bond Index for the year, and you look at the Merrill Lynch high yield bond index, you'll find that Merrill Lynch, I think, for that year was down about 1.5%, and I think the Emerging Markets Bond Index, because we had the devaluation in Mexico on the 22nd December, so it had a really rocky finish, was down about 22% on the year. If you look at the MB in 1998 through November, as well as the Merrill Lynch High Yield Bond Index, you'll find that Merrill Lynch finished up about 1.5 for the year, and the MB was down about 14% at that point of time. So, what we see is that in a good year, in 92, 93, or in 96, or even part of 97, you find that both of them outperformed for example, to a large extent, a benchmark like the L. * Brothers government bond index, which was in a good year up 6%, 7% and some of these indexes, the high yield or the MB, depending on where we were in interest rates, were up anywhere between 15 and 30%. And what it said to me when I was looking at these numbers was simply that you get a credit market in the US that catches a cold, and we have pneumonia throughout the emerging markets, and as a result we are unable, or have yet been unable, to attract investors who will stick with these markets in good times and bad times.

There are some individual glitches** in these markets that have to some extent favored the on-shore domestic markets. The first is the credit markets in this country, the non-investment credit markets, have generally been built upon a US style book building exercise. As a result, the lessons that we learned in the early 90's where we had a lot of defaults, where the Altman** index was out 10% the ** rate in 1990, we found that we came out of that period and the marketplace really made sure that the investors were taking paper for a longer period of time, there was a big growth in the prime fund business, and the pension funds, and the insurance companies in this country really embraced that asset class. As a result, in 94, it was only down 1.5%, a bad year for fixed income in the middle of an interest rate cycle change. In 1998, in the midst of the Russian debacle, it actually finished up positive for the year, while MB was down 14.5% and 22% in those periods respectively. So, I think that discipline that developed there is something that we need to see happen in the emerging markets, bond markets, and to some extent, I think it is also true for the equity markets. Now, I thought that perhaps we would see this start to happen somewhat earlier in the decade. I particularly thought that after the Tequila crisis where we had a not dissimilar situation to what we have seen this past year with Brazil, might in fact have taught us a lesson, i.e. momentum investors, particularly the hedge funds, would not be as important a factor in the market and more of the paper that was brought to the market by intermediaries would be well placed into the insurance companies, into the pension funds, into the long-term holders. What we found is, of course, that this did not happen. People levered up the dollar paper. They then went out and discovered over the last three or four years that they could lever up the local markets paper. We found that there was not, in terms of looking at counter-party risk within the big financial institutions, a great deal of discipline, so they were willing to go out. You know, it is one thing to give a 95% haircuts on US Treasuries. I think it is another thing to give 90% haircuts on Geckos on the Treasury bills in Russia. Well, in fact, all of that happened. And when it did blow up, we found that, as you had to take the leverage out of the system, we ended up with huge negative returns, and then the spillover from the emerging markets started to affect all other credit markets, like high yield and the mortgage markets.

I am not saying today that we can look forward to emerging markets where I think the MB index is 1400 basis points over Treasuries today, and assume that we are going to place that paper much deeper than it has been placed in the past, but I do think that we would have been better off had we had a market or a book building type of exercise in this market where we placed it much better. And I hope that the lesson that we learned from that this time is that when the capital markets come back in six months or a year or 18 months, whenever the net rates at which the borrow are sufficiently attractive for them to come back to the market and acceptable from a credit standpoint, that we start to look at placing that paper much more in terms of the industries for those companies, as well as taking a real fundamental look at the country credit. I think that it is somewhat unlikely that we will ever have the same kind of discipline in the emerging markets simply because we have that country overlay, that macro overlay that is always there and, as a result, with markets like the Brady bond market which are $140 billion of assets to trade almost as a quasi-treasury in emerging markets, it is very unlikely that the liquidity from those markets will ever go away to where... well, the example I would give is that we traded in 1985 5 billion dollars of loans, by the first time in 1992 when we took the first EMTA poll of trading volume, it was $775 billion. So during that period, exponential growth. I think it is unlikely we would ever roll back the clock, or would necessarily want to roll back the clock, to go back to a time where we had much more of a book building structured transaction type of environment for this market. The Bradys have been trading on the screens for a long time, they are financed in the repo markets the same way US Treasuries or investment grade corporate bonds today are. But I think that they trade and the market provides a liquidity that forces to market regimen that has really proved unsustainable during times of crisis. As a result, we probably over the last five or six years of developing these capital markets, haven't done ourselves a lot of favors in that regard.

To summarize, I personally feel that the best thing that comes out of this process, as I watched these markets develop, is that with each successive crisis, because of the transparency that is coming to these markets overtime, we can look at the outflows on a daily basis. I sit in front of my Bloomberg screen and I literally get the Brazilian outflow on an hourly basis as the day progresses. As a result, I think that these crises come and we move through them much more quickly. I think Brazil's problems today, as severe as they are, are unlikely to lead another lost decade as was described for Latin America in the 80's. I think it is much more likely that we see a situation perhaps that is more akin with its own obvious characteristics. In Thailand, where about this time two years ago, we started to see troubles in Thailand which led to the June/July foreign exchange debacle which now 18 months later perhaps we are only halfway through the tunnel, but we are starting to begin to see light at the end of the tunnel. I think that the Korean situation over the past two years is similar in that I can remember in the fall of 1997, they said they were not going to let the IMF plane land and they had a deal sixty days later. We now saw yesterday S&P followed Duph & Phelps, and in fact, one of our few emerging OECD investment grade countries within 16 months has gone through a good piece of the cycle, still a lot of work to do in the banking system, but is already back to investment grade as of yesterday. And I think that those lessons that we have learned ever since the 1982 initial debt crisis have meant that we can accelerate the process of reform. A lot of the political reform, particularly in Latin America, was done in the 80's, and I think that was a lot of the heavy lifting, some of that is being done today in Asia. I think that the economic reform, the fiscal discipline that needs to be there to help us develop these markets better will be happening quickly. And at the end of the day, the markets themselves, the bond markets, are just a reflection of the sentiment. We have let them get a little bit ahead of themselves in terms of development, we have paid the price now several times in the 90's, and I would hope that, coming out of this, we are much more aware, as investors, and also as practitioners at least those of us who have come from the new issue side of the business, that we take hit this time and are actually much more disciplined about how we go forward in the marketplace. Thank you.

Carlos Asilis: Thanks Peter. I will conclude the discussion session and then we'll open the floor for questions and answers. As I mentioned earlier, I worked at the IMF a number of years in the Developing Country Studies Division of the Research Department predominantly. I did work in the Western Hemisphere Department over 12 years ago briefly, and prior to that at Georgetown University for a number of years. more recently, I have joined the private sector and I have been working in New York for about five years at Merrill Lynch, UBS, and CSFB, and recently joined a global macro investment firm with an emphasis on G-7 countries but we do have exposure in emerging markets. As I mentioned at the beginning of the session, I think the focus of this session should be what measures should various players, and I will outline what that set of players consist of, do or can do to mitigate the onset of very drastic financial crises that carry with them the prospect of contagion. As such, I have come up with a list of potentially implementable measures which I think is key, as Mr. Hicklin from the IMF mentioned in the first session, a set of measures that both the IFIs and private sector participants first on the lending side and intermediaries can do to improve the workings of the financial system. Thirdly, what measures borrowers, particularly sovereigns which is the main focus of this session, can do to again lower the risk of major disruptions in the financial system. And finally, the G-7.

So, I'll start off with the IFIs and, within the IFIs, I think that the IMF and the BIS play a prominent role. What can the IMF do to help prevent the onset of very major, very drastic crises? One is of course to help improve the ability of the industry in assessing country-risk, and the prospects of a currency crisis, a banking crisis, which more often than not is a joint prophecy as Liliana mentioned. On that issue, let's look at the record briefly. I think the record speaks very highly for the IMF. If you look at the various special reports that the IMF produced over the last five to seven years, it is not very easy to read between the lines, but you can see very clearly that the IMF raised very important criticisms or concerns rather with Thailand, with Korea, with Brazil and with Russia. Moreover, at the IMF Research Department, a set of predictor models of currency risk and banking sector crises have been developed. I can cite the work by Carmen Reinhart, by Garcia Kaminsky, and others. Evidently as one of the speakers in the first session mentioned, Mustapha Nabli to be specific, it is impossible to think or expect that you can come up with a model that would predict with probability one the onset of a crisis at a specific point in time. that is clearly true. That is why I think that our task should be how to improve the ability of mitigating the onset of major very drastic crises. I think the IMF, in short, the staff particularly, has produced high value added work that, if conveyed, and this is where I would underscore my remarks, properly at the time to the international market participants, may have, you can argue, accelerated the onset of some of these crises, but presumably from a less dangerous set of initial conditions, i.e. domestic credit to GDP ratios in some of those Asian crises at much lower levels than they were in 97. Clearly, this is an issue that we can talk at length. And I am sure there are various opinions on how to proceed from an implementation standpoint, but I what I want to underscore, I think the first message of my comments is that the technology for trying to predict, for trying to identify situations of stress in the international financial system exists and works, at least to my liking. So, what does this mean? This means that what we need to do, I think the emphasis should be in how to take that product and bring it to the international marketplace. This, of course, is an issue where Mr. Hicklin stressed very emphatically, and I think he was absolutely right in doing so, the emphasis should lie: how to come up with incentive compatible mechanisms if you will that are able to further the disclosure of these findings to the international market participants. How to do it? I don't want to spend too much time on it, but I think this needs to be done, and this should be a very high priority project for the IMF, and I am encouraged to hear that this indeed is being discussed at the IMF. The second point has to do with the BIS, which is related to the second section of my discussion so to speak. The BIS should play a very important role and they are actually addressing this issue as we speak. They recently put out a report on hedge funds and the extension of credit on the part of international financial intermediaries to hedge funds. This is very important. I think regulating the creditors is a central part of any preventive solution to problems and situations of distress in the international financial system. So, I think the BIS is moving in the right direction. Again I think this is a high priority area.

The second section has to do with the private sector. What measures can the private sector, and in particular the international financial intermediaries and the investors, take to help mitigate the risk of financial crises in emerging markets? I think that we can talk about several areas here. In some areas, there isn't much that the private sector can do without undue excessive regulation of the investor industry, and I will be very explicit on what I mean. But on other areas, I think there is much that can be done. In terms of the international financial intermediaries, here we can talk about credit risk models. The two most prominent credit risk models that have been developed in the industry are those by my former employer CSFB, Credit Suisse First Boston, Credit Risk Plus, and the JP Morgan riskmetrics model. I have studied some of these models in not too much detail, but in some detail, and clearly these models need to be revamped, particularly form the macro side. These models are highly statistical in nature. They do not embody basic macro account identities. Here there is a lot of work that can be done. And I think an area that the IMF can really make major contributions in should be to talk to the industry, particularly CSFB and JP Morgan who are the leaders in this area, MacKinsey has done some models in this respect as well, to try to help improve these models. Why this is important? This is very important because, as another speaker mentioned, Mr. Dammers, some of these large houses in the period leading to the crisis of October, and more recently Brazil, they were largely hedge funds with stock tickers, some of them, and we have come to see this. Just look at the action on the stock prices of some of these international financial institutions to see which ones were penalized the most by the market. So, I think that the issue of credit risk is very important, and that is the second recommendation that I would make. It is a very specific one. I do not know, and I would be interested to see if Mr. Hicklin or any other IMF executive has anything to add to this, if there have been any discussions with the private sector on this regard. So, that is on the issue of the credit risk. there is an issue of moral hazard in the private sector as well. You may have a very adept, very capable credit risk group at a very large international bank that may have someone who expressed caution at a particular point in time to extend credit to a particular emerging market country or to increase or diminish the credit lien to a particular credit, but yet, the senior managers in some places, in some houses, the incentives just were not there to be on the side of prudence. This was largely, in some cases, a result of a compensation structure in this industry. There was a lot of moral hazard in place. Now, what can I say the private sector has done in this regard? I am in Europe these days so I do not know as much of what is going on in the New York financial institutions, but what I hear is that some houses have been reviewing the nature, the way they compensate business units. So, that is another issue that I think is very important to address. I think it is being addressed but I don't know to what extent. In terms of investors, I think it is extremely important because it really deals with the issue of contagion. The issue of contagion, of course, is critical. Brazil is of course a central point now in the IMF, the G-7, the Germans, the Japanese, the Swiss, everyone is concerned about possible contagion to the rest of Latin America, and what can be done to prevent that in this time around and also in the future. I think that, from the external side, there is the issue that Liliana pointed out on the arbitrage on-shore/off-shore, which I think is very important, but there is also another dimension to the issue which has to do particularly on the equity market side of the business. If you look at the makeup of investments, of assets within the equity side of the business, most of the investors, most of the mutual funds are global in nature on the fixed income side, but regional in nature within the equity market side. This is very important because of the implications of the contagion dynamics. I won't elaborate too much on it. If we focus within the equity market side, with very few exceptions, the number of country specific funds is very very limited. I'll give you an example. If I am a portfolio manager of a Latin American fund that invests in, of course, Latin America by definition, and Brazil has a major currency deval and overnight I incur a 20-30% loss on my Brazil part of the portfolio, Mexico clearly will sell off in the near term, let's say 5%=2%, but you have better be right that I will sell some of my Mexico part of the portfolio. Why? For various reasons. One because it is a region-wide fund, it is not a country-wide fund, so I can do that. It is the issue of feasibility. Second, there is the issue of redemptions. There is the uncertainty as to what is going to happen to redemptions within my fund. That means I may have to raise cash levels. And how do you raise cash levels? You raise cash levels by selling assets, securities that have not fallen that much in price, that is why you sell Chile and Mexico. This is very micro in nature, but this is very important because now we move on to what can be done. I don't think that much can be done because this is a market determined structure of how funds are made. But I would just mention it and leave it at that.

In terms of the borrowers, this is the third section of the discussion, what can the borrowers do, and in particular sovereign borrowers? Liliana, and peter, and participants in the first session have gone at length on this issue, so I won't spend much time on it. But clearly, you need to have credibility, that is the key. You need to have sustainable foreign exchange regimes, which of course need to be viewed in conjunction with the fiscal makeup of an economy, the two are very much connected, just look at the national income accounts. And the second issue of course is that you need the political will not just to hold on to the set of policies that the administration has committed to, but also, in some instances, further the application of some of these measures. this issue is very important, again, as Mr. Hicklin pointed out, because it implies, it suggests that we need to do something about the social safety nets and social policies. In some of these IMF programs, I think a lot is being done, but perhaps more should be done.

Finally, the fourth part of my discussion has to do with the G-7. I will be very brief in my assessments. G-7 is of course key because, after all the spread sector in general, high yield market in the US but also emerging markets, can be viewed as the recipient of capital. So, if you share that view, what that means is that interest rate differentials do matter, on dollar/yen for instance, also absolute levels of nominal interest rate levels in the G-7 matter a lot. After all Calvo, Reinhart and others have done a lot of work on this, a statistical work where you are able to ascertain with high degree of confidence that there indeed is causality. So, you may say, OK, that is true but what can we do about it if we are the IMF or we are the BIS. I think that you can do a lot in the sense of if you share this view, what comes out is that the global financial system is a closed system, so capital flows, to the extent you can forecast the changes in global capital flows, you have to look at the G-7, and for IMF policies and studies of risk in a specific country, that needs to be taken into account very explicitly. I know that it is taken into account a very high level, but it needs to be taken into account explicitly, particularly in a scenario now where the capital flows component is key and highly reactive and responsive to changes in the G-7 policies. So, I think there needs to be a lot more interaction between certainly the Bank of Japan and the developing country groups within the IMF, or put differently, the emerging market groups within the international financial institutions need to be very well aware of what is going on in the G-3. And with that, I will open the floor for questions.

Unknown: What kind of data do you need or is lacking for the assessment of countries?

Liliana Rojas-Suarez: There is not a single set of data that one using in making an assessment of individual countries. As I was saying in my initial remarks, the data that is most lacking is financial data. people only know, sometimes the IMF itself, quite late about developments in a specific institution that then tends to complicate or erode problems in the financial system. That would be the kind of data that is not easy to collect. I am very aware of the problems of collecting the data, but at the end it is behind many of the major problems, and I do strongly believe that the IMF has a role to do that. In terms of the usual macroeconomic data, I think that the IMF has done a terrific job in training almost everybody in the private sector to do financial analysis and accounting very nicely because I can almost with certainty tell you that most people in the private sector follow the same methodology as the IMF. We all now talk about primary surplus and operational surplus, and for people that have been in the Fund for a long time remember that ten years ago there was a new concept and nobody was talking about those kinds of definitions. We learned that from the Fund, and now it is being used all over the place. So, the basic macroeconomic framework one really uses is the IMF's for consistency purposes to be sure that you are in the same track. But basically, what you don't get from the country, you don't get from the IMF. The hole is there. It is not as if you can get a data from one place and not from another. That is the hole that the IMF could fill and it would be extremely useful also for the authorities, it is not only for the private sector. And it is on the financial sector.

Peter Geraghty: I think, as I said earlier, I am relatively new to the buy-side, so I am now being updated with data and research from certainly any number of sources. I don't know that I can necessarily point to one thing that I would see as a shortcoming right now. I think that, as I mentioned before, in general, transparency is much better than it has been in the past. I think that the countries themselves could be more forthcoming, but I don't see a great deal of information, if it is available, that is not almost instantly disseminated to the market either having come up through the Fund or through the private sector. We get it very, very quickly today. It is very current. In fact, we sometimes get a little more than we need so that I often think that the market looks at a lot of statistical data that really doesn't speak to the underlying political or economic situation as it is unfolding. So, I am not sure I have a lot to add on that other than to say that it is pretty good right now. I think that the data we have is probably more than sufficient, at least from an investor standpoint.

Unknown:

Liliana Rojas-Suarez: In the Japanese banking problem, it was precisely the maintenance of a set of institutions that have become redundant. It is the lack of political will to accept that those sectors are no longer competitive. This is the case for almost every sector. Remember that we have sold abroad the idea that we need this smaller government. Well, the Brazilian banking system is lending to the government. Maybe we don't need such a large government in Brazil. But there is still no political will to reduce it. It is always the same thing. It doesn't matter whether it is the private sector or the public sector, it is the lack of recognition that a part of the economic society has become uncompetitive and should be let go. the Spanish banks ran out of Spain to come to Latin America because they were no longer competitive there. The euro could create a lot of tension among a number of, I don't believe that the systems are going to be threatened there, but could create pressure on a number of institutions that start to be not as competitive as they were before when they had their own markets. So, yes I think you could start to see pressure there.

Unknown: Is there some way we could generate more diversity in the analysis?

Liliana Rojas-Suarez: You have to remember that somebody had to be the first in discussing those kinds of indicators that you have mentioned, and then the system proved that they had some validity and then converse into that. I believe that for instance these banking system indicators, and I could actually talk for hours about that and other indicators that I believe are right that the market is not even looking at. But I think that we work very differently among the different houses in the market and that some parts of the market basically focus on just macroeconomic data, and there is a few others that focus only on financial markets, and others that put those two things together. there is no such a thing as being able to predict the future ten years from now because the market by itself is evolving. Actually, if one tends to think a little bit about the future, clearly on is seeing a movement towards regionalism. If I think about Latin America in the future, what do I see? If someone told me what do you see for Latin America twenty years from now. Well, I see a Latin America highly dollarized, where basically most governments let their currency go. That is what I see. I see a small financial domestic system and lots of foreign banking operating. I see China with lots of problems. What you see for the future diverse enormously among houses. but it is what you see for the future that allows you or pushes you to focus on one kind of indicators versus another.

Carlos Asilis: I would supplement what Liliana has mentioned. I think you are absolutely right in the sense of how the industry looks at risks, particularly on the sovereign side and why have they ignored some seemingly key risk factors in the last couple of years. There is an issue here also of not just of people not being capable of assessing those risks, but perhaps of explicit choice that the international financial institutions may sort of help sweep some of these continuous liabilities under the rug through the transitory financing of some of these deficits, This is an issue that is altogether very different form the subject matter. I think we talked about it in last year's conference, the issue of moral hazard in the international financial system, so I don't want to talk too much about it. but I think this is another issue that should be key in terms of mechanism design because we have seen some Asian countries, Indonesia, Malaysia, etc., that the transitory dynamics, particularly as to the funding, the financing of these liabilities stemming form the collapse of the banking system, have been aided by the disbursement not just of private sector but also public sector.

Peter Geraghty: What I would like to say from a market perspective, we all know that we go through cycles, and as a result, traders whether they are on the buy-side or the sell-side tend to have the same trick, whether it is the Japanese carried-trade or it is on Geckos, or whatever it happens to be, and they ignored the fundamentals in many instances because there is that real search for return and the compensation that comes with it that was mentioned earlier, and so on, and so forth. I think that in 1994 when we really dodged the bullet in Mexico because the Tesebonos paid, if that hadn't paid, if the US hadn't bailed them out, we would not have had the same situation in Russia four years later because we would have found that local markets can provide as deep a hole as any other markets. And it would have really changed the way we do business. And I hope from a market perspective this time we think about the countries that have really bucked the trend this time. So I would hope that going forward, as part of the system repairing itself, that people don't just jump on the next trend whatever that happens to be so that once we all pile in, there is obviously no exit that lets everybody get out before we have another event.

Unknown: I would like to return to the disclosure issue. We discussed the disclosure by the country or the international institutions like the IMF, but how about the disclosure by the private sector? Do you think the disclosure by investors, including hedge funds, it is desirable, and how much you can disclose? And if you think you can do that, can you do that voluntary or do you think you need a supervisory framework?

Carlos Asilis: I'll comment briefly on this since this is closer to my area. Clearly, you raised the issue of desirability. I think it is even more basic than that, which is feasibility. I think it is just not feasible to implement a working mechanism you accomplish what you would like accomplished. So, as a result, I share very much Chairman Greenspan's view, which is shared also by the Germans, which essentially that the way to do it is to regulate and supervise the providers of credit to the hedge funds. And that has been done already. Initially, as early as months after the collapse of LTCM, even though we are a G-7 fund, some lines were sharply reduced even though we had no exposure to the afflicted countries, we were told by the counter-parties that this is just coming done from the Chairman's office, and form the Board, and that's it. And my conjecture I think is a reasonable one is that those instructions came from the authorities through moral suasion while they start working on the production and design of explicit regulations, which is already happening at the US Fed. So the answer is that it is being addressed already through implicit mechanisms, and also through explicit mechanisms.

Mustapha Nabli: I would like to comment on Liliana's idea that the crises are due essentially to the fact that you don't have full markets in many developing countries, because we develop some aspects of the market mechanism and it is not complete. You only have part of it. I agree to a large extent. The issue is what do you do about it because developing complete full functioning market economy is a long term process. So there are two ways of looking at it. One is crises are necessary during this transition period and then you have to live through that, learn from them and move on. Or is there another idea that you have to go through a sort of big bank type of mechanism, what is your view on that?

Liliana Rojas-Suarez: What is true is that the economy corrects itself through crises. Either you correct it ex-ante or the crisis corrects it for you, but I believe that there is a way out. It is the right sequencing. It is very clear that once you go and decide on the process of market development, you have to have the right mechanisms in place to actually implement markets. For example, if you go into financial liberalization, and you don't have a prompt action to let bad institutions go, actually it is not only prompt action, if you have not allocated enough fiscal or international reserves, which is a strong currency in most countries, to actually be able to let institutions fail, if you don't have that, don't open the market to anybody because you don't know what you are going to have in the system. So, it is more a question of sequencing. All these ideas are good ideas but what I was basically criticizing is that the good ideas were promoted without really thinking what were the preconditions for them to work. So, basically, work on the preconditions, and on each of that, I do have suggestions on how to implement them.

Carlos Asilis: Any other questions? All right then, thank you very much.

LUNCHEON **Keynote Speech**

Marc Uzan: Sorry to interrupt your lunch, but I would like to introduce our keynote speaker today. We are very honored to have Dr. Heiner Flassbeck to deliver today's keynote speech. Mr.. Flassbeck has been appointed State Secretary at the Federal Ministry of Finance in Bonn in October 1998. Before that, Mr. Flassbeck graduated in Economics at the University of Saarland concentrating on money and credit business cycle theory and the general philosophy of science. he also received a Ph.D. at the Free university of Berlin for a thesis on "Prices, Interest and Exchange Rates: on the Theory of Open Economy with Flexible Exchange Rates". In 1990, Mr. Flassbeck was granted leave from the Ministry of Economics to conduct studies at the German Institute for Economic Research (DIW) focusing mainly on cyclical labor market trends, labor market theory, business cycle analysis and forecasting, drafting economic policy concepts and shock analysis. In 1990, Mr. Flassbeck became the head of the Business Cycle Department at the German Institute for Economic Research, where he stayed until last October.

Heiner Flassbeck, State Secretary for Finance, Federal Ministry of Finance, Germany

Heiner Flassbeck: Thank you very much. Ladies and Gentlemen, I am going to talk today a little bit about overall worldwide currency problems, as you have been addressing these problems this morning already. And I am planning to talk about Bretton Woods, as you have heard from my curriculum vitae, I have been dealing with exchange rate questions all my life, or at least all my academic life. I am going to talk a bit about Bretton Woods and what it means today. I would like to say a few words concerning what was good in the Bretton Woods system, which was invented at the end of the Second World War, and what was bad and what are the lessons we can learn from the Bretton Woods experience. But, quite briefly, I cannot but make two comments concerning the discussions we had just before on exchange rate problems and other problems, about the information and markets, and the information markets get from government or non-government institutions.

The first observation is that it is a strange thing that in an exchange rate market, the market participants are getting their information from governments. I will be quite provocative now. They are getting information from governments and they are interpreting this information in different ways. You mentioned that in the community there are different interpretations. But if you think about markets, you normally mean something quite different, namely you mean, and this is what a famous liberal economist, Friedrich August Hayek, has brought to us, that markets generate information, information that is not available to governments. And if this is true, well, think about the question of whether the exchange rate market is a quite normal market. The second observation that I got from the discussions is that there is a lot of talk about institutional questions, for example, the existing banking systems. You said that a bad banking system can never survive a fixed exchange rate regime. But the question is what is a bad banking system. And my observation in the last three months in office is that too many people in my opinion are talking about institutional questions and too few people are talking about economic questions. The point I wanted to make is a quite simple one, namely is it quite independent from the size and the kind of shock a country is faced with when you are analyzing a country and you come to the conclusion that the institutional arrangements are bad? To give one example, Japan was facing an appreciation shock of 60% at the beginning of the 90's after the bubble had been burst. And an appreciation shock of 60% now I think in any kind of institutional arrangements that you have would be absolute disastrous. Germany had an appreciation shock of 15% and even the results there were rather difficult to overcome. So, it is not quite open to talk about institutional questions without taking into account the kind and the dimension of shocks with which these institutions are faced. And there are shocks all over the world which no institutional system could survive without collapsing. These were just two remarks I wanted to make before my discussion.

I come back to what I wanted to talk about: The Bretton Woods system. There are two things which were good in the Bretton Woods system. You all know the Bretton Woods system was a result of the experiences that many countries had during and mainly before the Second World War. one of these experiences was that it could be disastrous for the world to have something that we call today competitive devaluations, namely the attempt by countries to compete with one another and to be better than the other one without any kind of rule of the game under which this kind of competition takes place. I think it was a very intelligent idea to have an institution, namely the International Monetary Fund, to supervise the kind of exchange rate approach that countries take and try to avoid competitive devaluations. Why is it wise? Well, it is very simple, because we all know that at least the world cannot devalue against somebody else. And as long as we do not have trade relations with the moon, it is a zero sum game. And we all know that zero sum games can be disastrous because they lead to results that nobody wants at the beginning and nobody intends to have at the end. So, I think this was a very intelligent achievement, and I'll come back to that later because I think it tells us a lot about what we are doing and talking about today.

The second thing that was good in my opinion in the Bretton Woods system is that these people at that time were thinking explicitly about the question that seems to be an old fashioned one today of whether it is reasonable for countries to permanently, and it has very much to do with competitive devaluations, to go for permanent current account surpluses. And I think it was one of the achievement of economic theory, and the kind of thinking that these people who were inventing the Bretton Woods system brought about, that again we have this paradox that not all countries can have current account surpluses. And that is why this thinking and the economists of this time were thinking very much about what we call the target of an external balance, a balance of your current account or your balance of payments, however you may define it, but it was an explicit target for example in the so-called Stability and Growth Law that was brought about in Germany in the 60's. So this is something that, in my opinion, has been lost which is rather important, and, again, I'll come back later to that.

Now, what was bad with the Bretton Woods system? I think there are two things which were not clearly defined or thought through. The first thing is that in the Bretton Woods rules of the Bretton Woods currency regimes, they had the explicit mention that countries had to devalue their currencies, that they had to adjust their exchange rates in case of a fundamental external disequilibrium. Again, this was quite intelligent as far as the disequilibrium situation is concerned, but it was a problem as far as the timing of adjustment was concerned. here again, we come to questions we are talking about all the time here and in many fora all over the world, if we talk about world financial architecture, we are talking about the question of what is an early warning system. Even this morning it was mentioned explicitly that we need early warning systems. Now, what is an early warning system? You don't have an early warning system, if you adjust the exchange rate in case that you have already a fundamental disequilibrium visible in the statistics, but you need something else. Here again, the discussions, very much like the discussions about the world financial architecture, is a bit too abstract. Let's talk about the real things. Let's talk about the substance of the things. I think we are coming to a very easy point, namely we are coming to the point that all the problems that we have seen in the Asian countries and others have very much to do with fundamental misalignments of exchange rates. There is only a few disagreements that it has something to do with misalignments of exchange rates. But then, the question is why don't we address that, why don't we address that in the form of an early warning system, namely of the kind that will monitor real exchange rate development. And the IMF does that permanently in a very sophisticated manner. We could do it in more sophisticated manner but the question arises of why are we not doing that. Here is one point which is very important. Whatever the exchange rate system is, and again I do not understand fully the discussions of this morning, there can be misalignments obviously. We have seen major misalignments in flexible exchange rate regimes and we have seen major misalignments in fixed exchange rate regimes. And you have pointed out that in flexible exchange rate regimes, there were even more misalignments or currency crises than in fixed exchange rate regimes. So, why don't we talk about it? In reality, we do not talk about it. We talk about very abstract things like surveillance, and disclosure, and control of short-term capital, and all these wonderful things. But the diagnosis is very simple. All the countries in crisis, not only in Asia but all the way back into the Bretton Woods system and here the Europeans have much more experience than other people all around the world with currency regimes, there were always fundamental misalignments. And after the fundamental misalignments, it was visible in the statistics that you had a fundamental disequilibrium in the external trade. And those we can find in the statistics today. We find fundamental disequilibria in these countries in form of current account deficits, and we find major misalignments in from of a permanent overvaluation. But again, it is too simple in my opinion to say: well, we have seen all this, now we attribute that to the kind of exchange rate regime that we had in these countries, and now this is the clear proof that pegging the exchange rate is wrong, and let's go back to floating exchange rate regimes. I think this is a much too simple answer. It is simply not true that a floating exchange rate regime has avoided crises on the one hand, and given the experience that we have in Europe, it is not true that it is not possible to adjust a pegged system in time so that you avoid major misalignments. I think here is one first step that I would go in what is called the world financial architecture which is a very simple one, namely let's build up early warning systems and let's talk about what we need for early warning systems. And the first thing, the most important thing, and in the end, maybe the only thing, but I didn't want to go that far, is talking about real exchange rates. If we do, as I said, it doesn't depend on the kind of exchange rate that you have. So the early warning system was clearly missing in the Bretton Woods system. That is why we had a lot of crises, but meanwhile we have forgotten most of these things and we are going into crisis again without early warning or without sufficient ones. There may have been warnings but maybe they have not just been heard. I don't know. But what we have learned too in the Bretton Woods era was something very simple that, even when there were early warnings, governments do not like to listen to these early warnings. That is very important too. There is a long experience with that too because governments like to stick to a certain exchange rates. They have chosen an exchange rate, they like it very much, and again, don't forget it, in flexible exchange rate regimes, they even like an appreciation of the currency because it proves stability, it proves how confident the international investors are with their currency. But they only like it for a time, because there is a lag, and after the lag has emerged two, three, four, five years, whatever it is, the results will show up. And the results will show up in terms of major misalignments and major disequilibria, and then the painful part of the adjustment process begins. So, if we want to be successful in terms of a reasonable exchange rate regime, what we need is first an early warning system, and second, some kind of mechanism, not to put pressure on governments, but to make it clear to everybody that adjustment should take place and then, to bring about this kind of adjustment in one way or the other. And, if this adjustment takes place at a very early stage, we all know that a lot of problems can be avoided. So, I think this is very important.

The second point which was not perfectly ruled in the Bretton Woods system was something else that is very important but, let me say it quite frankly hardly understood, and maybe on this side of the Atlantic, even less understood than in Europe. But even in Europe, it is difficult to understand. What was the major problem in the Bretton Woods system that we have had after the Second World War? It hasn't been working quite well with all the crises and the adjustment problems and so on, but it has at least allowed the world economy to get unprecedented rates, full employment, and extreme increase of the standard of living of the average people. But what was happening? The system was abandoned, but why? It was very simple. The main critic of the system came from Europe, and Germany was at the front to criticize the system. But why did everybody criticize the system? Because this kind of system that we had in Bretton Woods was introduced not as the Keynes plan, as you know, but it was the Harry Dexter White plan, and this plan was one in which you had a leading currency. You have a leading central bank. And quite clearly, in Bretton Woods, the US Fed was the leading central bank, it was the hegemonial bank, which is not something negative, but which is necessary if you do not have introduce a world bank, a real world bank or an international monetary fund with all the rights that a central bank has. Then this problem is unavoidable. But this problem is a real problem, because it is quite clear that the leading central bank will always go for a monetary policy that fits the conditions of its own country, but not the conditions of the world. So, the criticism came from Germany saying well, the US goes permanently for inflation and we do want stability, so this system is not good for Europe. This was the main criticism in my opinion. Then what happened is that we abandoned the system of fixed exchange rates in 1973. We went to a system of flexible exchange rates but in Europe, and in many parts of the world, only very few countries really adopted a system of flexible exchange rates. What happened in Europe is that we quickly created in 1973 a new currency zone, with different names, later on it was called the European Monetary System. Because, and this is one of the very important experiences too, and not only an experience let me mention that because I have been studied that fora long time, an experience of the 70's or the 80's. We often tend to believe that what we experienced is something absolutely new in this world and it has never happened before. Again, it is very often not true. This time again, it was not true because in the 1930's, we had similar experience with large capital movements and a lot of books were written about the problems of speculative attacks and speculative capital movements, and the problems that mainly small open economies have in a globalized world. So, as I said, we tend to believe this is absolutely new. It is not. But it showed very quickly that in Europe, most of the smaller countries could not opt for flexible exchange rate regimes, or didn't want to opt for flexible exchange rate regimes, because mainly small open economies can hardly manage to keep their exchange rates as stable as it is necessary to have normal conditions for investment in your country in a globalized capital market. And again, the problem emerged in Europe with a leading currency. It is quite clear, in Europe the leading currency was the D-mark, and the leading central bank was the Bundesbank. Again, the problem emerged that had been shaken the Bretton Woods system, namely that the leading central bank cannot and by law it could not perform a monetary policy which was adequate for the whole area for which it was de facto the central bank. But the Bundesbank clearly chose a monetary policy only adequate for Germany. And that was a problem again for many other countries. You see what the outcome is. The outcome is that on the 1st of January this year, Europe opted for a very reasonable way. And it was not so much, and I want to stress that point because this exactly on this side of the Atlantic is very often misunderstood, that France was pushing for the European Monetary Union because they didn't want a political leadership in Bonn, and for political reasons, they didn't want a big Germany to be dominant in Europe. Well, this may be a reason for many people, but as I said, the economic rational behind that is really that it is impossible to have a comprehensive monetary policy for such a huge currency area in which you have a leading, hegemonial central bank. So this is why Europe in my opinion quite rationally, opted for a European Monetary Union because now for the first time we are on equal footing with the United States having, or at least a chance of having, a comprehensive European monetary policy which will help to solve a lot of problems that we had up to now. So this is how the idea, quite briefly and sketchily, of exchange rate regimes emerged. But again, I think we still have to address a lot of problems.

One of the lessons that can be learned from the Bretton Woods system and the Bretton Woods institutions I have mentioned already. We have learned the lesson that a currency regime with a leading currency does not work over the long term, but needs to be replaced by something like a monetary union or a currency block at least in which you do have a central bank which is explicitly responsible for the whole area. This can be very interesting in the next days, or months, or years, but if you take into account the discussions that go around about dollarization in some countries, and other things, currency boards, you see that this is an extremely important idea.

Now, what else can we learn? I think the lesson that is very important and that we can learn from the Bretton Woods institutions is that competitive devaluation doesn't make sense. This is now very important for Europe because we have no exchange rates anymore and there is a tendency in some countries to say: well, this is wonderful, now we can exploit our productive capacity or overexploit it by not only being highly productive but by beggaring our neighbors by a real depreciation which would not be compensated by a nominal appreciation of the exchange rate. And this can be done, and it has been done several times already in the world and in Europe by living below your means, by tightening your belt to a sufficient extent so that you do exploit your productivity gains to the full, but you reduce your unit labor costs below what the rest of the currency union has, and then your are gaining a market share, you are gaining an extra profit. This can be wonderful for you. But it can only be wonderful for you for a very short time because if you are a large country, the others will have to react, they cannot allow one country to be permanent better than the other ones. So, your devaluation will lead to something like a common movement downwards, in terms of what is the most important factor unit labor cost. And if something like that happens, then we are really in danger, because then we are in danger not only to lose the competitive advantage of the one country which would be a normal thing, but we are in danger to lose something else, namely to lose price stability because if all countries go for competitive devaluations, we will end up in deflation. We will end up in deflation, and I think it is really a threat to the world economy to go in that direction in one way or the other, to do it by nominal depreciation, which is then real depreciation because it goes far beyond the fundamentals, the price differentials. We see that all over the world in the emerging markets now as an attempt to solve their problems, which is perfectly understandable. But the danger is that this will be responded by the industrial nations again by belt tightening, and again by an attempt to keep their market shares at least, which is obviously not possible if the emerging markets are going to get out of their very difficult situation. So this is extremely important. And let me make one remark if I am allowed to do that. I think, and this is just again for thinking, it seems to be, I'll be cautious, that some kind of economic ideology always pushes the world in the direction of such competitive devaluation. And it seems to be that this ideology has very much to do with neo-classical economics because in the 20's, it was a development in this direction, and again in the 90's, we have a development in this direction. Why is it? I can give you a wonderful experience of Germany because we have tried hardly to be the best of all in terms of this kind of neo-classical ideology in the last years, and we were in many respect the best of all, namely we were the only big country in the world who was able to reduce, not only to lower the increase of unit labor cost, but to reduce the unit labor cost. Something that never happened for example in the United States, and was happening in the last three years in Germany. But the lesson from that is what you do not get, what is expected by neo-classical theory, you do not get something that is called substitution of capital for labor, so that you get much more labor-intensive kind of production. This neo-classical nexus did not work at all in Germany. Productivity was not reduced and employment was not increased, but the only nexus that worked in that kind of theoretical setting was the kind of beggar-my-neighbor approach by a real depreciation to increase your competitiveness. But this leads again, you see how complex things sometimes are, many observers to believe that the neo-classical nexus works because it was the beggar-my-neighbor nexus that was successful. But we have to be very careful with these things because, as I said, they easily can lead to situations which we cannot control anymore.

The third lesson we can learn from the Bretton Woods experience in my opinion is something I said already which sounds extremely old fashioned, namely that it should be really a target for national governments to try to get their current account into equilibrium, not to try to get huge surpluses. I think this is a lesson that at least two big countries of the world have learned in the last ten years. In one of these big countries, which I need not mention, we were lucky to avoid an ever-increasing current account surplus by a unique historical event. The other one is in bad shape and it may have to do something with that kind of attempt of economic policy. So, I really think that it is not reasonable to try to have current account surpluses for a very long time. I know all the objections economic theory has against such an old fashioned view. They say why shouldn't we export capital to other countries that can be efficient and will increase the real income of the world. This all is acknowledged. It may be true but the lessons from reality we have learned in the last twenty, thirty, forty, however years you like, is that it is nevertheless extremely important to have permanently flows of capital in one direction from one country to the other. Here my last lesson comes out, namely that we need some kind of cooperation all over the world to discuss these questions because if we don't discuss these questions, again the result can be disastrous for us all. Why is it that here the invisible hand of the market, so to say, does not work? We have a lot of discussion about that in Germany. Many people in Germany still say what we are heading for, what we should go for, is improving our competitiveness, mainly the companies and employers associations go in that direction. They have been pushing the old government of Germany permanently in that direction to improve the competitiveness because, they say, it is like in a market, one company is better than the other and one company has to win and one has to lose. And we all have to acknowledge as economists that this is wonderful, this can improve our efficiency. I really acknowledge. We said before that exit and entry is a quite normal thing in a market. The question is only whether exit and entry is a quite normal thing between nations. And if this is not the case, at least not with peacetime instruments, then we have to think about this kind of approach. We have to think about zero-sum games, about competitive devaluations. And then, I think we need institutions to monitor the development and institutional arrangements between governments to discuss the development, and then, but only then, we can hope that we an give the markets the signals that they need to get for a reasonable outcome for everybody. Thank you.

Marc Uzan: Do we have a few questions before reconvening?

Unknown:

Heiner Flassbeck: You are absolutely right. But the question is what has happened before. Why have these countries been in such tremendous problems? We have to analyze that question too. Here I said that if we look at the analysis and I am very grateful to what, for example, the World Bank has done and the World Economic Prospects in December, you clearly see that the outbreak of the crisis has very much to do with what I called a misalignment of exchange rates and overvaluation. They had pegged exchange rates vis-a-vis the dollar and they had much higher inflation rates than the US, or unit labor costs increases. It can easily get out of the statistics. And, if then you devalue because you are in trouble, then it is quite clear, and I said that, I acknowledged that explicitly, that you need that kind of devaluation to solve your problem or to regain your competitive position. But what we have seen is that much more than that happens. These countries have not only depreciation which compensates for the real appreciation that they had before but they go much below that. What I said only is that there is a danger that these additional real depreciations in these countries will lead to additional belt tightening, for example, in the industrialized countries or elsewhere, or additional attempts to devalue. And then, sooner or later, in this rather small world, we will come to an end with this kind f devaluation strategy because it is quite clear from logic that it only works if somebody refrains from taking additional action. This is only what I said. I said as an explicit strategy we should refrain from having competitive devaluations but as a result of a catastrophe, it can never be avoided. And I would never say that in case of diverging inflation rates, you can avoid depreciations. That is what I said explicitly. If you look at the experience, it is quite clear that you should avoid a real appreciation of your currency because this is not tenable over the medium term. It is tenable for one year, or two years, or three years, but sooner or later, it will come to an end, this kind of strategy because you are importing price stability by this kind of strategy, but you are importing something else, namely you are importing unemployment or current account imbalance, however you may call it. So, there is no such thing as a free lunch in this world and we should be aware of the side effects that this strategy has.

Unknown:

Heiner Flassbeck: Let me first say a word concerning the German experience. I will make it more explicit. What has happened is that we had a drop in nominal wage increases from 1995. Up to 95, we always had in West Germany, something like 4-4.5% nominal wage increases. Then we had a sudden drop down to 2%, and then last year, we only had 1% nominal wage increase in Germany, that is to say, in a country which has a trendwise productivity increase of something around 2-2.5%. So, you may say that this is not enough, but the logic is quite different. If this happens and you don't get immediately, and I mean really immediately, additional employment effects, positive employment effects, then the outcome will be negative because if wages drop from 4% increase to 2% increase, prices remain stable in the first round so that real wages drop to, say, zero, and you have still ongoing negative employment growth, then the demand effects on the consumption side are definitely negative. Then you are in a situation where companies have underutilized capacities, this was clearly the case, and this is the case when you do that. They have underutilized capacities and they see the demand dropping despite the fact that they have lower wage increases. So, the question is what is the outcome. The outcome is quite clear that you will not send a signal to employers ion a way that they now go for more employment intensive production because, first of all, they do not know what the real wage will be. And it shows up now in Germany that the real wage over the medium term is much higher than they could expect in the first round because prices are now falling. Because of your falling unit labor costs that we had in the first round, now in the second round, prices are falling or going down to such an extent that the real wage is not as low as they could have expected.

So, I think there is nothing in the practice, and this experiment has shown it quite clearly, that could prove that neo-classical nexus works.

Unknown:

Heiner Flassbeck: Well, we have both if you look at the pressure that we are facing now from the German industry and elsewhere, you see that clearly it is going into a protectionist direction. The other thing is that there is a pressure again on wage demand in Germany to say we have to be even more rigid than in the past because of these challenges that again we have from the emerging markets. But as I said, if you look at the outcome of the first belt tightening round in Germany, the outcome was such that we had clearly a reduction in private consumption and we had, more or less, stagnation in the last years, in the recovery phase in private consumption. Real private consumption did not rise, for example, in 1997. It was absolutely stagnating in 97. Something like that never happened in the United States, and everybody would have said that it is a catastrophe if in the third or fourth year of a recovery, you had constant private consumption. That is absolutely impossible. Everybody would say that this is the end of the world, and there would be a major slowdown. But what happened in Germany is that it was compensated for a part by a much better export performance that we had. But the export performance had been, for example, and export performance taking place in Asia or in Eastern Europe. So, the only thing I would say is that this cannot go on for ever. And that is why we cannot try permanently to improve our competitive position, because we are competitive. there is no indication that Germany is not competitive. East Germany is a different story but West Germany is clearly a competitive economy, otherwise it is quite clear that the Eastern European countries could not stay in the kind of exchange rate regimes that they have but they should then depreciate their currencies more than they normally do.

Unknown:

Heiner Flassbeck: If you look at the long experience of industrialized nations, you see that between the capital labor share and employment, there is no correlation at all. It is absolutely clear that we will have permanently higher labor costs if this is in line with productivity, and productivity is in line with real income increases, I see no problem why we should not go on with higher absolute labor costs. Everybody knows the famous figure saying that the average hour in Germany costs 45 D-marks, but hardly nobody knows that the average productivity per hour in Germany is 85 marks. So, this is a quite normal relationship and there is enough room for good profits. If you look at the mergers and the direct investment in the world, you see that German profits are absolutely okay.

Marc Uzan: Thank you very much Mr. Flassbeck. We are going to conclude our lunch and we should reconvene in five minutes.

PANEL 2 The Resolution of Financial Crises

Chair: Andres Solimano, Director, Country Unit, the World Bank

Andres Solimano: Good afternoon. We start now the second panel: "the Resolution of Financial Crises". We have as speakers Ms. Karin Lissakers, Executive Director for the US at the International Monetary Fund; Daniel Jackson, Managing Director of European Emerging Markets at Nomura International; Timothy DeSieno, Insolvency department at Hebb & Gitlin; and then Mr. Paul Leake, Partner at Weil, Gotshal and Manges. The rules are that each speaker has fifteen minutes and then we will provide half an hour for general discussion. Perhaps, I will take the liberty as Chair of this session, to congratulate the Bretton Woods Committee for organizing this interesting event. I also participated in the previous one in January of 1998, and these are really interesting and important activities that the Bretton Woods Committee is performing under the directorship of Marc Uzan. So, my congratulations to him for the ability to mobilize all these people that are present today, and keeping working in this area.

The only observation I would make is, perhaps the speakers are invited to elaborate, on two meaning s in my view of the word resolution of financial crises. One could think of the distinction between short term and emergency measures to cope with financial crises perhaps to avoid an ongoing crisis from deepening or to be extended and the contagion mechanism to operate, perhaps through the provision of additional liquidity to assist them. And the second concept of resolution of financial crises could be a more structural concept in a way of how to prevent in the future crises to happen and to occur. And here one may think of more fundamental reforms both at the global or institutional level which has been called the architecture of the international financial system or other names, and also measures and reforms at the national level in terms of domestic economic and financial policies. Perhaps those two levels, global and national, or global, regional and national, are important when we deal with the subject of resolution of financial crises from a more structural perspective or how to avoid in the future the occurrence of crises that are becoming very frequent and intense. Ms. Lissakers, you have the floor for fifteen minutes.

Karin Lissakers, Executive Director for the United States, International Monetary Fund

Karin Lissakers: Thank you very much. I am not going to deal with issues of cosmic architecture but focus a little closer to the day today work of crises resolution. We seemed to have had a system overload of that kind of work recently at the IMF. And just to outline what I think are fairly obvious and simple parameters of a crisis, a response to an international financial crisis, but to touch on some of the underlying complexities which have some bearing on our thinking about the larger architecture questions.

I think the core elements of a crisis response are fairly obvious. One is obviously an effort to stop panic and to calm markets and investors-residents who may be quickly trying to transfer their financial assets abroad. The elements involve some combination of talk policy action and almost inevitably money. I think we have seen that the absence of any apparent coherent response of the official side, be they the local government officials in the country, that is the target of the crisis, the victims of the crisis, or the international financial community, can feed panic. That silence is frightening. And on the other hand, in the early days of a crisis we have seen that statements, the sending of a Fund's mission, some sense of coherent statements from the government officials can, for a very short period of time, by themselves have a soothing effect. The prospect that somehow, somewhere adequate financing will be made available to reduce the prospects of default and large losses obviously also has an effect on calming markets. But again, these are the short-term responses and their shelf life may indeed not be very long.

The second component, element, obviously is to identify the underlying policy weaknesses and problems that led to the outbreak of financial panic in the first place. Sometimes these problems are quite well-known and fairly obvious and may have been the focus of policy advice and criticism for some time. Brazil's budget deficit, I think, has been identified as a risk factor and as a problem for some time. Corruption in Indonesia was obviously apparent for some time and in need of correction. Sometimes the crisis itself exposes weaknesses, or at least magnitudes, that were not obvious or apparent either to the authorities or to outside official institutions like the IMF or the World Bank or to investors, at least until the moment of flight. For example, the weakness of the Korean banking system and corporate balance sheets, I know that it is possible that people who followed closely the individual corporate institutions may have had a better picture, but from the more removed perspective of the Fund's analysts, I don't think that we had a clear picture of the weakness of the banking system and the corporate system in Asia. Now, that is partly because until fairly recently, we had not looked closely at the banking system as a source of vulnerability for international financial disruptions, or really as a fiscal problem, but as Liliana Rojas-Suarez said this morning, if we didn't know it before, we certainly know it now that the liabilities of the banking system that have access to the official safety net are in fact contagion liabilities of the public budget and should be considered in that light. The third difficulty in assessing the underlying problems that need longer-term fixes are the fact that the crisis itself creates feedback which can be quite enormous, rather it is a dramatically slowing growth and therefore reducing government revenues and obviously severely damaging the balance sheets of corporations and banks, which then again can feedback to budget problems and cumulatively can build into a very severe crisis. And trying to put together a coherent policy response in a crisis that is evolving very quickly and deepening very quickly, which is the situation we have been facing, is an enormous challenge even given strong political will and excellent analytic capabilities.

The third component of crisis resolution and one that is getting increasing attention at the IMF and is leading to much closer interaction with the World Bank for example and other regional development institutions is trying at the outset to cushion the blow of an economic crisis, to limit the social disruptions and the human costs of a financial crisis and to build in at the outset provisions for social safety nets and other emergency responses, the sort of economic stabilizers that are already a normal part of the fiscal and economic management in most industrial countries but largely absent in most emerging market countries.

And fourth, the challenge is to put all this together: the money, the policy consensus and then the implementation. And because the kinds of crises we have been dealing with recently involve a complex web of domestic sovereign responsibilities, private forum, commercial enterprises and multilateral institutions like the IMF, getting all these pieces in place, getting agreement on what is the right policy response, and then as I said delivering it, is no small task. And at every level there are trade-offs that have to be balanced, as Mustapha Nabli said this morning. If you just take the financing, which in some way should be the simplest because it shouldn't involve political will or building political coalitions, even figuring out how much financing is (A) necessary and (B) desirable, the two aren't always clearly symmetrical, is an issue. First of all, the Fund, I think, has not been terribly good at figuring what the current account swings are going to be in a country that is under financial pressure. I think we have seen a much, generally in the Asian cases and in Latin America if you take the Mexican case, much larger current account swings that we had assumed in our program planning. More delicate is the question of what assumptions does one make about that servicing. Do you assume that all obligations must be serviced at the going contractual rate? Do you assume that all private sector or public sector obligations can or should be serviced? There is the complication, now increasingly, or the blurring of the line between foreign debt and domestic debt with the indexation of domestic government debt, domestic currency debt to the exchange rate, the large scale investment by foreign holders in domestic currency obligations with the Tesebonos or GKOs. And that presents, if not a direct, an indirect claim on foreign currency whether or not they are denominated in foreign currency. Even once you figure how much, at least hypothetically, financing is necessary, and I'll come back to the desirable part later, there is the question of who: who is going to put up the money: the country itself, i.e. through adjustment, through lower consumption, the multilateral institutions like the IMF, the IMF has been and, even after the quota increase, continues to be somewhat resource-constrained given the scale of the financial demands and these crises far outstrip the relatively modest resources of the IMF, even with the augmentation of the NAB and the 90 billion quota increase that just took effect. Bilateral official financing is certainly part of the picture but that often involves complicated relations. Some countries have greater access to bilateral support than others. And then private creditors, which is obviously a central concern to this group. Now usually, private creditors aren't exactly lining up at the door to contribute because the reason you had the crisis is that private creditors have decided to take a hike, and they want to get out, not stay in.

And underlying this is a tension between from the official side in making a decision about the financing mix and the magnitude is the inherent tension between the immediate goal of stabilizing the markets, calming investors, rebuilding confidence and normalizing market access for the country that has just lost it, the tension between that and the moral hazard of unlimited bailout. And that tension obviously is greatest in a time of enormous contagion risk, when you are not dealing with an isolated case of financial disruption but with a clear threat of a spreading crisis that can engulf many countries in a region around the world. As Larry Summers said in a recent speech: Moral hazard in a way is the mirror of contagion. When the availability of a supply of capital raises confidence and investment, it can either be called confidence that reduces contagion, or it can be called moral hazard. I think that tension is inherent in any official financial rescue, whether it is the provision of liquidity by a central bank to troubled domestic banks or the IMF acting in the guise in which it was created. I think it is very clear, if you read the history of the IMF, that the founders were very conscious of this potential tension. I noted the comment someone made this morning about Mexico or if there hadn't been a complete financing of Mexico, then we wouldn't have had the GKO problem in Russia. Well, that may or may not be, but if you look at it from Mexico's point of view, and think about the damage that wasn't done to the Mexican economy and the quick recovery that resulted, one can say that certainly, in that narrow context, what was done was the right response to the crisis. And for Latin America, the region as a whole, again, given the alternative contagion scenario, again one could argue that that was the right response. It limited the damage both to Mexico and to the global economy which was the objective.

The other component, I think, of the financing dilemma of how much and who is the absence of a comprehensive legal framework for allocating losses in a cross-border context. Investment contracts may be governed by New York State law or British law, but the enforceability of those provisions may be something else again. We don't have a global bankruptcy court, though there are those who would like to push the Fund in to becoming a global bankruptcy court, but certainly that is not part of its mandate now. We are still dealing with a world economy of sovereign States and sovereign legal systems by definition. So, we find our way if you will. As intense as it is, and as serious as it is this global architecture debate, I don't expect it to produce some full blown new global legal order for resolving crises, rather I think we will, as we have in the past, develop case law as we go and elaborate on pretty well functioning voluntary processes for resolving and restructuring a cross-border obligations. The Paris Club for official bilateral obligations works pretty well. People are familiar with the process. There are, I think, shared expectations about how it will work, but there are good understanding about to come to an agreement in a specific case. The London Club for commercial bank claims also works pretty well. But as we all know, these two institutions don't cover the universe, far from it. We don't have similar widely accepted and well established processes for dealing with securities claims, with these hybrid domestic debt claims that have an international component, with private on private cross-border obligations where the lack of domestic bankruptcy systems is a problem, if you look ate the Indonesian example or Thailand. Clearly, we will need to address those weaknesses, those gaps in the system. And we have, and I think it is pretty clear that the sooner you do it, the lower the losses are likely to be, and the less protracted the economic downturn is likely to be. A system for allocating losses is absolutely critical. I think, personally, my view of the Latin American debt crisis is that one of the reasons the downturn for Latin America was so protracted and the delay in Latin America resumption of access to market financing was the attempt to preserve the par value of the commercial banks claims, to preserve the par value of those claims as long as possible and to delay the allocation of losses as long as possible, which was understandable given the magnitude of those losses potentially. But there is a huge cost to the global economy of delaying the allocation of losses in a situation.

And finally, the policy coherence which goes to the political will in the countries most directly affected. And one of the features of many emerging market countries, since we are focusing on them, is a weak political system. And that is an impediment. That is not something the outside world can do much about. I think we can do something but you need some policy and political coherence in a country to carry through difficult economic adjustment processes. And the weaker the state, obviously, the less policy coherence there will be. I think the Fund and other multilateral institutions can contribute and are contributing to strengthening the political and the policy coherence in our member countries through our insistence on transparency. The publication of letters of intent, the details of agreement with the Fund, I think, make a difference in the quality of the political and policy debate, and ultimately increase the chances of an effective implementation in the countries that have adjustment programs with the Fund. Obviously having an effective social safety net to cushion the blow for the poorest will also help to sustain political support for effective reforms. I think our targeting of corrupt practices, which has really become a serious component of Fund surveillance and conditionality, is an important contribution, certainly will be over time. And, speed. The speedier the resolution and the clearer the day of turnaround seems, I think the easier it will be for governments to carry through the necessary policy measures. I think I will stop there.

Andres Solimano: Thank you very much. Now is the turn of Mr. Daniel Jackson.

Daniel Jackson, Managing Director of European Emerging Markets, Nomura International

Daniel Jackson: If I could begin with a preliminary word on the issue of moral hazard. I think that one perspective from the private sector talking about its multiple characteristics is that moral hazard tends to be the other side of the coin of the public policy to facilitate private capital flows to public sector. And to the extent that is a question and the issue of the interpretation of public intention is important, I think that the initiative that are being taken now to increase the transparency of IMF intentions and decision making is quite crucial to addressing at least part of the problem.

Going on to the issue of dispute and conflict resolution in these cases, I think, is something of a process of moving from the general to the specific because while we can say a great deal on general terms about precautions to prevent financial crises, when you talk about their resolution, they tend to be very fact driven. Nevertheless, I think there are a couple of generalizations that can be made about the implications of capital markets in sovereign financing and international finance in general that are significant for crisis resolution. The most important factor is that in the capital markets, cohesion does not work. It is very much, in the capital markets, a process of herding cats, and the moment that you telegraph a course of intention, you tend to be more counter-productive than productive. So, I think that is very binary, if you are looking to involve the private sector in the resolution of a crisis, you are either going to involve them very earlier on a non-cohesive basis or you are going to be involving them very late in the context of a workout. There is relatively little scope for involving them at the cusp of a crisis. A couple of examples of that. I think the other feature that this rises is that if you are going to bring the capital markets in, you have to propose a solution that is voluntary and market-based, and you need to confront the reality that this means you need to offer a significant incentive to the capital markets. Now, the example of Korea is perhaps a classic one where investors switched out of a bank obligation into a sovereign obligation in exchange for extension. One other that I would mention just as a matter of personal experience was the restructuring of the debt of Czechoslovakia when the country divided in two. That was a complete non-event in the capital markets, and that is perhaps why it is worthy of mention. What was done in that case was to engage in a collective action among the bond holders to amend the terms so that there were different obligors, but in order to induce the cooperation of the capital markets, both the Czech Republic and the Slovak Republic offered a put to investors so that they could get out rather than to participate in the new bond deal. And I would say that, in its own ironic way, that was probably the single most important factor in getting in excess of 95% participation in those bond exchanges, which were conducted under circumstances that actually were not that easy at the time.

The good news is that if you do involve the capital markets, I think you do harness a lot of creative solutions and possibilities to address the resolution of a financial crisis that are not available in a more conventional context. And in particular, the feature of liquidity and the ability of capital markets to stratifying segment risk are crucial to coming up with new ways going forward when you confront a crisis. The bad news, based on the experience I have seen so far, is that investment banks are culturally highly unsuited so far to dealing with crisis resolution. There are a lot of reasons for that. One of the most significant perhaps is that there is a great deal of difficulty in the investment banking community to cooperate with your competitors. I think that will change with experience and probably the most important thing that investment banks can do is to begin to approach these restructurings as a deal rather than a workout. And if they bring that different perspective to what they are trying to do, I think that you'll find that you are mobilizing the resources of these institutions much more effectively. Likewise, I think that as this transition to capital markets occurs, I think there is going to have to be a change of approach on the part of the debtors as well, particularly sovereign obligors who are accustomed to a rather different context in a traditional bank restructuring.

Having made some general comments, Marc Uzan did ask me to speak specifically about what is going on with the Russian GKO restructuring. So, first the news on that. As everybody knows, Russia made a unilateral announcement in August proposing to default on their bonds and to restructure those obligations. In response to that, 19 foreign banks did form a creditors' committee to provide the Russian Federation with an opportunity to reach a negotiated solution. And that in itself, actually, was quite an accomplishment. It almost did not happen, and certainly was not easy under the circumstances of a domestic Treasury default where there was a complete absence of any formal mechanism for bringing creditors together. Negotiations did begin in October and those have been terminated now. They have been terminated on the basis of a judgment of the creditors' committee that Russia is not yet ready to engage in good faith negotiations. And I think there was a collective concern among all of the creditor banks that continued discussions might be used by the Russian Federation to mischaracterize a unilateral deal as in fact something that was a product of negotiations. In terms of why we are at this juncture, I think the most charitable construction that can be put on things is that they were premature. We were trying to talk to the Russians about one problem in a context where they had many others, most of which were domestic political problems and which must be resolved before they are going to be able to address issues like relationships with their foreign creditors. SO, I think that we can say in retrospect, that while it was a good idea to begin the discussions with the Russians, those discussions were begun too early. The situation that we have now is that Russia is proposing to proceed with an exchange. The terms of that exchange have been unilaterally determined and the exchange period has begun. For foreign investors, the overall situation is aggravated by the fact that the exchange has begun without the articulation of crucial terms that would be important to a foreign investor's assessment of rather to accept the exchange or not. The behavior of Russia is sufficiently egregious. The creditors are seriously considering their legal alternatives. I know that was mentioned this morning as something that the creditors don't like to do. It is something that is considered only as a last resort by the creditors' committee. It is something that is being taken more seriously than it might ordinarily be taken because the behavior of Russia as been such that it has triggered protection under a network of investment, protection treaties. This is of great significance to this particular class of creditors because it has two principal impacts. The first is that it elevates the claims of the creditors from claims under Russian law to claims under international law, and provides for compulsory arbitration. The second element is that the mechanism of the treaties which is a bit esoteric, but significant to this investor class, fixes the quantum of your claim in US dollars. So, it addresses the inherent dilemma that investors find themselves in that if they try to reach a good faith solution, they are simultaneously watching their investment wasted away by ruble depreciation, and the treaty in rather impressing anticipation of precisely this situation protects against that.

Having given the update, I guess the question is what does all this mean from a policy perspective. certainly, from my viewpoint, any meaningful resolution of this crisis that would provide significant value to GKO investors is going to be a relatively creative solution, and probably one that is going to have implications for microeconomic reforms in Russia. At the same time, it would be my perception that in trying to map out a future strategy for Russia, the IMF must be thinking very carefully about microeconomic reform issues. And that is for two reasons. The first is that one of the principal causes for the Russian crisis in retrospect is probably that the microeconomic infrastructure wasn't there to support the macroeconomic stability that appeared in some ways to be quite successful. And the second is that it is difficult for my perspective to see how the IMF will achieve meaningful conditionality if it doesn't focus on some of these issues. You would think that from this potential confluence of interests that there would be a fairly intensive dialog between the IMF and the creditors' committee on these issues. And what we can see from the way the respective institutions operate is that there really isn't an occasion or a mechanism to achieve that kind of dialogue. There are obvious and justifiable concerns about the IMF in becoming excessively involved in any particular creditor dispute. AT the same time, it would be helpful where there are common policy implications to see a better dialog. So, to the extent hat this all addresses the policy question that is appropriate for this forum to consider further, it might be whether this is an occasion for a more intensive dialog between the IMF and the private sector creditors, and secondly, what would the mechanisms for an effective dialog be.

Andres Solimano: Thank you very much. Now is Timothy DeSieno.

Timothy DeSieno, Partner, Hebb & Gitlin

Timothy DeSieno: Thank you. My name is Tim DeSieno. I work at Hebb & Gitlin in Hartford, Connecticut, in a law firm. And I find myself in an odd position. I feel regularly like I am a member of the private sector. On the other hand, our firm is engaged by the government of Indonesia in connection with what we are calling the Jakarta Initiative, the debt restructuring mechanism for out-of-court negotiations for corporates, private sector companies. So, I find myself standing admittedly somewhat bewildered on this wonderful bridge that Mr. Uzan has built for us between the private sector and the public sector. And I thought I would just spend a few minutes at his request chatting a bit about what I am going to get to is what we are trying to do in Indonesia. I thought I would spend a few minutes before I lay the groundwork of how I see it fitting into this forum. Obviously, what I want to talk about is a form of market exit. I want to talk about insolvency systems and workout systems as a part of the resolution of these crises that we are talking about today. I think that insolvency system for corporates is equally important for the resolution of a crisis as it is for the prevention of a crisis or the reduction of the scope of a crisis in the future. So, I'll touch on some of the main issues, and then I'll get right to Indonesia.

As I see it, from my little perspective, a financial crisis is illiquidity and it can be due to many factors, political instability, lack of hard currency reserves, other policy choices or market perceptions that exist, and this clearly has effects on the sovereign, as well as on the financial sector, and then, consequently, on the corporate sector. We like to turn it around and see it from the worms' eyeview, down in the dirt looking at it upside down. We think of it as once corporates are stressed for working capital, they quickly become a drain on the financial sector, which then in turn becomes a drain on the sovereign. And if you can start to focus on the corporate sector a little bit, you are not going to solve the whole problem, I would certainly admit, but you can start to address a big piece of what is going on. So, what is it that can be done? If a country is not doing well having placed effective insolvency regimes, bankruptcy laws that work well in theory and in practice, they are enforced well, they are enforced consistently in a transparent way and a way that is perceived at least to some degree to be fair, and certainly these insolvency regimes differ from country to country depending on the national policy choices, you are going to have vastly different insolvency regimes, and these in turn lead to vastly different perhaps workout arrangements, at least on an initial glance because workout arrangements are of course based upon the alternative which is insolvency, but regardless of the kind of systems that you have in place, most well functioning systems will introduce a couple of critical elements. And those are predictability, and speed. Maybe not enough speed in all cases but these things come together. And the best systems, I think, recognize that in a crisis like this, the debt of the overleveraged companies is really equity, and the mechanisms that are in placed, in court or out-of-court, offer an expedite and efficient way to recognize that fact. So, you have things in an insolvency law like an absolute priority rule or the ability to swap debt for equity in a relatively straight-forward way. You have mechanisms like prepackaged plans that allow the insolvency to proceed quickly. And you have systems that promote efficient out-of-court negotiations.

So, what is the result if you have this in place and is it working well? Well, you have corporates that, in a relatively speedy basis, can resolve their financial issues, addressing their debt problems, equityzing the debt as needed. The system provides the chance for the companies to take a look at their business plans, and to the extent they need improvement, to do that. And as a result of the process, the corporates regain access to working capital. They are now financeable and, therefore, they can turnaround and start to grow, and start to hire more employees, as opposed to shrinking their market share and laying their employees off. The effect on the financial sector is that the bank's customers to whom they have made their loans are becoming healthier. And these dynamics have the effect of increasing the value of the paper held by the banking sector. And so the banks liquidity is improved, and they, consequently, drain fewer resources from the sovereign.

I think it is clear that insolvency law can play a role in helping during a crisis and preventing the scope and extent of the next crisis, simply by increasing the value of the paper held in the financial sector. Just to touch for a second on some our other private sector colleagues, particularly those in the secondary market who are out there looking at opportunities in Asia, Latin America and Central Europe at the moment, they are shying away as far as possible from countries in Asia for example where the insolvency regimes have yet to prove themselves. They are ascribing a very high value to a properly functioning insolvency regime. Today, what you are seeing is the secondary market which is an aggregation of billions of dollars looking for distressed opportunities is staying away from market places simply because the insolvency and workout regimes in place are not workable. And when I think about that, I think what a tremendous waste because there are so many dollars that would be happy to flow in some of these countries if they simply improved their insolvency system, which is not something that has any cost to the government. You simply amend your rules. It takes time. It is not easy, but it is critical.

In light of this background, what do we see in Indonesia and what are we trying to put together and how is it working? I guess I don't have to repeat all of the story but I guess I'll just point out some of the major features that the government of Indonesia has tried to put in place to address the currency situation, for example the Indra program that we have all heard and read about, which is based to a large degree upon the Mexican Ficorca model. The Indonesians recognized that the insolvency law that they had in place was weak and consequently through the great effort of the IMF, as well as the government and others, the law was amended. While I won't sit here and tell you that the law is perfect, I will tell you that it is a good law. It actually works quite well, at least on paper, and we are making good progress towards getting it to work in the court system, although you wouldn't believe that looking at the press. These things were under way when we approached Indonesia. It has long been our view that the insolvency law and the currency mechanisms are critical, but they represent maybe 20-30% of what needs to get done if you are really going to properly attack corporate debt in a country in crisis because where do most restructuring really get done? They get done out of court, outside of the context of government involvement and court supervision. So, what we decided to do was to suggest to the government that they launch something called the Jakarta Initiative ultimately which is designed to be a set of rules and guidelines for restructuring debt. What do you do if you are an heavily overleveraged Indonesian company and your response to your creditors has historically been not to answer the phone because you don't have to, because you know that, even if you don't talk to your creditors and they want to get angry and they want to take you to court, they are going to get no joy? Well, what you do, I think, is you set in place these rules, you set in place a government body which states that it is now the policy of the government of Indonesia to restructure, and that we believe as a government that we are losing value to our foreign competition by simply allowing continued creditor stalemate, because it is not as simple as just not answering the phone. the other side of the equation is while you are not answering the phone, you are finding it increasingly difficult to borrow additional funds from other sources so that you can continue to grow your business and you are finding that your business is going like this. Consequently, it is important to put this set of rules into place.

What is the Jakarta Initiative? Just very briefly, it is a set of rules loosely based on out-of-court restructuring rules that most of us would be familiar with in the United States, in Europe, elsewhere. It is a process whereby a company is to organize its creditors, it's private sector driven process to a great extent. It involves a standstill, information sharing, etc. What we found in Indonesia is that has been very important for the government to play one role, and that is in the selection of private sector facilitators who can get involved to mediate some of the initial cultural and procedural differences among the parties in interest. Notwithstanding the skepticism that I can feel in the room, and that I feel everywhere that I talk about this, I think you all would be pleasantly surprised to be in our offices in Jakarta and see what is going on. We admittedly have a long, long battle, and we have a great degree of difficulties on issues ranging from improvements to the insolvency law to questions of corruption, and on, and on. But nevertheless, we have about 100 companies in Indonesia now under the auspices of the Jakarta Initiative who are actually seriously talking with their creditors. And the creditors hold in aggregate some 11 billion dollars which is a significant percentage of the roughly 80 billion dollar external debt problem. Several agreements in principle have been reached. A couple of major deals have been reached. I just came from a meeting with another company that has got about a billion in US dollars in debt and was talking seriously with its creditors about a huge equitization of the debt, parting with some 40% of equity. So, yes, we have a lot of to deal with, but we have been very encouraged so far. And, yes, the initial response of the private sector has been cautious and has been skeptical but those who are exposed in Indonesia now have been coming to the table ready to roll up their sleeves and try the process. And that has been a productive start. The features I think that they are finding most attractive are the fact that the rules are predictable, that they are transparent, and that they are familiar, the fact that, if it is needed, there will be internationally qualified and talented independent private sector facilitators who have played a critical role in a number of our deals, and the fact that the government has made its commitment as clear as it has.

So, I guess I would just sum up by saying that again, from our perspective, we believe these crises are, at least to a significant degree, rooted in the problems that the private corporate sector, and that to focus on those, at least in part, can help lead us to solutions. And that is why I was very pleased when Mr. Uzan invited us to come. Thank you very much.

Andres Solimano: Thank you Timothy. Now, the time is for Paul Leake.

Paul Leake, Partner, Weil, Gotshal & Manges

Paul Leake: I too hesitate to tackle topics of cosmic importance. I approach these conferences in the following way: I guess everybody should speak about what they understand best and what they do for a living, and hopefully, some of us, maybe all of us, are smart enough to understand what the links are between everything we are saying, and get something productive out of it. So, having said that, I am going to make some observations about things that I do for a living.

I am a US corporate restructuring and bankruptcy lawyer. So, I am going to make a couple of observations about how the corporate private debt restructuring works and then, how transnational corporate debt restructuring work in theory and, more importantly, in practice. I will conclude, because Marc asked me too, with a couple of comments about what role the IMF may or may not play in a transnational scene, but I hesitate to do so with a representative of the IMF next to me, though, from what I heard a few minutes ago, I think I am safe.

One of the things that we all heard, certainly at the beginning, and all through the Asian crisis, was that each of these countries have to develop better bankruptcy law, better insolvency law. I think some people meant that as a short cut of some type to a predictable fair process where there could be actual true restructuring of corporate debt. I think that school of thoughts kind of looked at the nation builders and said, it take too long, and we are not even sure you'll be getting it right, so let's get some pure and simple rules in place and we'll just live by those through this crisis and other people can worry about the long-term aspects. It is not quite so simple, and in fact, it is one of the good thing about the Jakarta Initiative, it goes well beyond saying let's fix the bankruptcy laws. And the reason it is not so simple is that bankruptcy laws are not much more really than a collection of procedural rules that govern how you deal with centralization in one form, when you talk about a domestic bankruptcy, of resolution of assets and liabilities. There certainly are some very powerful substantive rules that are incorporated in various bankruptcy laws, but for the most part, it is a procedural code in most countries, and in every single country that has a bankruptcy law, the bankruptcy laws look to the equivalent of US State law, the non-bankruptcy to determine a lot of the basic rights and remedies between parties to a commercial transaction. So, having understood that complexity about putting together a decent set of what people short handed call bankruptcy law, but it really means putting together a legal set of laws and institutions to create a decent legal system. So understanding that difficulty, I guess it is worth asking what is it that everybody thinks is beneficial in that bigger bankruptcy structure. The fancy answer is that bankruptcy laws are intended to balance the competing interests of the debtors and their creditors and other constituencies in a distress situation and, in doing so, the laws are intended to take into account some pretty important factors. One of the things you want to do is avoid the courthouse, you want to create a leveled playing field, you want to basically inject fairness into the process. And one of the most important things is you don't want to lose value unnecessarily. That is, I guess, the fancy answer.

The better answer is something that Tim did a little bit earlier, and that I do want to spend a couple of minutes to go further on the notion, is that what people are looking for when they said let's get some decent bankruptcy laws in here is predictability. I'll use the US as an example, and it is not because I think the US has a particularly great system. It certainly has all its deficiencies. The important thing is that even the deficiencies are predictable. So, I would go so far as to say what people are asking for is a set of bankruptcy laws, almost no matter what they say. If it is an unleveled playing field, at least just tell me where the tilt is and then I can decide whether I want to participate or not. We call that, in my practice here in the States, the Chapter 11 paradigm, or the Chapter 11 backdrop. And all that really means is that when I enter a room, literally or figuratively, of debtors and creditors, everybody in that room basically knows what the governing laws are, everybody basically knows how they are going to be enforced, and everybody basically knows how long it is going to take and at what cost. And what we don't know is what the particular facts of that restructuring are, we don't know the particular personalities, we don't know the personality out of the judge, whether they have a tendency one way or the other on gray issues of law, and we certainly don't know what the underlying motivations are that are motivating different constituencies in the room that goes beyond simply maximizing value, competitive interests and the likes. Those are the uncertainties that in the US restructuring just provide for give and take. They don;t ruin the process. And the reason is, ultimately, in the grand scheme of things, there is relative predictability about where you are going to come out. And it either leads to an out-of-court restructuring because if we don't play by the rules and generally get to where we want to get, it will be a disorderly liquidation, or even if you do reach a resolution, you may want to do through an orderly Chapter 11 process whether again, orderly reorg. or orderly liquidation. The point being though, is that you bring relative certainty into the process. That is exactly what most commentators were complaining about in the beginning and even today in the Asian crisis, you don't have that predictability. The important point, though, being that it is not a matter of just drafting up some bankruptcy laws that look good on paper. Coming back to it, that is what is interesting about the Jakarta Initiative. I wont spend any time on it, perhaps we can in the give & take. The Jakarta Initiative goes well beyond drafting some bankruptcy laws that seem to make sense in their face. There is a one-stop shopping regime, I would call it, that is incorporated into the Jakarta Initiative that seems to be a sort of acknowledgment that we need more than laws, and it is an acknowledgment of let's try to put it into effect, almost overnight, a backdrop of legal laws and institutions that will bring the ultimate predictability to these laws.

Let me jump now to how this all fits into a transnational restructuring. Let's assume, for the time being, that we can get past the first issue, which is a big thing to get past, and that most of the nation states get around to instituting some bankruptcy laws that we all can basically understand. Where does that get you in a global economy? How is financial distress dealt with in a global economy? Take your typical multinational corporation. It operates businesses, owns assets, has creditors and employs people in several, sometimes many, jurisdictions. As soon as that enterprise hits financial wall, goes into distress, there are numerous competing parties asserting competing claims in competing jurisdictions applying competing laws. It is kind of a mess. In order to get your hands around a transnational insolvency, there are a couple things you have to look at. The first is, and again each of the bankruptcy laws that are incorporated in different countries takes a different emphasis on the different size of these questions, do you use one forum to deal with the many different countries that are relevant to this particular multinational restructuring or do you, in deference to the sovereign rights of the different nations, decide that you are just going to have to live with concurrent proceedings, and you can either live with them, try to make them work together and coordinate them or you are just going to have multiple proceedings and no coordination, which is the worst of all circumstances. A related point is do you use one set of laws. You could conceivably come up and identify what is the main forum in any transnational restructuring and decide those laws are going to apply to restructuring assets and liabilities no matter where they are, and no matter what country there are in. It goes too far, obviously. The other extreme is when there is no acknowledgment of anybody else's laws and all you do is that you apply your laws to the assets and liabilities that are in your resident forum, and in the worst case scenario, you don't try to coordinate anything, and there is going to be unequal distribution of value to creditors in similar situated circumstances. The last major theoretical underpinning of those restructurings is the concept of comedy. How much deference does one court give to another court? These are all beautiful nice theoretical concepts. The amazing thing is when you get involved in a transnational insolvency, you are immediately hit against reality. And the reality is what our short-handed would call the bankruptcy or insolvency laws and related laws in the countries that are relevant to the transnational insolvency you are dealing with at the time, and the differences, in many, in virtually all circumstances, very significant, very material. We are not talking about marginal issues. We are talking about governance. Who runs the company when it is in distress? What are the duties and liabilities of the officers and directors? Is there a moratorium put in place in different countries? Do the bankruptcy laws in one country respect rehabilitation more than liquidation? What are secured creditors' rights? What are property rights generally? What deference is given to priority and distribution schemes? You look at different bankruptcy laws and you get involved in these restructurings. And it really becomes a real game of trying to coordinate the entire restructuring.

Now, given all this uncertainty, given all the diversity of laws and theoretical underpinnings here, superficially, I guess, it is remarkable that there has been so little globalization of international insolvency the way there has been globalization of international commerce. Earlier we heard references to it, there is no international bankruptcy court. There is no international bankruptcy law. There are no international conventions that bind countries. There are a few bilateral and fewer regional treaties that attempt to deal with bankruptcy issues. But, for the most part, there are marginal and barely used. The best we have going at the moment, and I don't want to denigrate great efforts on a lot of other initiatives, but the best thing going at the moment is what is called the model law on cross-border insolvency that was put together by UNCITRAL, which is the United Nations Commission on International Law. Even that, though, is really, let's talk a bout the limitations of it, a procedural mechanism for coordinating transnational insolvencies. It is not binding on anybody yet. It is only going to be binding on those countries that choose to adopt it. It is currently winding its way through Congress, which puts the US far ahead of most other people who haven't even looked at this law. Assuming the best case scenario that you get a number of countries adopting it, all it does again is really talk about coordinating multinational cases. It doesn't talk about imposing some overarching supranational bankruptcy law.

So, understanding all these theoretical and practical deficiencies, how does this transnational insolvency work in practice? It kind of surprises my clients sometimes. I have three transnational restructurings going on right now. One of them is turning out to be a successful reorganization. One is turning out to be an orderly liquidation. The other one is still trying to figure out what it is. I could choose any of them, but I will describe one of them and the process is basically going to be the exact same thing. I got a call from a client. The client turns out to be the largest creditor in this case of a Dutch holding company. The Dutch company through its subsidiaries has operations in the US, in various European countries, and japan. First thing you do is you get hold of the documents and figure out where the assets/liabilities are, just to figure out the basic picture. Second thing, most important thing in the whole process, I pick up the phone, and I call my favorite Dutch lawyer. His name is Dirk. And I call my favorite Japanese lawyer, and he says here is the situation this time around, here is basically where things are. And you talk about what is going on. This is on the creditor's side the example I am giving but I could talk about the debtor's side. But from this perspective, you talk about given the various bankruptcy laws and other related laws that exist in these three relevant jurisdictions of this transnational insolvency, what is the debtor planning now to get the greatest advantage in this restructuring, what form are they going to shop for in order to get the greatest leverage. And how in the bankruptcy courts am I going to coordinate very material differences and substances of law? None of this process implicates other than at a very sub-conscious level, all the very fancy discussions you can have about these international treaties, conventions and initiatives. It really comes down to, on the legal side, on an ad-hoc basis, lawyers trying to coordinate all the various differences in the restructuring.

So, it brings me to, I guess, the concluding point. What I was trying to really get across is that we can talk all the theory you want, and I drafted with some colleagues a very long paper if you want to take the time to read it, go ahead, but what I really want to get to is that as a practical matter, how does this stuff work? And understanding some of the difficulties, what can the IMF's role be in a transnational insolvency? Well, from time to time, we have heard three basic roles being considered. The first is acting as an international bankruptcy court. Not going to happen, certainly not going to happen anytime soon. A couple of major reasons: one is that for a body to take on a judicial role, it really has to have absolute disinterestedness. And given the IMF's other very important role, and more important than even considering a new bankruptcy court role, it just simply will not have the disinterestedness necessary anytime soon to play that role in an effective way. Just as importantly, there is no bankruptcy laws, we said earlier. What law would the IMF be applying if it was acting as a bankruptcy court? It certainly could choose from various laws that are available, but that immediately implicates the conflict question again. Because the IMF has the other roles, including lending to various of those nations, you run towards a conflict issue. Third and most important, I don't think the IMF wants to do it.

The second role that has been spoken about from time to time is acting as an international mediator. That is getting closer to something that is realistic. In fact, some of what they do already has aspects of it. An important distinction I think is that, if there is a role to be played as mediator, and again, you have some conflict issues, it probably is more relevant to a workout circumstance than it is to a formal bankruptcy circumstance. In a workout, certainly on a consensual basis, people can have anybody they want in the room, which is one of the downside of the role as well. The IMF can't be forced on anyone else in that circumstance. In a more formal bankruptcy role, you are going to have to have international treaties and laws that give standing to the IMF playing a formal role with any power in the various countries in which the restructuring is taking place. We are having enough hard time getting something of the nature of UNCITRAL through, so I think it would be some time before you get a real credible role of the IMF as a mediator in a bankruptcy case.

And the last role, and by far the most relevant, is the IMF acting as an international law reformer. It does a lot of that already. The only observation I would make about that is, going back to the theme at the beginning of my remarks, that first, the IMF can play a big role in just getting any laws in place in some of the countries. Like I said earlier, almost no matter what they are, it can get something in there that is predictable. Much more importantly, and this goes to I think what was requested of us by the moderator at the beginning, looking at immediate versus future, much more important is the future role. The IMF could really play a role in bringing some convergence to the very different bankruptcy laws in the international community. In the last ten to twenty years, there has been a remarkable transition to more convergence. Having said that, they are still as disparate as you can possibly imagine. That is a real creative and effective role that could played.

Andres Solimano: Thank you very much Paul. We now open the floor for comments, discussions, reactions.

Riccardo Faini: It is a question for Mr. DeSieno. It is more a curiosity than a question. One difficult issue in a bankruptcy procedure is to determine the liquidation value of the firm. My question is the following: this is even more difficult of course in the context of a major economic crisis like the one we had in Indonesia. So, how did you go about in determining whether a firm is more valuable in a situation where the currency was fluctuating from 15,000 rupiah to the dollar to 7,000 rupiah to the dollar? How can people find an agreement under these conditions?

Tim DeSieno: I think that is a very good point. Had we launched the Jakarta Initiative about a year ago when the rupiah was 12-13-17, we would have gotten nowhere. As a matter of fact, I think we just got lucky it happened to have swung back down into a range when people seemed to be willing to talk, and it has remained relatively stable. The fundamental point is, I couldn't agree with you more, when a currency is going like this, it is hard to nail anything down. But I suppose something could be done anyway if people wanted to. It is all about information. It is all about evaluating that information and trying to evaluate whether you are willing to cut a deal based on it. And if you don't have trust in where the currency is going to be, you can try to design deals that would adjust based upon where the currency is in the future. So, there is nothing that perfectly can be done. We just happened to be in a fortunate phase right now where I think deals can be struck. Let's wait to see what May and June bring.

Unknown: I have a question for Mr. DeSieno also. You talked about the incentives for getting bankruptcy laws in place, or bankruptcy systems, and how there seems to be good opportunities to do so. One thing that was very frustrating in Indonesia when I used to go there in the mid-90s as Mission Chief and trying to argue that different laws would be implemented that they already had is that we had very little leverage to get what we wanted. What scope do you see from bringing together interested parties or using IMF's surveillance, if you like, to get bankruptcy provisions more suitable or those that exist to be implemented better from your observations?

Tim DeSieno: I ma not sure I am perfectly qualified to answer that. We observe the IMF in a very active role, a very constructively active role suggesting that the insolvency laws could be looked at, playing a substantive role in looking at it. And I have always assumed, perhaps too simplisticly, that the leverage was the monthly review process and the letter of intent, and whether the next trench of a billion dollars was going to come to sort of keep the process moving along. That won't last for ever of course. I think it is critical enough that it be done that everybody should be advocating it, and if the Fund finds itself in a position to have the ear of the government, it should take that position. I think that one thing you can do is point to Indonesia. This way, you may end up if you continue on this path.

Paul Leake: Perhaps, I could make a comment on that. I was at a meeting virtually to the day a year ago with a number of distressed investors in my offices and it was kind of remarkable that they represented several billions of dollars of money waiting to go to Asia. And listening to their agendas, one is going on Monday, one is going on Tuesday, and everybody is going to four-five different countries over the next two weeks. For every dollar that was invested in that group, 10 dollars came back non-invested. In Indonesia, what I heard was, at the time that was too preliminary really for the Jakarta Initiative, but when the Jakarta Initiative was beginning to formulate, what I have heard from my clients who otherwise had that money to invest in distressed situations is the one thing the Jakarta Initiative cannot address and had to address, even if it was totally successful on its own objectives, is political risk. Political risk factor in Indonesia is so extreme that it has to be dealt with otherwise this money will not be made available for investment there. Every debtor that goes through the Jakarta Initiative is going to need, at least from what I have see, and I don't pretend to be anyone nearly as informed as Tim on this, new capital. There is no doubt about that. Forget trading their debt, new capital is going to be necessary. What I heard from my clients is we will not put new capital in Indonesia because of the political risk. So, what you have to do is come up with, overlaying on top of the Jakarta Initiative, some kind of political risk insurance arrangement. There are many ways to do that. Obviously, you can go to guarantees but immediately that allows somebody to stand up and say if you talk about the government doing that, or some international agency doing that, you raise moral hazard. And as soon as somebody can raise moral hazard, they have won the debate. So, there are different ways to do it. You can use structured financed techniques that subordinate certain creditors,, and it could be governments, in a manner that provides that funds being provided as an indented fund fro political risk. There are several different types of credit enhancement tools that have to be overlaid in Indonesia, just given the extremity of the political risk issue there.

Robert McNally: I would like to come back to a point that Ms. Lissakers raised, and this is a question for her regarding the measurement of the liabilities of the banking systems under stress and the link between those liabilities and the public budgets. We are particularly concerned about that regarding Europe. But my question is are you satisfied that the potential liabilities of banking systems under stress are adequately measured now, and that the links between those liabilities and public budgets is understood? And to the degree you are not, who and how, from where can we expect efforts to measure that more adequately?

Karin Lissakers: I don't think that anyone can be satisfied with the precision of measurement. I think that one of the major purposes of the preventive efforts are in introducing sound banking practices and effective supervision and regulation into member countries generally. This is an effort, a broad-based effort that involves not only the IMF, but the G-10 central banks, the various Basle groups, BIS. A key component of that will be to try to improve the quality and timeliness of the disclosure and accounting principles. And all of these go together. it is not a construct that you can put in place overnight, but I think there is now a very concerted effort, as I said, not just by the IMF. We are building up our expertise in this area necessarily, and the World Bank is very actively engaged as well. But it is now important an area where the regulatory authorities of the major industrial countries are very actively engaged, and engaged in a proactive way of trying to work with interested emerging market countries to improve the systems. And that obviously, will reduce the implicit contingent liabilities for the public sector.

Andres Solimano: If there is no other questions, we will close for a break, and come back in 15 minutes. Thank you very much.

DISCUSSION **The Response of the Private Sector**

Chair: Andres Solimano, Director of Country Unit, The World Bank

Andres Solimano: Let's pursue the discussion and try to get the response of the private sector. We'll have four speakers for this afternoon. We'll start with Mr. George Vojta, Vice-Chairman of the Board at Bankers Trust.

George Vojta, Vice-Chairman of the Board, Bankers Trust

George Vojta: Thank you very much and good afternoon. In thinking about the response of the private sector to the issues that we are addressing today, I would like to just begin by obviously restating what is well known to all of us, and the fact is that our financial and economic world is increasingly inter-connected. But, beyond that, prior to the onset of the current crisis, we reached a rather extraordinary time in the world in that, as many commentators have pointed out, the so-called ideological debate about the best system of economic governance in the world seems to have ended in favor of a market-based economy as opposed to a command style of economy or a socialist style of economy. And we can all remember the period of great optimism that followed that which somebody coined a wonderful phrase about we are ending the era of goldy locks capitalism, the unbridled sense of positive things to come now that the world ideological economic conflict had finished. Of course, in addition, we all know that the technological advances in the world in the spread of information technology has reinforced the inter-connectivity of the world of finance, and brought us what we have come to call the phenomenon of increasing market correlation during periods of stress and disturbance, the so-called contagion effects making things quite more hazardous for everybody. I think that if you accept that framework, one way to look at this current set of circumstances is, as many have pointed out, this is a confrontation between the forces of globalism, or market connectivity, with the traditional presence of national economies, nation states sovereignty, protected markets to some extent, and so on. For me, anyway, one of the conclusions I draw is that this clash of market discipline impacting on the economies and financial markets of so many nation states, this time around was particularly brutal, particularly painful, and fraught with losses, many of which are yet to be recognized. And as Ms. Lissakers pointed out, an open questions around the world today are the allocation of those losses between segments of society within the member states and the economic system, as well as the allocation between the public sector and the private sector. So, while we are pointing towards, in many ways, a more inter-connected, and we have serious thinking going on about how to improve the governance of the world financial system and the economy at the official level, looking ahead for the near-term, three to five years, something of that nature, we can say that it is unlikely that we are going to see a radically different structure of global governance. If anything, we'll iterate our way to that. So that we are faced with the extension of the phenomena of nation states, governance models practiced by nation states operating in again an inter-connected world. Although many argue that there is a serious risk of a reversion to protectionism, or financial controls, capital controls, exchange controls, certainly that cannot be discounted, but I would say the best estimate going forward is that the degree of inter-connectivity that now prevails and has prevailed in the last few years is likely to stay pretty much intact., and, if anything, to extend. So, my sense of this is that looking at the private sector relative to these general statements, this is about the right framework to do.

First, the private sector's role has to do with the general situation when things are in a more normal state of affairs prior to a crisis emerging. And if you accept my basic formulation that the path to sustained growth and development under reasonably stable conditions is something like the model of a market economy with good fiscal and monetary discipline, a competitive exchange rate, an incentivizing investment climate, acceptable legal regime, absence of corruption, and so on, it comes down to looking at the world as evaluating particular member countries in terms of their state of execution along the path towards this model. I don't think it is a matter of fundamental debate. It seems now to be a matter of execution. Where are countries, in terms of their present circumstances and direction, going towards the model that in the history of economic affairs, the development experience, let's say, since World War 2, seems to have proven to be the best alternative under many competing choices? And, as the world has become inter-connected, in this pre-crisis frame of mind, since all nations of any significance must access the foreign capital markets and attract foreign investment and so on, those who are in a position to make commitments in this area, as investors, lenders, market participants in the local markets, I would say fundamentally in this circumstance have the role of validating in a positive way, or being negative, about the direction of policy execution in the markets in which they are participating. In other words, if you go in, on some basis or another, you are going in because presumably, you have made a professional judgment that the risk/reward trade-off is acceptable. And therefore, the underlying performance track of the economies that you are participating in is decent enough to afford to take a principal risk in some form or another. So, if a private sector, broadly defined, is functioning in this regard, it comes down to the fact that those economies that are on the right policy track, the right performance track, should be able to attract sufficient investment, capital and support for their financial markets to keep them moving along the developed path in reasonably decent circumstances. And those that can't do that would have either more difficulty or, in some cases, be unable to attract such support from the markets in the global sense. All of the things that we have heard about transparency, improvement in monitoring national economic performance, disclosure, obviously contribute to the possibility of making more enlightened and rational risk/reward decisions by investors and market participants in the respective economies around the world. So, I don't think it is particularly controversial to support those in terms of al of us here.

Now, when we come to the actual crisis itself, as has been the subject of many points of discussions today, it seems to me that what we can say in terms of the private sector's role is that it varies depending upon the nature of the situation. I think there has been, among the more seasoned people who have managed crises, a tendency to become most hesitant to say or support publicly disclosed formula for crisis management. It comes down, as I see it, to people saying case by case is the only way that we can approach these things because the nature of the circumstances in each case are tending to be different. The mix of exposures, the pattern of participation is going to be different. The nature of the problem is different. So, there is an inevitable customization of the solution that has to be made in reference to the particular situation. Just to repeat, in the South Korean situation, as you all remember, the precipitating point in the crisis was the cessation of rollovers of short-term trade credit from the banking system. And this occurred after there were the first announcements of the public sector support programs. And as that hammerage developed, it became clear that unless something was done about that, the whole crisis management solution was at risk. And in that case, the pivotal variable in the equation to turn things around was to get the commercial banking system in the trade credit picture of Korea to go to a standstill and a rollover, and a renewal, and so on, and from there, things went forward. In the Brazilian case, it is clearly fiscal deficits, the value of the exchange rate, that is a matter for official discussion as opposed to private sector discussion. Private sector is involved in every crisis, but the nature of that role depends on circumstances.

I would lie to make one more point in this respect, which is to emphasize that in terms of claims on countries, I think it is very important to keep emphasizing in our thinking that, given the nature of external debt and investment now, principally insecuritized form, as opposed to bank credit form, and with such other types of exposures as derivatives and off balance sheet issues, the debt is more defused. But the professional management of that debt is in the hands of fiduciaries who have accountabilities in the fiduciary sense that are quite strong. A fund manager is responsible for publishing its performance regularly, and most of the instruments that he is involved in are subject to market to market evaluations. That is quite a bit different when the international credit was in the hands of the commercial banks not subject to market to market disciplines. SO, the nature of increased fiduciary scrutiny is extremely important to understand. I think that is the reason for these abrupt turnarounds, these sudden cessations of support for a currency or for a market. While supported by the information technology, this scrutiny can only intensify in the future. It means that reaction times are short. A crisis can come up more quickly, and that is the ultimate consequence.

My concluding sentence is simply this: I think the long-term consequences of this situation that we are managing through will be to raise the bar of country access to the global financial and investment markets, as a result of these experiences. And access or not will be a matter of national will, national success in execution in terms of governance policies, macro policies that make sense. And regrettably, I feel that the risk here is that many countries will not be able or be unwilling or both to execute along this path, and their access to the global markets will be severely restricted, and unfortunately, in too many cases, denied. So, the long-term consequence of this to me is that the "have/have not" problem is likely to get worse, and I believe that is quite dangerous for all of us. Thank you.

Andres Solimano: Thank you. the next speaker is Ms. Mary Podesta, Senior Counsel, Investment Company Institute.

Mary Podesta, Senior Counsel, Investment Company Institute

Mary Podesta: Thank you. I am not an economist. I am a lawyer with the Investment Company Institute, which is the trade association for the US mutual fund industry. And I am here to present the somewhat unique perspective of one group of institutional investors in emerging markets: regulated investment companies. Regulated investment companies include both open-end funds, what we in the United States call mutual funds, and closed-end funds. Both open-end and closed-end funds in the US are sold to ordinary retail investors who use these funds as a means for making international investments. The distinguishing feature of a mutual fund is that it always stands ready to redeem shares from its shareholders. Every day it is required to pay shareholders who want to redeem the net asset value of those shares on a daily basis.

In the interest of time, I am going to try to keep my remarks quite brief. I really just want to make three points. First, that regulated investment companies are different from some other institutional investors in emerging markets. They operate under a regulatory regime that requires full disclosure of their activities and significantly limits their ability to borrow or to engage in leveraging. And second, investments by US mutual funds in emerging markets represent a stable source of potential capital for developing countries. Institute research for the period from 1990 to the end of 1997, the period for which we have detailed information, shows that neither shareholders of emerging market funds, nor portfolio managers in emerging market funds behaved in a manner that would have precipitated or exacerbated market volatility. And third, in dealing with volatility and financial crises in emerging markets, policy makers, we would submit, should consider the impact that their policies may have on investors, such as regulated investment companies. While investment companies are long-term investors, they operate under regulations that require daily pricing and liquidity. As a result, measures that seek to lock their money into a country may serve only to keep their money out of the country entirely.

Let me start with some background about the role of mutual funds in cross-border flows. Mutual funds really have become the investment of choice for middle-class investors all over the world. As a result, mutual funds are playing an increasing role in the world's capital markets. In the US, for example, mutual fund assets have grown from $371 billion in 1994 to $5 trillion today. More than half of these assets are in equity funds. Mutual fund assets outside the US also have grown significantly from $1.3 trillion in 1990 to $2.3 trillion at the end of 97. And during the 1990s, mutual funds dedicated to investing outside the borders of their own countries became quite popular in the United States and elsewhere. In the US, for example, at the end of November 1998, total assets of US equity funds specializing in investing outside the US were $383 billion, compared to about $29 billion at the end of 1990. It is important to know that the vast majority of US mutual fund assets that are being invested abroad are in equity funds. Total assets of bond funds invested abroad were $25 billion as up the end of November 98. A portion of the equity assets invested abroad is in funds that specialize in investing in emerging markets. Assets of US mutual funds specializing in emerging markets were about $1 billion in 1990 and increased dramatically to $35 billion at the end of 1996. They stand at about $32 billion as of November 98. This capital represents an important source of long-term capital to emerging market economies.

The first point I want to make is that to appreciate the role that investment companies play in cross-border flows, it helps to understand something about how investment companies operate and are regulated. Investment companies that are sold to the public must register with the SEC and are subject to extensive regulations and rigorous oversight under the Federal Securities Laws. These regulations are designed to achieve two principal goals: to protect the integrity of fund assets and to ensure that investors receive adequate and accurate information about the fund. The Investment Company Acts severely restricts the fund's ability to leverage or to borrow against the value of its portfolio. The SEC also requires that funds that engage in certain techniques, including the use of options, futures, forward contracts and shortselling, must cover their positions. And the effect of these constraints is to severely limit leveraging by mutual fund portfolio managers. Under the US system of regulation, there are no surprises about an investment company's activities. the SEC requires prospectus disclosure of a fund's investment objectives and all principal investment strategies, and about portfolio turnover, if it is high. In addition, a fund has to disclose specifically its policies with respect to certain activities, such as concentration and borrowing money. And in addition, a fund cannot change these policies or any other policies that it deems to be fundamental without submitting the change to a shareholder vote. So shareholders and the market knows what funds will be investing in, and how frequently they will trade their portfolios. Thus, under the US system of regulation, the activities of registered investment companies are strictly regulated and fully transparent. From a policy perspective, this is because these investment companies offer and sell their shares to the public. US law provides a different treatment for private investment companies, such as hedge funds, that are not sold to the public. It is assumed that, while the institutions and individuals that invest in hedge funds and the financial institutions that lend to them are sophisticated enough to properly evaluate these funds, and to make appropriate investment decisions.

What do we know about the behavior of US investment companies in emerging markets? This morning, Carlos Asilis wondered whether certain emerging market funds had to face redemptions or whose portfolio managers might have thought they needed to raise cash to deal of the possibility of redemptions in a financial crisis. Are shareholders in emerging market funds prone to panic during significant market events, and even if shareholders do not panic and redeem in large amounts, how do the portfolio managers behave? The Institute has published two research studies on this subject. The first covered the first half of the 1990's, a period that included the Mexican peso crisis. And the second study, which was published last year, covers the period to the end of 1997, a period that included the Asian financial crisis of the summer and fall of 1997. Copies of these studies are on the table outside, if you haven't already received them. These studies show that, despite considerable volatility in return on equity investments in emerging markets during the periods that we studied, shareholders of emerging market funds reacted calmly. Notwithstanding the magnitude of the losses in those markets and the publicity that they received, shareholders' withdrawals from emerging market funds, when they occurred, were not precipitous and, in fact, were relatively modest. This is consistent with our findings as to the behavior of US mutual fund shareholders during market breaks in the US. Because fund shareholders do not panic during these market events, there is no pressure on fund portfolio managers to sell securities quickly in order to meet redemptions. Portfolio managers themselves also reacted to the financial crises in a measured fashion. After the onset of the Asian crisis in July 97, US emerging market funds added to their holdings to their holdings of stocks in Asia. They were net sellers of Asian equity securities only in November 97, and the liquidations were almost entirely in funds that invested only in Asia, and likely were a response to shareholders' redemptions. US emerging market funds that invest across the globe were net purchasers of significant amounts of Asian equities during the last half of 1997. We think that the Institute research demonstrates that investments in emerging markets by US mutual funds is not hot money, and that the behavior of shareholders and portfolio managers from 1990 to 1997 indicates that US mutual funds instead represent a stable source for potential capital for developing countries.

And that brings me to my last point. In dealing with volatility and financial crises in emerging markets, policy makers need to consider the impact that the policies will have on investment companies and other long-term investors. Some measures to control emerging market volatility have the perverse effect of discouraging investments entirely. As we have seen, mutual funds have a good track record as long-term investors, but they operate under regulations that require liquidity and daily pricing. The SEC requires mutual funds to invest substantially all their assets in liquid securities in order to remain ready to satisfy redemptions. Mutual funds also are required to value their investments in US dollars on a daily basis. Repatriation restrictions and other measures that are designed to make it harder for foreigners to get their money out of a country make it difficult for funds to comply with these requirements. In addition, currency and repatriation restrictions raise concerns for all investment companies, not just mutual funds. These restrictions limit the investment managers' ability to make portfolio decisions. And a portfolio manager that commits funds to a market like this has to consider, as a fiduciary, whether the investment can be justified in light of available alternatives. Thus, the imposition of measures to keep foreign money in a country can have the effect of keeping the money out entirely. When you think about this, it is not illogical. Knowing that a fund can get its money out of a country at any time is an important ingredient in allowing fund shareholders and the fund itself to have the confidence to be a long-term investor. Let me give you one example. The currency restrictions imposed in Malaysia on September 1st were designed to curb speculation in short-term flows, but because of US regulatory requirements, they have had the effect of discouraging any new investment in Malaysia by registered investment companies. I mentioned Malaysia not to single out the Malaysians but to just to illustrate the point that I would like to make in concluding my remarks, and that is in dealing with short-term volatility and in trying to deal with a financial crisis, policy makers need to fashion measures that don't operate to discourage the long-term investments that these economies need. Thank you.

Andres Solimano: Thank you very much. Now is time for Ernest Patrikis, Special Adviser to the Chairman, AIG.

Ernest Patrikis, Special Adviser to the Chairman, AIG

Ernest Patrikis: Good afternoon. One of the responses to a crisis is privatization, and I think both Jeff Shafer and I represent privatization of the United States **. I am quite new to the private sector, having been at AIG for about six months. Therefore, if you want to discount my remarks based on my experience, I will be willing to accept that. What is the role of the public sector and the private sector? The private sector generates capital flows, the public sector bridges bumps. We cannot forget that the private sector are not philanthropic institutions. The directors of a corporation have a fiduciary obligation to their shareholders. Another point I want to make at the start is that markets are not always reasonable, but they do things for reasons. If there is a problem and the country has no coherent or credible plan for dealing with the problem, then the private sector and the public sector cannot solve the problem. Before getting to the issue at hand and the role of the private sector in the resolution of financial crises, I would like to start off with a principle. Do know how. In other words, there ought to be a minimum level of behavior governing the actions of financial firms. This falls someplace between the first private sector panel, "Preventing Financial Crises", and the second "Resolving Financial Crises". What I am getting at is the situation of relatively small countries with emerging economies whose financial markets can be manipulated by private sector market participants, which can amass substantial amounts of funds. The question here is whether these smaller countries can develop mechanisms to address potential and actual financial market manipulation which do not themselves hamper the efficient and liquid operation of those financial markets.

Malaysia has taken an action in one direction. I would assume that people located in places such as Hong Kong, Basle, and Washington are devoted resources to the study of this issue. The smaller countries need to have the ability to protect themselves against massive attacks. Part of this defense might be disclosure. Another part might be rules against manipulation. Another way to deal with this issue is that taken by Chile, putting a governor on the entry of funds into the country in the first instance.

I would like to inject a thought here on the nature of the problem we are addressing. It is not necessarily a private sector response, but an observation. In the sovereign debt crises of the 1980's, central banks provided bridge financing facilities. These facilities were bridges to IMF and World Bank facilities. These bridge facilities were designed to be short-term. In the crises of the 1990's, those bridge facilities did not exist. By the time a Fund program could be put in place, the situation in a troubled country worsened considerably. I would like to pose the question whether there is a need for short-term lender of last resort that would extend secured credit to the troubled nations until a more durable means of addressing the nation's balance of payments problems can be met. Must that lender of last resort consist of central banks? Could it consist of foreign governments, or even private banks? The use of collateral is not entirely revolutionary. If you recall the central bank arrangements with Mexico in the 1980's and the United States arrangements with Mexico in the 1990's, there was provision for an assured means of repayment. Not quite collateral, not quite unsecured. the question remaining is is it practical to try to design some arrangement of this sort for after-shelf use in the future?

AIG is a true multinational financial organization. It does business in countries on a local level. I think 132 countries. It operates through branches and subsidiaries. Consistent with the original purposes of the IMF, AIG encourages countries to open their borders to foreign firms, to capital investment. In carrying on the business of insurance, AIG takes a long-term view. Indeed, I believe we help domestic corporations in product development and marketing techniques as they strive to learn from our activities. Of course, we would be concerned of exchange controls, prohibited current transactions, in effect limiting our ability to withdraw profits or diversifying risk and assets. The challenge for a company like AIG in doing business this way is that our local businesses will suffer, just as other local businesses will suffer, from marasm in macroeconomic policy. In addition, the value of our assets translated into US dollars will be adversely affected if the value of the local currency declines. This is one area where I see the role of the official and the private sectors being complimentary. I believe that the role of the international financial organizations should be to encourage countries to take proper action in the first instance. So, where does this put the role of the private sector? I think that it places us on the side of the IMF engaged in prophylactic action. We should encourage good macroeconomic policy. The best defense is a good offense. The foreign private sector can encourage good economic policy. For example, as busy as H. Grinberg is, nonetheless he finds time to participate on the advisory committee of a number of nations. Well, then what happens when things go wrong? What we have learned is that official money can only buy a short period of time for a country to take action.

I spent a little time thinking about the differences between the debt crises of the 1980's and that of the 1990's. The 1980's debt crisis was one of mostly sovereign borrowers unable to pay US dollar denominated debt. In the 1990's, it is one mainly of private sector firms unable to pay US dollar denominated debt. Well, there is more than enough blame to go around for the cause of the 1980's debt crises, clearly commercial banks did not do a good job of credit risk management. Countries do not fail, they just fail to pay their obligations. In the 1980's, the injection of new official and private sector funds, as well as the rolling over of private sector debtors, was coordinated. The private sector consisted mostly of multinational banks who had a keen interest in not having to write off their debt. The Brady bond was invented. And part of that government debt was securitized. In addition, the government also facilitated debt equity swaps whereby US dollar denominated debt was converted into equity. Countries opened up more to foreign investment. The 1990's crises involve the inability of the private sector to repay dollar denominated debt. In many cases, local banks served as the intermediaries between foreign banks and local borrowers. To what extent was that encouraged by the believe that banks do not fail and that the Basle Capital Accord imposes a 20% capital charge against the credit to a bank, and 100% capital charge for credit to an ordinary business firm? In Mexico, Mexican banks entered in to forward foreign exchange agreements, facilitating investment by institutional investors in Tesebonos, peso denominated dollar indexed government obligations. The Tesebono signaled that the government could not issue straight debt but had to guaranty against exchange risk. Brazil, I believe, issued a similar instrument. Risk management on the part of institutional investors and the Mexican banks was lacking. In other countries, much of the problem was reflected in the inability of local banks to repay dollar obligations. Underlying all of this, were government economic policies that would resolve in problems sooner rather than later. Unlike the 1980's, the off-shore private sector was not initially made part of the solution. Official money was granted without the involvement of the private sector. This permitted some lenders to receive repayment of substantial funds, as central banks credits to local banks replaced funds lent by off-shore banks. After some delay, involvement of multinational banks' debt in restructurings became part of the scenario. It made no sense for official money to be lent to the country if multinational banks were not willing to become part of the solution. In the 1990's, the of-shore multinational banks were not motivated by the threat that the failure of their foreign debt could affect the survival of the bank. Instead, these off-shore multinational banks acted in their own interest. they wanted to continue to do business in these countries. A swap of government debt for private debt was also in their interest. Another development since the 1980's was the amount of private sector debt in equity held by institutional investors, some of this is referred to a short-term capital. No one has figured a way to get these creditors involved in restructurings under current legal regimes. However, official funding to repay these creditors is not a solution. The existence of these off-shore equity and debt security holders should serve as a source of discipline now. For example, knowing that debt security holders can take actions to protect their interests should help motivate debtors to avoid problems.

I would like to dwell for a moment on what I think is a key issue here. Capital markets for both government and private sector securities have grown tremendously. In times of financial turmoil, this blessing soon becomes a curse. The holders of these liquid assets will promptly liquidate them in the troubled country. This will drive asset markets down and will be exacerbated through a feedback mechanism. This will also drive the exchange rate down. The effect will be to drive otherwise good firms into bankruptcy. This will then cause a downward spiral in economic activity in the country. The great challenge is to deal with this problem. Again, two answers I have seen today are capital controls imposed by Malaysia, and the governor imposed on Chile on the entry of capital. I do not possess a better answer, but I suggest that is one of the key problems to be resolved.

Where the private sector can be helpful is acting as a financial adviser. the expertise learned in private debt restructurings can be brought to bear in these situations. A financial adviser can advise on the timing and the pricing of securities to be issued by the government. A financial adviser can help package assets for sale. Governments have been selling off assets acquired from troubled firms that received government support. The financial adviser can assist private debtors in financial reorganization and in bringing in new equity. Once some bottom fishes enter a market, other will follow. One question I have is to what extent is that going on today in South East Asia? Is the same amount of equity investment we saw in Latin America in the 1980's going on in South East Asia today? In other words, is there something about the structure in some countries, where firms have little or no interest in restructuring, or in outside capital because that would destroy the existing political economic and social state of the country? What is desirable is to encourage financial firms to sponsor investment funds designed for long-term investment in these countries. These funds typically are unregistered and have only sophisticated investors as participants. Governments can be helpful here. the host country government, the one in which the asset issuer is located should ensure that it has policies and laws that facilitate this type of investment. The home country government, the one in which the investors are located, should also ensure that it has policies and laws that foster these investment vehicles.

In closing, I feel I can;t adequately respond to the question posed through our group. To me, the answer lies in ascertaining whether the official multinational organizations are designed and have the tools to assist nations in a world where massive amounts of capital flow freely. That is not the world of Bretton Woods. Thank you.

Andres Solimano: Thank you. Now, our last speaker, Mr. Jeffrey Shafer, Vice-Chairman of Salomon Smith Barney.

Jeffrey Shafer, Vice-Chairman, Salomon Smith Barney

Jeffrey Shafer: I had the feeling I was going to be the last speaker at the end of a long day, and I have been trying to decide what I ought to say. In the end, I am going to try to react to or elaborate on a number of points that were made today. And please bear with me if as a result of taking that approach, it is not as clearly structured as it might ideally be. The issue before us is resolving financial crises and the role of the market in that. I must say that when I was on the official side, I sometimes felt the market side's role to sit on the sideline and tell the officials what to do. But where you stand depends on how you sit. And I sit the role of the private sector much more constructively now. I think though that there is something that hasn't been said often enough by this panel, and is very important to recognize, and that is it's far better to prevent than to resolve. And it is probably easier as well. Once a crisis has affected the functioning of markets, it may be that the change is irreversible or takes a very long time to shift back behavior to the way it was before. Therefore, what can follow from the issues we discussed this morning is probably much more important than anything that we are going to be able to add at this stage in the discussion.

Crises are, nonetheless, going to occur. I think it is inherent in human nature, and in financial markets, in an uncertain world to build up vulnerabilities that will eventually expose themselves, so we do need to address the issue. It is worth just a few minutes on where these crises come from before going on to see how the private sector can or should respond to them. One potential source of a crisis is a real shock. And it is amazing how small a role they have played in all the important crises that are on our mind, although it is important not to lose sight of the kind of financial, as well as real, devastation that was created by the hurricane that swept through Central America this year. And they are some small countries, and, therefore, are not in the center of our radar screen, facing financial difficulties as well as very real concrete on the ground difficulties. real shocks can happen and they can be big. But I think it is very instructive how little a role that they in fact have played in the major episodes we are looking at. Policy shocks play a very large role in most of the distress that we have seen. But policy shocks are not usually something that come in a vacuum, although a sudden change of government can trigger that. Most often, they come after a long period of popular delusion that is often sustained by poor information and always sustained by efforts of governments to keep alive an image that is increasingly underneath not supportable. That is what we saw in Mexico at the end of 1994. That is what we have seen in the Asian economies. That is what we saw in Russia. That is what we are now seeing in Brazil. And, I asked a question this morning of why is it that markets are so easily let down the** path. I think there is a problem, that it does happen. It was true of the banks twenty years ago, it is true of the capital markets now. It is probably a reflection of human behavior. And having missed some of these, and think back to 18 months ago, I was part of the general consensus that Asia was doing something that had never been done before in human history in sustaining unprecedented growth rates. And although, yes, there were problems around the edges, I certainly cannot say that I was one who saw how much vulnerability had built up. But that vulnerability was real. And when it was exposed, it does raise a real question. But I must say, if you look back, even the danger signals that were there in the euphoria of the time were largely ignored. I was concerned about the fixity of exchange rates and found it impossible to engage officials in these governments in a serious discussion of the risks of fixed exchange rates. But neither were markets particularly concerned about that. (end tape)

There were two common elements: one, policy track that was unsustainable and therefore policy changes supported by popular delusion in the global financial markets. I believe that another popular cause of shocks is something I find very difficult to document. Ernie Patrikis referred to it, and that is the fact that the countries are victim of massive attacks. I have seen enough to think that there are occasions when there are powerful investors who have exploited weak situations. I don't see any of those work in cases of major financial crises. I think it is just wrong-headed to focus attention on the issue of actual or potentially predatory investors as the core of the problem that exists here. I don't want to say that they are no problems, that nothing needs to be fixed here, but if all the hedge funds in the world went out of business, it would not have changed the central financial history of the last 18 months, except perhaps, to have created bigger problems sooner because ironically, they were major sources of liquidity well into the crisis. And it was only when these investors were overwhelmed in August of last year that what was a problem of a number of individual countries became an incipient global crisis. And all of the sudden, the world stared in the face the terrible and frightening implications of a world without hedge funds, when they, along with everybody else, ran for cover.

As I said, the core problems that build up and then need to get resolved are widespread popular misevaluation of investment opportunities and that requires adjustments. We have to expect market participants to behave like economic beings. They are going to pursue returns and they are going to manage risk, and the lawyers at the other end of this panel have both reminded you that if it wasn't human nature, the law would require most investors representatives fiduciaries to behave in that way in any event. We should not sit around and fantasize about the world in which investors are going to do other than pursue returns and manage risk. But how they do that does depends on the environment and it is important that, in creating the environment in which crises are resolved, that be done in a way in which both elements of human behavior, both greed and fear, are channeled constructively. And that the process of workout is one that results in a transition back from markets that have become dominated by fear to ones that are dominated by greed, that is the search for a return. That is the healing process. That means allowing those who are willing to back recovery to be rewarded. And that means working to remove uncertainties and attempt to not leave administrative arrangements up in the air indefinitely. What do market participants do when a crisis takes place, responding to these incentives of fear and greed? The first thing they do when they sense that there is a change in the environment, is to tighten their risk controls and look for liquidity, and this often happens, as somebody referred to earlier, because the locus of decision making within a firm elevates. The people that are making decisions are pushed aside, and their superiors come in with less information initially, making more conservative decisions. The second thing that people in the market do is collect information. And you have to frantically try to find out what you didn't know, try to find out what is happening. And, as that happens, the market continues its job of seeking to establish values. And one thing that has happened throughout the last 18 months in the public markets is that day by day, risk has been priced, values has been established for a very broad range of instruments, for very many countries. And that, I think, has been a very constructive role that facilitated decision making both in the public and the private sectors. A second thing that is followed from that, that really should not be underestimated, is that when a crisis occurs, much of the investment is going to shift ownership from people for whom it no longer fits their investment objectives to those who are specialists in workout, who have a taste for risk, who have a different time horizon, and so on.

Day 2

Panel 3 Strengthening International Monetary Cooperation: The Euro in the International Monetary System

Chair: Marc Uzan, Executive Director, Reinventing Bretton Woods Committee

UZAN: Good morning, everyone. We are going to start the second day of our conference. Yesterday we talked a lot about preventing and resolving financial crisis. But if we want to talk about a new financial architecture...and all these plans for this new architecture currently being discussed...I haven't carved out a role for international monetary cooperation, and the development for a new mechanism for action rates surveillance, multilateral cooperation at the international level, given the advent of the Euro. So if for this panel we want to talk about the new financial architecture, we have to take into account the emergence of a new currency in the world, and how this currency will affect the architecture of the world monetary system. We are very pleased to have an impressive panel again this morning. We will start with Mr. Herve Carre. Mr. Carre is the director for the economy of the Euro zone, at the European Union since January 1,989. And before that Mr. Carre was the director of monetary affairs of the State Department. Mr. Carre.

CARRE: Thank you, Marc. It's very difficult to talk about...at this juncture to be the first of such an impressive panel, but I'll try to make some remarks at least. The top balance in the international financial system in the past eighteen months has confirmed the extent of change in the international financial system since the '80s. The scale and mobility of capital flows across the global economy have undermined the traditional certainties. For example, no longer is any financial crisis too far away to be important. No longer can any economy be regarded as too large to be affected by such a crisis. No longer can any one country be expected to resolve a crisis on its own. No longer are the multilateral arrangements for crisis management through Bretton Woods Institutions adequate to the task. This is an impressive list for our agenda.

The introduction of the euro, on the 1st of January of this year has brought yet another major change. The US dollar remains the dominant international currency, but the euro promises to change the dynamic of international monetary relations. As a major currency area, the European Union must assume new international responsibilities. In particular, the European Union must seek to engage its main partners in a constructive dialogue on how the international monetary and financial system can be improved to better manage the crises of the future. This is why I welcomed to opportunity to participate in this seminar on international monetary cooperation. The euro first. It's already a major currency. The euro realm, eleven member states of the European Union, has a population of almost 300, 000, 000. It enjoys a very substantial share of world GDP and world trade. The economic and commercial weight of the euro area is larger than that of Japan, and is broadly comparable to that of the US. In addition, eleven national financial markets have been aggregated into one euro financial market. This will create a situation in which euro denominated assets are actively traded both domestically and internationally. Euro area financial markets will be on a par with those of the US in terms of size. They may be less sophisticated in the early years of the EMU, for right now, but enhanced competition will ensure that they develop relatively quickly. So objectively speaking, the international system has changed since January the 1st of '99.

Second, the euro's potential to become an international currency. There is more room for argument on the prospects for the euro as an important international currency. Also there is a wide spectrum of opinion among academics and policy makers on the issue. At one extreme there is the view that the stability promised by the EMU policy framework, independent monetary policy, and forced fiscal discipline, will ensure that the euro immediately inherits the credibility of the Deutschmark. In these circumstances, there will be a high demand for the euro, and it will become a major international currency almost from the outset.

At the other extreme, there is a view that the emergence of the euro as an international currency is highly unlikely. This view is normally based on predictions of the malfunctioning of the EMU, and/or the idea that investor inertia will constrain demand for the euro. In my opinion the answer lies somewhere in the middle of these two extremes. It's difficult, and I cannot be any more exact than this. Attempt to quantify the future demand for the euro are by nature speculative, because the EMU is a clear structural break with the past. So the determinants of the financial demand for the euro may be predictable, but their effect in terms of magnitude and directions are not.

On the other hand, it is safe to say that euro can become a major international currency, only if financial markets are satisfied with the economic management of the euro area. The EMU policy framework is sound. It is based on a clear and credible commitment to macroeconomic stability and market-based competition. It has already produced demonstrable benefits for the euro area member states in terms of lower inflation and improved public finance.

But financial markets are unlikely to accept the credibly of EMU on trust. They will reserve judgment until they see how EMU operates, how EMU is operated. They will need to be reassured that all the relevant agents are willing to abide by the rules of the game. For this reason, the functioning of EMU in the coming years will be crucial to the future of the euro. As EMU becomes increasingly credible in financial markets, the euro will gradually emerge as a major international currency.

As the euro evolves into a major international currency, the impact on the international monetary system will be profound. The IMS (International Monetary System) will become progressively bipolar...or tripolar: US dollar, euro, and yen. And there will be an inevitable shift in balance within the present system. It is regrettable that the emerging international role of the euro is so often discussed in terms of potential rivalry between the euro and the US dollar. The two currencies may well be competitors as reserve currencies. But this must be seen as a possible outcome of financial market behavior, rather than an objective of economic policy. It should be recognized that the introduction of the euro is not motivated by some desire within the European Union to hijack the dollar as the most important international currency. The objective of EMU, the objective of the creation of the euro, is to set up a more economically dynamic and prosperous framework for Europe. Nobody doubts that such a more dynamic and prosperous Europe is good for the United States and for the world economy. The real issue is whether the euro will contribute to a more stable international monetary system. And this is an open question.

There is no reason why a bipolar, or a tripolar international monetary system should be inherently more stable than the present arrangement. The pursuit of sound economic policies in all the major currency areas would certainly help. In these circumstances financial market expectations would adjust relatively smoothly to international economic developments. Smooth adjustment of expectations would be reflected in correspondingly smooth movements in interest rates and exchange rates, with less disruption to the international monetary system. But is this enough? Will the "sound," quote, unquote, of one economic area always be sound from the viewpoint of other currency areas? The risk of exchange rate volatility in multipolar international monetary system could be increased by the fact that each of the major currency areas is likely to have relatively low trade exposure. As relatively closed economies, they might not be overly concerned about developments in their exchange rate. In these circumstances the negative impacts of exchange rate volatile would be felt more in third countries that had trade links with the major currency areas, or that had targeted their exchange rate against one of the major currencies.

Because of the systemic risks involved, there can be no question of managing the international monetary system on a policy of mutual benign neglect. To avoid such an eventuality, there will be a need to improve the quality of macroeconomic dialogue among the major currency areas. Such improvements would include enhanced surveillance by the relevant international organizations, so as to ensure the necessary transparency in economic developments and policies in each currency area. With the benefits of greater transparency, policy makers in the main currency areas could then begin to intensify monetary cooperation.

However, we must be clear on what is meant by monetary cooperation. Cooperation would involve greater and timelier exchange of information...more frequent multilateral discussions to identify and discuss policy intentions and possible conflicts. However, the basis for such cooperation must be a common commitment to sound economic policies. These practical improvements in international monetary cooperation are clearly achievable and would represent a good beginning. Whether an improved dialogue between the major currency areas evolve into more concrete forms of international policy coordination cannot be foreseen right now. There is no doubt that a Europe with a single currency and a single voice will be better placed to fulfill its responsibilities in any such arrangements.

However, for the moment at least, I feel we should not set our sights too high if we are to avoid creating unjustified expectations. One area in which there is a more urgent need for concrete policy coordination is in responding to international economic and financial crises. As I have already said, the extraordinary events of the past eighteen months have demonstrated that no county or group of countries, irrespective of their size or economic importance, can be fully insulated from contagion effects. Therefore, governments, central banks, and private sector institutions have a strong common interest in working together to overcome, and more importantly, to prevent major disturbances in the functioning of the international economy and financial system. In this respect it is to be hoped that the European Union will bring a unique experience in building consensus between different national viewpoints on complex economic and financial issues.

The member states of the European Union have agreed that they act in concert on these issues. To this end, the heads of states and governments have agreed on how the EU should be represented on the external side. This agreement foresees an important role for the President of the Euro Eleven Group of Finance Ministers, this informal grouping of ministers of finance of the member states sharing the single currency, for the European Central Bank, and for the Commission on issues that are of direct interest to the union. Issues involving the international role of the euro and international cooperation fall clearly into this category. These proposals have been put to the EU's partners in the G-7, and we are waiting for their response. In parallel with the arrangements to streamline external representation of the European Union, efforts are under way to develop common understandings among the member states about the future of the international system. This is work in progress right now. The main areas under consideration include improved transparency and policy making procedures--and this clearly would build on the codes of conduct prepared by the interim committee of the IMF -- but also financial sector supervision, possible measures to deal with volatility in international capital movements, exchange rate regimes, targeted financial and technical assistance, reform of financial institutions, private sector involvement in crisis management. This is the whole agenda of the present conference. This is the whole agenda of the policy makers world today. This is why I'm very glad to be here with you. Thank you very much.

UZAN: Thanks, Herve. We are going to have now Mr. Paul Kimball. He's the Co-Head of the Global Foreign Exchange Department at Morgan Stanley and Dean Witter, a position that he has held since 1993. And Mr. Kimball served as well as the Chairman of the New York Foreign Exchange Committee. Paul.

KIMBALL: Thank you. I will try to give you a practitioner's view of the euro and the prospects therein for the future. First of all, I'd like to make the comment that the euro has been earned. This is a currency that is not artificial in any way. When you look at the convergence of the major policy indicators that occurred within this trading area, from which the eleven came together to create this currency, it is very impressive. I've got some charts, but I'm going to hold all of them until the very end. But I think if you go back and you look at the convergence on, certainly, M1 and M2 within the euro area over the last ten to fifteen years...that in turn converted a convergence on inflation rates. The stability pact gave the impetus to have enough convergence on fiscal policy, by which you then had an eleven that had economic cycles that if not perfectly converged, were very synchronized. On top of that, you can overlay the fact that Europe is very unique in that these eleven are contiguous countries, and the largest proportion of their trade is with each other.

So where the euro is earned, and I think it has been launched very successfully, and it will be a very successful currency. The conditions are very unique to Europe. And I think, if I can just cut really to the bottom line of how I've seen the progression over the last decade of the move towards this currency, my view is that the surprise will be that the euro will actually expand. It will be very successful in the first few years, and satellite countries surrounding these eleven that also have very similar percentage of trade with the euro area, for example, the Scandinavian current countries, obviously Denmark and the UK, they will be very easily absorbed into this currency once it is up and running for a year or so. So as far as I'm concerned, when you look at the convergence of the monetary policies within this area, which is the bedrock for at least thinking about establishing a common currency...and then you have the added element that these are countries that are contiguous and have the majority of their trade with each other, and then you add in the administrative inner play of the European Commission, which constantly binds these markets together, you have the conditions for a very successful common currency. And I know these are all denominations, all these legacy currencies are denominations, they're not composite currencies of the euro.

And so I think what we will see in the year 2001, 2002...we will see a tremendous momentum of these peripheral countries, that I just mentioned, to join. And that will lay the groundwork eventually, if the best prospects beyond that being Greece and Poland...if they continue to do good work on inflation, on money policy, and ultimately on fiscal policy, although the Greeks have more work to do than Poles, actually. They could be next potential candidates for joining, but that would be several years out.

Now, the big question that I have to figure out with my group is where is the euro going to go, because my ability to trade this thing is pretty directly correlated with the fact that I'm sitting here and I have the position I hold--that and other currencies. And I think there's a great debate, as my distinguished central bank colleague here just mentioned, which is that the euro is now a contender for reserves in the world. But I'd like to break that argument down a little bit. The most recent figures I have show that the US dollar has 60% of the world's reserves, and it represents 21% of the world's GDP. The numbers I'm looking at show that euro or collection of currencies, mainly the deutschmark as a predecessor to the euro in terms of reserve holdings...all European euro land currencies represent about 20% of the world's reserves, which is fairly equal to the euro lands' proportion of the world's GDP. So that's a pretty big differential between the US dollar's 60% and the euro at 20%. The one thing I would caution you about, as to this differential creating a big run into the euro, is as follows. The dollar is used in roughly 45% of all trade transactions that are done in the world. And that is not going to change any time soon, not in my opinion. So the dollar isn't as overweighted as it looks. I would compare it's 45% usage in world trade versus it's 60% reserves holding. And I see a differential there, and I think that differential will go to the euro, but that's a much smaller differential than the 60-20 split that the initial analysis would lead you to see. So I think the advent of the euro as a currency that I would say is earned, I mean this is a real currency...it is not going to break up, it is a truly permanent fixture in the world... But it has a positive, which is it is somewhat underowned...but I would posit to you that it is not as underowned as people like to talk about. So it's a positive, but I'd say it's a mild positive.

Now, on the other side of that I think there are a couple of negatives. Number one is a very short-term negative, but this may not go away any time soon. And that is...I'm a great believer, and I've traded off this for a long time, and I'm still here, so it must have made some money somewhere along the line...I'm a great believer that currency markets do to some degree arbitrage banking systems. If you have a great dichotomy between the health of a banking system in one country versus another, it will create a movement ultimately in capital flows between those two countries, and affect the exchange rate. Now this can only be a factor in the extreme, and I think we saw that in Japan in 1997 and 1998 as the world felt that the Japanese authorities were not taking care of the banking system in a way that the West thought was reasonable. I think you saw a great deal of capital flight, and it affected the exchange rate between the dollar and the yen, and the deutschmark and the yen to a great degree. As the Japanese have laid out a very thoughtful, and very long-term, and very potent plan to deal with some of their financial sector problems, that banking system arbitrage has evaporated, and with it the strength of the dollar versus the yen.

So, that is a long-winded way to say that we do have a huge process going on in the world right now. And that is, we have a process of efficiency being injected into the debt management of the private sector. And there are a lot of very questionable loans right now that have been made by the world's banks to the emerging markets, and unfortunately for Europe they have by far the lion's share of these, when you look at the G-7 area. In fact, if you take all emerging market debt, European banks own 68% of it, versus roughly 20% for the United States, and 15% for Japan. So, in a short-term way Europe is going to have to demonstrate in a world where crisis continues, crisis is been contained, and crisis is being worked through, but we are still in a world of crisis...and as we have these hundreds of billions dollars of bad debts, or potential bad debts in the emerging market arena, Europe is going to have to demonstrate over the next eighteen months to two years that it can absorb the capital hit that nonperformance of these loans represents. So that is on the other side a counterweight to the very real activity that's going on in the market, which is the world is accumulating more reserves at the margin in euros than in dollars, and that percentage is shrinking.

So, I see those both as a wash, and for the long-term understanding of where the euro is going to go, I will put it to you, and I'll posit to you... I'd like to use this overhead if possible.

UZAN: Yeah, sure.

KIMBALL: I would like to posit that the old relationship that governed the value of the dollar versus [I/A] still hold. [PAUSE] [LAUGHTER] [I/A]... I found, I mean I've tried to look at [I/A]. We all try to understand the market as best we can. But over twenty-five years trading in the markets I found the relationship that works best to predict the value of the US dollar versus [I/A] currency area, now the euro [I/A] and a lot simpler, is the correlation between account balances between the US and Europe in relation to the interest rate [I/A]. Pretty simply, [I/A]. And I think at the end of the day there will be enough factors on the positive/negative side of the euro because it is a new currency. [I/A] and bring us back to the old fundamentals, that is, how does the US [I/A], relative to the interest differential [I/A]? And that at the end of the day, that relationship, that balancing act, that tug of war, will determine the value of the euro. And I feel right now that we have the best conditions for stability that we've had in a long time. There's a lot of talk about [I/A]...this number here. I'm sorry, this chart is not that legible for you. But this here is [I/A] growing current account deficit the US has with Europe. And you can see that it has had ebb and flows. It's been positive, it's been negative, and it's grown [I/A]. But what's also growing at the same time right now, [I/A] probably proportionally larger in terms of exchange rate [I/A], is the interest differential. And use the [I/A] I found to be the most reliable. [I/A] any interest rates are much more investment driven. They're not subject to short-term swings of liquidity, or short-term factors. The 10-year rates really represent investment flows into those securities. And the 10-year interest differential right now is at a [I/A] the US dollar. And as you can see, that is the orange line. You can see it's a pretty high level, in fact, it's at an almost unprecedented level if you look at it over the last ten years. And I feel that will easily compensate for the deterioration that we have experienced [I/A]. And in fact, what we have is a perfect balancing act. I've had the most success in business when you do not get the countervailing balancing act [I/A]. In other words, when the current account goes against the US., and for whatever reason, political or otherwise, the interest differential falls, [I/A]. The euro...the European currencies will rally [I/A].

What we have here is a perfect offset. Current accounts growing, but the interest rate differential is growing as well. That is usually grounds for stability. And if you dissect this, which of course I have in the most minute detail over the years, those are the periods when the dollar/euro or dollar/mark relationship [I/A]. So right now I think conditions are pretty positive for stability, if not slight dollar strength. And I think that this relationship [I/A] the euro's value versus the dollar.

The last thing I'll leave you with is the thought that, at the margin [I/A], I think this currency will prove less volatile than the old deutschmark, and the collection of currencies related to the deutschmark. And if you look at this chart, this is a chart of the annual volatility [I/A] the deutschmark [I/A] the last ten years. Interestingly enough [I/A] had less volatility than the deutschmark, and there's about a 2% differential here [I/A], and that doesn't look like a lot on this chart. [I/A].

And so my view is that because we don't have the ERM dynamic, which is when the dollar would get weak, for reasons related to the United States, versus the deutschmark, [I/A]. And in fact, exactly why the Europeans wanted to create this currency was [I/A]... So, at the margin, I think, over the long haul this relationship of the euro versus the dollar will probably be less volatile. Thank you very much.

UZAN: Thank you, Paul. We are going to continue with Dick Ware from the World Gold Council. Dick is responsible for encouraging deregulation in gold markets, as well as closely following activities in those markets by official institutions.

WARE: Thank you, Marc. Inevitably, I suppose, in a panel like this I'm not going to duplicate, but certainly implicitly or explicitly comment on some remarks of the previous two speakers. Obviously the title of our session this morning emphasizes the advent of the euro, and the effects that this might have on the international monetary system. We are undoubtedly entering a new era. This is only too obvious when one considers the various different ideas which have recently been, and are still being, floated. To start with, there's been vigorous debate on the ideal exchange rate arrangements for emerging market economies, and we had some discussion about that yesterday.

In addition, however, on the exchange rate front I would also cite one, the proposal floated by French, German, and Japanese ministers for the introduction of more formal target zones for the major currencies. Such schemes have, as we all know, been around for many years. And this is a very good demonstration of the fact that there's nothing new under the sun, when comes to discuss international monetary arrangements. And I should also comment that, of course, these proposals for target zones by finance ministers, prime ministers, have been firmly rejected by a number of senior central bank officials. But the fact that such ideas have resurfaced is clear evidence that people are increasingly concerned at the effects of total freedom in global currency markets.

The second thing I would cite is the idea, which in recent weeks seems to be under increasingly serious discussion, that some countries, especially perhaps those in Latin America, might benefit from dollarization. In other words, the US dollar would replace their own domestic currencies. So it's quite clear that a large number of balls have been thrown into the air, and are still up in the air at the moment.

And so the question I would pose--and given where I come from, you would expect me to pose it--why should gold not be one of those balls that are up there in the air for discussion at the moment?

As I'm sure we all know, the second amendment to the IMF Articles in 1,978 removed virtually all official functions from gold. Herculean efforts were made by the Fund and the US Treasury to demonetize, and perhaps you'll allow me the speculation that it was to demonize rather than to demonetize gold. As part of this process more than 40 million oz. of gold were sold by the Fund and the US government. And both those bodies put strong pressure on Japan and other Asian countries not to buy gold for their reserves. And of course, ultimately the IMF moved to outlaw any member link between gold and their currencies. For some people this attempt to demonetize gold was a success, because it's role in transactions between central banks virtually came to an end. For others however, it was a failure, because gold remains today the second most valuable component in official sector reserves, behind only the dollar, accounting for 16% of the total. And I'm going to talk to Paul later about his calculation of 20% for euro currencies, I'm not quite sure that he took into account the fact reserve currencies, which were, are no longer reserve currencies. But we'll talk about that later. Anyway, as best we can see gold still accounts for 16% in value terms of official reserves.

Anyway, the result of the attempt to demonetize gold was to institutionalize the hegemony of the US dollar. Now, clearly the advent of the euro upsets this situation--this stability, if you like. In the new environment, some would say that gold should be put back on the agenda of those seeking to produce the blueprint for the new financial architecture, which he hear so much about.

What I'd contend however, is that gold has never been away. It's not a question of putting it back. It's never been away. And you've only got to look at the continued role of gold as a major central bank reserve asset, to accept that, I hope. So in this context, and given a number of senior IMF representatives in the audience today, I'd ask a first question: why should a Fund member not be allowed to peg or to link in any way to gold, if it so wants to? The amendments to the Articles in 1,978, Article 4,2B, allows a member of the Fund of the Fund to do virtually anything with its currency, except link it to gold. Why is this? Well, if you back in history, the move to do this twenty-five years ago was designed to enthrone the SDR.

The SDR hasn't, however, succeeded in establishing itself as a genuine international reserve asset, except in the books of the IMF itself. In such circumstances there should surely no reason why gold is precluded from competing on all fours with other reserve assets. For the Fund to outlaw it in the Articles is an outmoded restriction, I would contend.

Now, going back a bit further in history, it might useful to recall earlier exchange rate arrangements. In the 18th and 19th centuries we had bimetalism--currencies defined in terms of both silver and gold. So there were two competing, if you like, reserve assets behind domestic currencies. In the 1870s gold won out, and the gold standard then ensued, which was a brief and relatively stable interlude before the '30s, when the UK and others came off gold. And that in turn led to that dollar exchange standard inaugurated at Bretton Woods. This in turn changed again in 1,971, when the US formally abandoned gold convertibility. In practice that had happened in '68, but it happened formally in '71.

And one lesson we can draw from this brief history, is that international monetary can and do change. And the coming of the euro provides an obvious opportunity to reconsider the whole system, which is why, as I said earlier, there are so many balls up in the air at the moment.

What does today's system look like? For the last half century the dollar has been the hegemonic currency. Why? To start with, and don't forget this, because of the explicit link it used to have with gold. Subsequently, because there was no possible competitor, and the US was after all the strongest economy, and possessed the most liquid capital markets in the world.

Now, however, comes the euro--a currency representing eleven European countries whose combined GDP, as we've been reminded by Mr. Carre, is almost equal to that of the US, and whose internal trade flows immediately make the euro system's economy as closed as that of the US. I won't develop the point today, but it seems to me this is likely to lead to the European authorities, the ECB, but more importantly perhaps, the finance ministers of the eleven countries putting less weight on the importance of the exchange rate as a macro policy tool--benign or malign neglect, whatever you want to call it. So much for the history and my speculation, and I use the word advisedly.

What about the future? Exchange, quite clearly, have always been volatile. And that's one way in which Paul earns his money. The reasons for that volatility are fairly obvious--the particular place of major reserve currency countries in the business cycle, the influence of this on interest rates, and expectations in general. With a single hegemonic currency, however, there weren't many choices to make. Clearly, you might, to hedge your bets, place a part of your portfolio in something else, in DM, yen, sterling, or Swiss francs. But the bulk would remain in dollars. You'd be unlikely to be criticized for so doing. Now, however, we have two potentially equal reserve currencies, and I accept that euro has still to develop into a full-scale reserve currency, but I have no doubt that it will in due course. Although the combined capital market of the EU eleven countries is not yet as large as that of the US, it's dramatically larger than any of the previously individual European countries, as Mr. Care has reminded us. Any central bank looking to diversify its reserves now has a real alternative to the dollar. What might that mean? A basic stock adjustment, presumably, as country which consider themselves underweight in the euro, move to correct that. After that stock adjustment, we will have to wait and see how things stabilize.

But one thing seems to me fairly clear. And I think this is where I differ from Paul, now that countries have a genuine choice between two global currencies, there are likely to be significant moves in and out of them, as sentiment ebbs and flows. The well-observed herd instinct in markets makes this pretty inevitable. Such movements would only go to reinforce the similar instability, which was at times evident in the bimetallic era in the 18th and 19th centuries.

If this prognosis were to turn out to be correct, it's interesting to speculate on the outcome. Can the world live with competing currencies? Or will one eventually become supreme, just as gold ousted silver? Might the SDR or similar globally created money be seen as the ideal ultimate solution? An SDR or a globally created money would after all be an instrument much less influenced by the vagaries of economic policy making in any one reserve currency. Or might gold, as a recognized store of long-term value, stage a comeback on the international monetary scene? It's probably worth noting here that all previous reserve currencies, including at the outset the SDR, had some kind of link with gold. So when the previous speakers have talked about moving from a unipolar to a bipolar, or tripolar system, I think I would argue personally...

Tape 1-Day 2-side B

...do something in relation with the major currencies.

There are a number of possibilities. Quite clearly, you can peg to a major currency, be it the dollar, or now the euro. You can adopt a currency board. And that's a more rigid version of the pegging. You can choose to peg your currency to a basket of some sort, which you would presumably define by trade and investment flows, and possibly also take into account the currency composition of any external liabilities you might have. For commodity producers there may also be value in incorporating in any such basket the price of one's major exports.

But for any country, I would suggest gold should at least be considered as part of a basket. Now why is this? The Bank of England did some internal studies a couple of years ago, and indeed we in the Gold Council have done our own, which on a preliminary basis, at least, support them. And they suggest that the volatility of a central bank's reserve asset portfolio is reduced, and the risk-return balance enhanced by holding anything up to 20% in gold. I grant you that these studies were done before the advent of the euro, and we will have to look at them again, but I actually see no reason why some role for gold should be overturned when we redo them. And the conclusion may surprise you. But it is actually an observed fact that historically gold has been negatively correlated with all other asset classes--stocks, bonds, and the dollar. It's interesting to consider the reasons for the latter inverse relationship between gold and the dollar. I mean, obviously in case the alleged safe haven status of the dollar...geopolitical concerns may lead funds to flow into the US currency. And when the dollar is, in any case, strong for macro reasons, the same effect will be seen. And when the dollar weakens for whatever reason, the position is reversed.

Not every alternative currency will necessarily appear attractive at that time. And some of the reflux from the dollar will go into gold. Most central banks do not see it as their business to take risks. So, by incorporating gold both into a currency basket, used for exchange rate management purposes, and a reserve asset portfolio, volatility is reduced, and the risk-reward picture, as I said, improved.

Which brings me back, to conclude, to the IMF, and, as I would contend, its no longer justified prohibitions on various potentially useful roles for gold, which I mentioned earlier. Perhaps I might just say a few words at the end on the IMF's own gold holdings, which at 103, 000, 000 oz. make the world's third single largest holder of gold, behind the US and Germany. In 1,995, as I'm sure a number of you know, the executive board at the Fund held a long and thoughtful discussion on the subject, and came to some important conclusions. These included the view that gold provided a fundamental strength to the Fund's balance sheet, giving it operational maneuverability, and adding credibility to the level of its precautionary balances. Thus, the board said, any mobilization of gold should be carefully thought out to avoid any weakening of the Fund's overall financial position. In addition, and they said this explicitly, the board felt that the Fund should continue to hold a relatively large amount of gold among its assets, not only for prudential reasons, i.e., to prop up its balance sheet, but also to meet unforeseen contingencies. And I would suggest, with the current state of flux in international monetary arrangements, the debate that's going on, which I attempted to summarize, and others have done so too...who knows what eventually will result in the next year, two years, three years, on the international monetary system. The presence of gold in anyone's balance sheet is a very precautionary asset for unforeseen contingencies.

So that debate took place in 1,995, and I don't think that anything's happened in the outside world in the last four years to invalidate those judgments, very positive judgments which were made by the Fund's EDs. And indeed, given the systemic uncertainties caused by the arrival of the euro, there are surely all the more reasons for the official sector to preserve its gold holdings, and actively consider ways in which its real value can be utilized in this brave new monetary world. Thank you.

UZAN: Thank you, Dick. We are going to Mr. Heins Juergen Scheid, Senior Officer at the European Central Bank.

SCHEID: Thank you. Let me start by saying that as yesterday's discussion mainly focused on financial and possible ways to resolve these, I feel myself in a much more comfortable situation today. I'm providing you with some good news. Some might say the single European currency, the euro, has brought back good old Europe on stage. I'm very much convinced that the euro will be a stabilizing factor in the international monetary system and in the world economy. This conviction is based on the fact that we have a very sound institutional monetary policy framework ensuring that this European currency will be a stable one.

Maybe I should now provide you also with some bad news. Although working for the European Central Bank, as the institution responsible for the supply of euros, even if you find this morning's session so convincing so that you might now immediately go to your bank and try to exchange your greenbacks for euro bank notes, this unfortunately will take some years to come. So you have to wait a little bit more to get the euro bank notes and coins.

Well, now more seriously, before turning to the international side of the euro, please allow me a few words on the general aspects of this advent of a new currency. The introduction of the euro certainly can be considered as a quantum leap in the economic, financial, and institutional integration of the European Union. Looking at the history of the international monetary system, it's probably the most important event since the end, or one may even say, since the start of the Bretton Woods system. Please have in mind that eleven sovereign states decided to replace their national currencies with a common monetary unit. And it's now only a few weeks ago that this third and financial stage of European monetary union started, following a period of intense preparatory work, and considerable progress in macroeconomic convergence. The eleven participating member states have now transferred their monetary policy sovereignty to the European Central Bank and the European system of central banks. Now, this euro system is responsible for determining monetary policy for the entire euro area. As has already been pointed out by previous speakers, that means for a population of almost 300 million and a GDP roughly equal to that of the US.

Now, I think almost at the end of January 1999, it's fair to say that the start of European Monetary Union was a tremendous success. Such a smooth launching of a new currency was not widely expected until the very end of last year. To some extent, this relates to the so-called changeover weekend, that means the time between December 31st of last year, when the Council of the European Union adopted the final conversion rates of the euro against the participating currencies, and the opening of financial markets on January 4th, 1999. Although I spoke to Paul Kimball before, and he said that there are still some problems in the banking community related to the payment systems, I think it's worth keeping in mind that under very severe time constraints the banking and financial community in the euro area and beyond, had to carry out the task of converting billions of electronic records with the implications that there were a variety of logistical challenges.

This smooth start is certainly reflected in the fact that the euro has been well received in the international financial markets. So the exchange rate of the euro vis-a-vis the US dollar has been quite stable during the last weeks. Furthermore, the introduction of the euro has already led to a very effective integration of European money markets and short-term capital markets. With a common overnight trade and very similar short-term interest rates for comparable instruments. This provides for attractive financing opportunities for the global banking community. Regarding the longer end of the maturities spectrum, the trend toward market integration over the past few months has been evidenced by a convergence of long-term interest rates. And this process has been accelerated through the redenomination of outstanding government debt into euro on January 1st.

My view is that it can be expected that uniform market standards will develop over the medium term, creating a large and liquid market for investors outside the euro area also. This successful launching of the euro was certainly facilitated by a favorable economic environment. In particular, the euro area currently registers a very high degree of price stability. Most recent figures show an inflation rate for the euro area of 0.9% with neither up side nor down side risks at hand. Certainly growth prospects have deteriorated over the last months, mainly due to financial turbulence in the emerging markets, and the following slowdown in the world economy. Nonetheless, a growth rate of around 2.5% for the euro area in 1999 still seems feasible, since we can expect the current slowdown to be of a temporary nature.

I should say that, with such a high degree of price stability and continued economic growth, the euro area serves as a stabilizing factor in the world economy. The underlying philosophy of the euro system's institutional framework is to ensure domestic price stability, thereby fulfilling one major precondition for sustainable economic growth within the euro area. It also contributes beneficially to the world economy, and to more stable exchange rates between the major currencies. From that perspective, maintaining price stability as a primary objective of the European Central Bank, has beneficial effects both from a domestic and an international point of view.

Let me know turn more specifically to the international side of the European monetary union. Clearly, the newly designed monetary setting in Europe will have far-reaching implications, not only for Europe, but also for the world economy and international community. The introduction of the euro represents a major institutional change in the architecture of the international monetary system. However, it does not in itself imply a regime shift from the present manage floating exchange rate system. A number of observers consider that one important motivation behind EMU is a creation of a major international role for the euro. Some previous speakers have pointed that out as well. But, I should say, this assessment is not correct. The European Central Bank takes a neutral stance with respect to the international role of the euro. First of all, the euro represents a major contribution to the completion of a fully integrated single European market, encouraging competition and innovation at the euro area wide level in an environment of stable prices.

The international role of a currency implies different aspects. It can be used as an anchor, and as a reserve currency on the official side, and on the private side, as [U/I] currency for international trade, as well as a currency of denomination for financial assets. In addition, there are very different groups of economic agents which decide on the use of the currency, including governments, central banks, institutional and private investors, corporations, and traders.

At any rate, it will time for the euro to develop its role as an international currency in its various functions. In this context, it should be recalled that it took decades for the US dollar to replace the pound sterling as the major international currency.

In principle, two basic factors will determine the future international dimension of the euro: risk and size. Economic agents may use the euro to hedge their risks through portfolio diversification. If international investors and borrowers consider that the euro will become a stable currency, they will hold euro assets to minimize risk in their internationally diversified portfolios. With regard to the size factor, a broad and liquid euro financial market may lead to a widespread use of the euro, which in turn would facilitate its development as vehicle currency for trade and commodity pricing. The euro is likely to develop over time as a such an international currency used by the private sector, although the pace of internationalization may vary on the function.

As far as the future share of the euro in overall official reserves is concerned, it may be expected that central banks of non-euro area countries will also reassess their reserve management strategy, in light of improved global diversification opportunities offered by the new currency. Moreover, the euro might also assume a greater role as an anchor currency for other European countries, which formally or informally intend to peg their exchange rate to the euro or to trade weighted baskets of currencies, which might include the euro as a large component. In this context, the euro may increasingly become part of foreign currency reserves held by central banks for diversification or pegging purposes.

Let me now turn to some institutional aspects. The euro area is a new counterpart in the context of international policy cooperation. By reducing the number of key players, the euro will simplify the process of international policy cooperation between the major economies. In particular, it should make the process more efficient by facilitating the exchange of views and formulation of common understandings on economic and financial issues at the global level. Each of the main partners, the United States, the euro area, and Japan is in a position to speak for a comparatively large economic area, similarly vulnerable to adverse shocks to the international financial system. A more balanced relationship between the major players might help to induce each of them to take on responsibility for contributing to a stable global environment. In many ways the European Central Bank, as part of the euro system, is already represented in international institutions and fora. Although some decisions are still under consideration formal and informal agreements have already been reached with the International Monetary Fund, the OECD, the Bank for International Settlements, and in the G-7 and G-10 context. I should particularly mention that in December 1,998 the IMF has granted observer status to the European Central Bank. The IMF, as the cornerstone of the international financial system, plays a key role in the process of multilateral surveillance of economic policies. Therefore, it is important for the ECB to be represented at the IMF right from the outset of start three of European monetary union.

Let me now finally make a few remarks on the renewed interest about the concept of target zones for exchange rates among the main currency blocs, namely, the United States, the euro area, and Japan. In a world characterized by highly integrated and sophisticated international financial markets there are serious doubts whether target zones for exchange rates are feasible. Apart from the obvious risks of undermining price stability, such exchange rate targets would in essence imply that domestic policy objectives would have to be subordinated to external requirements. I should add that it is difficult to imagine that two relatively close economies such as the US and the euro area would be willing to follow that road. This is the reason why exchange rates are not an explicit objective of the euro system's monetary policy. This stance is based on the conviction that the exchange rate of the euro is primarily the outcome, and not an objective in itself, both of the economic, monetary, and other policies pursued in the euro area, and, of course, of cyclical developments in the euro area and abroad.

Of course, this does not mean that the euro system will neglect the exchange rate of the euro. In this context, I think it's important to note that the monetary policy framework of the European Central Bank is based on two pillars, one pillars being the monetary growth--since coming to the basic economic truth that money matters for inflation--and the other pillar is a broadly based assessment of future price developments, and in this context, the exchange rate is one major element which is very closely monitored. That means, if exchange rate developments jeopardize price stability, corrective actions might be needed.

In line with this euro system's approach to the exchange of the euro, the European ministers of finance, who are ultimately responsible for the exchange rate policy of the euro, agreed in December 1,997 to issue general orientations for exchange rate policy only in exceptional circumstances, such as in the case of clear and persistent misalignments of the euro. As I've pointed out before, it might not come as a surprise to you that the ECB takes the view that we have not reached that stage. Thank you very much.

UZAN: Thank you. Mr. Yoshimura, Executive Director from Japan.

YOSHIMURA: Thank you, Marc. As the last speaker, I'm tempted pretty much to comment on what the previous speakers said, especially Dick's comment on the IMF policy on gold, but at this stage I think I better concentrate on my own statement. I already had the privilege of commenting about the euro and international monetary stability, when I was invited by this committee to speak in October of last year. My general views have not changed since then. What I emphasized then was that the success of the euro would strengthen the stability of the international monetary system, but that the current turbulence in the international financial markets would make management of the euro a very delicate balancing act. The successful introduction of the euro and the stable developments so far, as previous speakers explained, has dispelled many of the doubts, which the so-called "euro skeptics" had. However, as the international financial environment continues to be uncertain, and the volatility of the market has increased because of various development, including the Brazilian devaluation and others, further careful management of the euro is necessary both for the euro area and the global financial markets.

The committee has kindly given me another opportunity to talk about the euro and the international monetary system, and I would like to comment today on the impact of the development of the euro on the Asian currencies, especially those suffering from the recent crisis. I would like to give the Asian perspective to our discussion. In this context, I will later touch on the redefined role of the IMF in the changing status of currencies. This is, of course, closely related to yesterday's discussion, and since I didn't speak yesterday on this subject, I'd like to provide some views on this matter. In my view, this year will see a clearer trend toward the, in my tongue, the oligopolization of currencies in the world. The successful launching of the euro is, of course, a major development in this direction. In addition, as many speakers in this conference pointed out, dollarization is a growing trend in the developing and transitional economies, because of the instability of their own currencies. A recent conspicuous example of this is the proposal made by Argentina to make the US dollar its own currency, and to develop a dollar zone among Latin American countries. After seeing the collapse of the pegged currency system, first in Asia, and then in Russia and Brazil, it seems some countries are daring to sacrifice their own currencies and accompanying sovereignty, in order to avoid the devastating economic consequence of a currency crisis.

We have to wait and see whether this radical proposal will be considered seriously by the parties concerned, especially the United States. But I do believe the oligopolization of currencies is becoming a definite global trend. The influential European countries left behind when the euro was launched, such as the United Kingdom and Sweden, are now under strong pressure to join. Other European currencies, including those in Central and Eastern Europe, that are successfully transforming their economies, will strengthen their relationship with the euro by means of the new ERM mechanism and others. On the other hand, the development of dollarization is a fact of life in many parts of the world, regardless of whether the dollar is strong or weak.

This oligopolization of currencies is a challenge for every country, but especially so for the Asian countries, many of which have suffered from the recent currency crisis, and which are having to exert their maximum effort to recover their economies, and stabilize their currencies under floating exchange rates. Many of them, however, are looking forward to a more solid currency arrangement in the future, and they are observing the development of the euro and dollarization in other parts of the world with keen interest.

Another important player on the Asian currency scene is, of course, the Japanese yen. In this context, as Mr. [U/I] pointed out in his speech yesterday, the issue I have to address is whether the Japanese yen is a leading currency in Asia, or if not, will it become a leading currency or hegemonic currency in the region? In my view, unfortunately, the role of the yen in international transactions has not been particular significant so far. Its role in international transactions in Asia, for the moment, does not reflect the economic strengths, or the relative share in trade and so on. Partly, it is because the Japanese yen is not conveniently designed for the use of nonresidents, in particular, to invest their assets and keep their reserves and assets in Japanese yen.

In retrospect it was wise for Japan to limit international use of the yen, as this facilitated the management of, especially, taxation, and monetary policy in Japan. In Japan taxing authorities have a very strong power and influence even in the Ministry of Finance. And their strict policy on taxing nonresidents for their interest payments, certainly adversely affected the use of the Japanese yen internationally. If Japan wishes to stick to narrowly defined domestic interests, it should not expand the role of the yen in the international market.

In light of global currency developments, however, Japan will need to review the role of the yen. That is why Prime Minister Obuchi recently announced a new policy initiative to promote the internationalization of the yen. While the weight of the yen in international transactions is significantly greater in Asia than elsewhere, it will increase with the new policy measures Japan will take. The yen still will not become a dominant force in Asian financial transactions any time soon. The US dollar will continue to play a major role in Asia, and the euro will also play a proper role as an important international currency. Taking this reality into account, Professor Sunamura of Kyoto University, in an article in an upcoming Far Eastern economic review, proposed an adjustable currency basket system for the Asian currencies. His idea is for Asian countries to adopt a balance of currencies composed of the yen, the US dollar, and the euro. By doing so they could lessen the likelihood of the recurrence of the currency crisis, if their currencies were pegged solely to the US dollar. In addition, they would be able to maintain flexibility in coping with the development of currency oligopolization by adjusting the weights of the three currencies.

In any event, most of the Asian currencies are not ready to sacrifice their own currency to the major ones, nor would they be comfortable with a freely floating currency. In reality, in practical terms it is difficult for a country to let its currency float freely in order to avoid having it attacked by the market, and not having to depreciate its exchange reserves. An exchange rate mechanism linked to a basket of the major currencies could, therefore, be a practical way for Asian countries to manage their economies with policy discipline.

Even if the Asian countries were to adopt a currency basket system, it would not mean that they would be immune to currency crises or their contagion effects. On the contrary, large and swift capital movements, as we are now seeing in the market, could promote attacks on these countries currencies, even if policy discipline is maintained.

The next question, therefore, that has to be answered is whether the present arrangement to defend their currencies is sufficient. Many people are unsure whether the present mechanism of the IMF is sufficiently well equipped and effective to prevent crises and their contagion effects. A fundamental question we have to address is, in my view, whether the IMF financing mechanism and decision making can keep abreast with today's very rapid massive international capital movements, encouraged by global deregulation and technological developments. My impression is that the IMF traditional methods of financing, using conditionalities, [U/I], and periodic reviews are not keeping up with very volatile capital movements, and the relevance of these methods, especially for emerging market countries, is decreasing rapidly. Timely decision making in connection with programs is becoming more difficult. Even if the IMF staff work day and night, and the IMF Board decides financing within forty-eight hours of receiving the staff's proposal, markets change much faster than IMF can process loans. And it will not be easy to prevent contagion.

Therefore, I think a new approach, distinct from the traditional approach programs and financing, is worth exploring. The proposal President Clinton made in New York last fall for a contingent credit line at the IMF, as well as the Japanese Finance Minister [U/I]'s proposal for a new facility for the IMF, based primarily on a country's good track record, as certified through regular IMF surveillance, are, I believe, leading us toward a new approach, which I have been discussing.

Stanley Fisher, the IMF's first Deputy Managing Director, in personal remarks at the American Economic Association on January 3rd, in New York, examined these issues from the standpoint whether the function of international lender of last resort is needed to cope with currency crisis. I think Mr. Fisher provided the IMF with an urgent agenda for it maintain its central role in the international financial community. Finance Minister [U/I] has also proposed establishing regional currency support mechanisms that would complement the role and function of the IMF. I believe such regional mechanisms, which would be anchored by solidarity and mutual dialogue among countries in a region, could be very beneficial, especially for Asia. As I have already mentioned, Asian countries are now facing challenges stemming from the oligopolization of currencies. The necessity for a regional currency support mechanism in Asia is, therefore, particularly strong, together with support from the IMF, which should continue to be at the center of the international monetary system. Thank you.

UZAN: Thank you, Mr. Yoshimura. We are going to take a couple of questions, and we will have a break for coffee, since we can reconvene for discussion afterwards if we have time.

[PAUSE]

[BACKGROUND VOICE--LAUGHTER]

YOSHIMURA: Well...[LAUGHS] Oh, yes...this is of course my personal comment. All my statements and comments are to be considered as mine, they do not represent the view of the IMF or of the Japanese authorities, but Dick provided us, I think, with the new important point of the role of gold in the international monetary system. This aspect was neglected in our discussion of the new architecture. I see his point, but at the same time, because of the declining trend of gold prices, from the practical point of view, I can not ask other colleagues to discuss this matter in a lively mode. But what is Dick's view on gold prices and the future?...that would help us [U/I] to have a stimulating discussion [U/I] informally [U/I]. Thank you.

WARE: I'm quite unable to forecast the gold price, indeed I'm not allowed to, I'd get sacked if I attempted to...[LAUGHTER]...forecast the gold price. Then only thing I would say, Yukio, is that if you held in 1,971, when it was worth $35/oz., and you hold it now when it's worth, let's say, $290-- that's not a bad return. And I think people tend to think in terms of the gold price, looking at the spike in the early '80s, when it got, for one day, as high as $850. And they look at it now at $290, and they say...well, dramatic decrease.

But I don't think I'd want to make the case for gold on a price basis alone. As we all know, [U/I] central banks, that the individual return to gold is only in terms of the price. But of course, central banks, large institutional holds of gold, can get a return in the form of lending out their gold, getting the least rate for it. And indeed, this is probably an unkind remark, but until Japanese bond yields went up a few weeks ago, the lease rate was higher than the yield on JGBs. But forget I said that.

So there is some return to gold, but the point I was trying to make in my talk, I think, was that an element of gold in a portfolio provides some stability. You don't have it there, because you're going to earn lots of money on it, [U/I]. And you have to take into account the likely price movements, either up or down. But the point it's there, is to reduce the volatility of your portfolio. If you just have currencies...I mean, you can say today, "I can earn, you know, 5% in dollars," or whatever it is.

But, of course, if you are not a domestic US resident, you're taking a currency risk. You're not actually taking a currency risk with gold, you're maybe taking other risks, but not currency risks. And I think people, you know, tend to forget that when they look at 5% versus, perhaps, 1% on the gold lease rate. And therefore, it's obvious you have to go into dollars. US economic policy is very good at the moment, the performance of the economy is very good. But, you know, as we all know, it hasn't always been thus. And inflation can affect values of currencies, and can offset whatever interest rate you happen to be earning.

UM: Yes, thanks. I have actually two questions, one for Mr. Ware, and anyone else who would like to comment. Is there some way that a bigger role for gold in the case of Russia could help stabilize its situation and its international monetary relations? And secondly, I would like to ask Mr. Carre to comment on Mr. Kimball's remarks on some of the vulnerabilities in the European banking system regarding their exposure to emerging market debt.

Tape 2-Day 2-side A

WARE:...as I'm sure you're aware, been discussing among themselves various ways in which they might use their gold. You know, clearly, in the state that the Russian economy is, gold is one of the few real assets they have. So, they are still a major gold producer, although gold production is been falling in recent years, primarily because they don't have the funds to invest in the mines. But that could change.

So there have been proposals for gold-backed bonds. So some of the country's gold reserves could be used to back bonds which would then be bought by the state, and the proceeds passed to the mines. So that they could finance next year's production, or indeed, increase investment. So that's one idea they have. Another idea they have is to produce gold coins. Now, they've got quite large reserves of gold, they could mint gold coins. And I'm quite sure that the population would swallow them up. They would rather have gold coins than rubles, at the moment. At the moment the only alternative is dollars, and of course, there are an awful lot of dollars circulating in Russia. The danger with that, and I'm all in favor, given my job, of gold being utilized by the man in the street, but the danger is [U/I], really. If the gold coin were available, then people would buy it, sell their rubles, buy the gold coin, stick it under the mattress. You know, it wouldn't actually circulate or anything. So I'm not quite sure how that would benefit the Russian economy. Well, it wouldn't be a dollarization, it would be a goldization, wouldn't it? It would be recognizing the ruble was very unstable, very weak, and gold was better. So that would have to be a good thing for gold, but I don't think it would actually act as a coin which would circulate very much, as I say, I think it would be hoarded.

The other thing the Russians have discussed is a currency board arrangement. I don't think that's live on the agenda at the moment, but they discussed it a few months ago. A currency board perhaps not backed by dollars, as it is in Hong Kong and Argentina, but perhaps backed, in whole or in part, by gold. As I say, I think that's on the back burner at the moment, but that's another way in which they are thinking.

So to summarize, yes, the Russians have gold, they can potentially produce a lot more. And so they're actively thinking about ways in which it can be mobilized. And from my point of view, that only goes to demonstrate that gold is not a dead asset at all. For some countries in some circumstances it can liquid, it can be very useful.

SCHEID: If I may, I would just like to add one point on this. I mean, one has to see, certainly, that in the case of Russia the pegging to the US dollar of the ruble in the past did at least some good for a certain period of time in terms of macroeconomic stabilization, or bringing down the inflation rate. But, as was pointed out yesterday, I think very impressively, what is primarily needed now is really progress in the structural reforms. So whatever currency arrangement you might think of, even going to the extreme of a currency board, with all the implications that such a currency would mean in terms letting interest rates skyrocket in Russia, we certainly have seen a period of macroeconomic stabilization, but this was not used for really giving impetus to the microeconomic reforms. If we don't see a very strong commitment by the Russian authorities to step forward on this, I mean, the tax collecting problem is just one aspect of it, but there are many others--the legal framework and all these things that have to be developed--then any currency arrangement whatsoever can't work, and it will end up again with a ruble crisis, as we have seen last year, when they had to give up [U/I] to the US dollar.

CARRE: Well, turning to the European Bank's exposure to emerging countries, Paul showed us, and he showed me now quite interesting figures: 68% for the European banking system, versus 17% vis-a-vis all emerging countries. It's clear that the European banking system is largely exposed. You have to disassociate...according to the breakdown, I'm quoting from memory, it's a very high exposure vis-a-vis Russia, for example. And it's specifically the case for the German banking system, it is very exposed. But all these debts are government guaranteed. The German Federal Government guarantees. And the Austrian banking sector also is federally guaranteed by the Austrian government. Vis-a-vis Asia, the bulk of the exposure is vis-a-vis Hong Kong, which is not the worst risk in all the area. Vis-a-vis Latin America, there is also quite a huge exposure from the Spanish banking system vis-a-vis this region.

I share the view which was put forward by Paul. It is a potential negative for the euro. There are also many potential positives. And, I'm quoting myself, but attempts at quantifying the future demand for the euro are by nature speculative. We can only list the potential negatives and the potential positives, and the outcome will given by the market.

UM: I have a question for Mr. Kimball about his investment strategy. What you said about the current account deficit and interest differentials was very interesting, but I'm interested in the time dimension of this strategy, because, as you have shown, this relationship holds in the long-run. I assume that this can be so while you have a large volatility in the short period. And I think that currency trading is something where you decide on basically a daily basis. And also the current account deficit data [U/I], so I assume you must be using some forecast as well to make a judgment. Can you comment on that?

KIMBALL: Absolutely. One element to help you with the current account forecasting is obviously the differential and growth rates. And those numbers are a little harder than the current account numbers. Not to mention the notorious problem the US current account number has, in that it's probably overstating the deficit and understating the surplus we have on services. But aside from that, if you work with and focus on the interest differential component, I found that the market has trouble figuring out where the current accounts are going. It's very, very difficult. But the market's judgment usually comes first on the interest differential, and then works its way back to the exchange rate. In the work I've done over the years, I have always used the interest differential as the leading indicator of where the currency will go, and it's served me very well. I mean, obviously, in my business if you're wrong seven out of ten times, you're doing a great job. So you just have to manage how much you lose on the seven times you're wrong to compensate for the three times you're right. But I found that the interest rate markets, because they're dominated by capital flows, obviously--investor flows--are the most prescient aspect of the markets. I think the foreign exchange markets can have a lot of short- term noise in them. So, I've used that as the leading indicator for the currencies. And particularly, in dollar-Europe relationship, that has borne a lot of fruit for me over the years. And then to work on some supposition on current account, again, the differential and growth rates. I'll tell you, the economists have gotten a lot better at predicting the actual, nominal, and real growth rates in local economies, and particularly the US and Europe. So hopefully that gives you some sense of how I attack it.

By the way, the Japanese situation is very interesting because we have a current account that has risen, obviously, versus the US, and we've had an interest rate differential that's narrowed. And that poses one of those special opportunities that market players get, because you've got both items going, from a central banker's point of view, in the wrong direction. You've got one reinforcing the other, as opposed to one counteracting the other. And I think the market has taken great notice of the reported activities of the Bank of Japan a couple of weeks ago. It was reported--it wasn't confirmed--but the market is sensing this year, because you have a situation in the relationship between the dollar and the yen which is potentially very unstable, in that there could be a greater demand for yen than the supply thereof, that they may adopt a policy this year of counteracting that by supplying yen to the marketplace via the foreign exchange mechanism. And so that is a new element in the equation this year.

UM: But aren't you afraid to speak publicly about your methods, fearing that you may lose them, and that some others may start doing the same?

KIMBALL: I'm sorry...I just didn't catch the last half of that question...

UM: Aren't you afraid to speak publicly about what method you are using in currency trading, and that some others will start to copy this method?

KIMBALL: Well, given than any method, if it even works decently, you'll wrong seven out of ten times, let anyone copy what they want. It's actually managing the process which is so important. I can tell you, I know more people who went bankrupt in this business with the right idea. [LAUGHTER] Because they simply didn't manage their inevitable losses along the way to their ultimately right trade. So managing your risk is really as important as getting the market right ultimately.

UF: The question is for Mr. Scheid of the European Central Bank. The president of your institution, [U/I], recently said, also as you alluded in your speech today, that the ECB would not pursuing a policy of benign neglect, and in the event of, what he called a strong and abrupt appreciation of the euro, the ECB would act. I'm wondering if you could give us an idea of what the ECB would define as a "strong and abrupt appreciation of the euro."

SCHEID: You want me to tell now when the ECB is going to intervene in the [U/I] market... To be quiet frank, you have to see it in a broader context of the monetary policy framework. So, there are two pillars, as I said. And, I mean, we are simply obliged by the treaty to our primary objective of price stability. So, I would say that the one pillar, as I said, is monetary growth, and the other one is an overall assessment of price developments. And within this second pillar the exchange rate plays a role. That means, the Governing Council, which meets regularly closely monitors these price developments, and within this context, the exchange rate as a major indicator. And if there is an exchange development that might endanger price stability, from the upside or the downside. We are also symmetric in our approach to inflation, as well as deflation risks. By then the Governing Council has come to a conclusion.

But you can't say that in terms of having a clear idea that a certain appreciation of the euro, or a certain depreciation, would immediately lead to an automatic monetary policy response...that's not the case. So it has to really be looked at in a much broader context, and not mechanistically... that we use certain figures for the exchange rate that might immediately lead to interest rate policy action... This is not the case. It's just one very important economic indicator. So looking at it from that perspective, it's not a policy of neglect.

UZAN: I have a question for Paul. You say that the euro will be less volatile than the deutschmark. But if the euro is going to be a reserve currency, that will mean it will have more responsibility in the international financial system. So does it mean that we will have more volatility from the fact that it will gain that stature?

KIMBALL: Outside the euro-dollar relationship?

UZAN: Yeah.

KIMBALL: Well, volatility is in direct proportion to the discontinuity, or the lack of convergence in policy between two countries. And I just think that the scene from where I observe it...between the US and Europe there's a growing level of transparency, both in policy and in the economic functioning of these two economies. These are very mature, becoming very integrated economies, and I see a tremendous similarity in policy at the monetary level between the US and Europe. And that's translated into very similar inflation results. There is still a difference in fiscal policy between Europe and America. But it's not an enormous difference. But the rest of the world is still up for grabs. And there are still many countries that are having a hard time dealing with the high standards that have been set by, quite frankly, the euro area and the US area in terms of monetary policy and fiscal policy discipline. And I think we're just going trough this right now with Brazil. Brazil is simply being [U/I] for having a combination of a fiscal and monetary policy, that's translated also into a current account structural problem, that's simply out of the boundaries of what other countries, and specifically these two have established. And so there's volatility there, and there's uncertainty. And we'll continue to have both until they clarify, and modify, and make closer to the policy regimes that are in the G-7 world, make what they've got more convergent with that.

So, volatility outside the euro-dollar area is going to be very contingent on countries' ability to converge their policies towards this oligopolistic core of countries that is rapidly developing, and rapidly becoming very transparent.

KLEINMAN: Gary Kleinman, with a question for the Japanese representative. In the early days of the Asia crisis there had been an agreement, an informal one, between central banks in the region to provide overnight facilities in support of the currency. And it had had some success initially in defending the [U/I] before it was overwhelmed by the scope of the onslaught. And I'm wondering, though Miazawa plan and the purported IMF are still being defined, is there any thought or any provision considered for direct currency intervention in the region, particularly with the rupee and some of the weaker currencies?

YOSHIMURA: Well, yes, you are right. The central banks had and still have an arrangement of the kind of currency swaps. And also, at the beginning of the crisis in Indonesia, Central Bank accounts managed by the Foreign Ministry, together with the Singaporian authorities, jointly coordinated the intervention we made, in order to support the Indonesian rupiah. At some stage, such an intervention was successful. But as you know, because of the lack of policy implementation by the Indonesian side, this intervention was not able to sustain a certain level of the exchange rate. But still, this is an agenda for us to consider if necessary. So that is why when Finance Minister Miazawa proposed the so-called Miazawa plan to support the other Asian countries, he pledged 30 billion, as a total, and of which 15 billion is from the short-term financing window from Japan. And the possibility that such short-term financing would be used for currency stabilization is not excluded. Thank you.

UZAN: We're going to break for coffee, and we'll reconvene for 50 minutes, thanks.

[NOISE]

[BACKGROUND VOICES]

[PAUSE]

UZAN: Okay, so we are going to continue our discussion. Let's leave the floor open.

[PAUSE]

UM: Hi. Regarding the international role of the euro, maybe a question for Mr. Carre: there seems to have been one factor for the international role of the dollar, which is the current account deficit of the US, the EU or the euro zone will have a current account surplus, it seems, will that hamper the potential for the international role of the euro?

CARRE: Well, clearly, this was an important element in the past. I don't think it's an important element for the present and for the future, because financial markets are so developed that they can build on the euro, and offer any type of security which is needed. But of course, the mere existence of a deficit helps for the development of this kind of financial assets. It's not a major element. When you say that the current account balance of Europe is in surplus, we are wondering if we are in surplus, right? [LAUGHS] You know that with the internal market, [U/I], all customs declarations have been abolished for goods which are traded within the single market. And the single market is larger than the euro area, and as a result we do not know exactly what are the figures. But there are estimates, according to which the errors could be up to 1% of GDP in the current account balance. If you consider that our figures for the official current account are between 1.5 and 2%, this gives you an order of magnitude of the phenomenon. We live in an uncertain world. In order to have good statistics you have to regulations. It's unfortunate.

SCHEID: Maybe I would just like to add one point on that. Certainly, this is really a problem in terms of statistics. What we know at least is that if we have a current account surplus at all, it's much lower than the figures that have been published, based on adding up the national current account figures. So I would say, there is not really that much of a surplus in the euro zone after all.

But I would also like to make one more general comment, by pointing out that maybe we should not focus so much on the current account, but on the capital flows. If you have a current account deficit, as the US does, you have a net capital inflow at the same time. So, these are two sides of the same coin. And it's rather clear, as Mr. Carre has already pointed out, that with these developments of capital flows in capital markets, the capital flows might dominate the current account developments. And, after all, one has to look at the savings-investment balance in the US, and it's rather clear that from a macroeconomic perspective the US is attracting capital. So, obviously, investment opportunities in the US are not that bad. And this has been certainly reinforced by the crisis in the emerging markets, a lot of capital has been distracted from these emerging markets, and has been invested in the US. So, I would rather focus a bit more on the capital flows than on the current account.

UZAN: I have a question for Mr. Yoshimura. What are the prospects for an Asian currency unit that you mentioned a couple of months ago?

YOSHIMURA: Yes, that idea is still there. Some Japanese politicians especially support the idea of an Asian currency unit. But I think it takes time for us to implement this plan. That is why today I suggested the possible link of Asian currencies to those major currencies, as a form of basket currency. If such a basket currency system works well, then we can consider the Asian currency unit as a next step, as a base for future Asian currency union or arrangement. I think that is a step the Europeans took when they started the process of currency unification.

UM: This is a question for Mr. Carre. If I understand it correctly, the responsibility of being a lender of last resort will be at the national level, if that's the case, do you think that's possible?

CARRE: Certainly not for the time being, but what to do? This is part of the agenda of the Reinventing Bretton Woods Committee, but I'm afraid I will not provide the answer today.

UM: I was thinking more like if it was a European bank that had a problem.

CARRE: Are you mentioning the fact that the European banking system is heavily exposed vis-a-vis emerging market countries?

UM: Not so much, but you could think of, for example, some of your smaller countries...the monetary policy of Europe at large may not be ideally suited to them, that could lead to a credit boom, and at some point, maybe not in the too distant future, credit problems that would be specific to the country itself. And that assistance that might be coming from the domestic central bank would be inconsistent with the broader monetary policy of [U/I].

CARRE: You are referring to the lender of last resort function within the euro area.

UM: Yeah.

CARRE: Clearly, my colleague from the ECB...[LAUGHTER]...try to answer.

SCHEID: I should say the ECB is not functioning as a lender of last resort for the European banking system. Of course, the proper functioning of the financial system within the euro area is one of the important tasks to be fulfilled by the euro system. So from that perspective, of course, the European Central Bank and the national central banks are concerned about what's happening with individual banking systems.

But I should say that this is in the first place a question of proper functioning of the banking supervision, in all the euro area member states, or more in general. And for the time being this supervision in the euro zone seems to work rather properly, so we didn't see any systemic problems. And if individual banks would face a problem of solvency, then it's more to the national governments to jump in, and not to the central banks...to see what's to happen. And I think one of the major lessons to be drawn from the Asian crisis is that certainly a sound banking system is really one of the major preconditions for sustainable economic development. From that perspective, the European banking system is soundly based, and I don't see that we would face systemic problems in a specific smaller country. So banking supervisors should develop early warning systems, and corrective actions should be taken to avoid such situations, and not allow a situation to develop where would need to put in official money for the private sector.

UM: So your view is that if corrective actions were needed, this would be on the regulatory front as opposed to a change in monetary policy.

SCHEID: Yeah. It's much more a requirement related to the banking supervision side than the regulatory authorities. And if a need arises to deal with solvency problems, then national governments would have to put in money if at all. But it's not up to the Central Bank.

YOSHIMURA: May I comment on this matter?, because we had the same discussion in the IMF. So far as I understand, from what European representatives are saying, he's right, if the lender of last resort function becomes necessary, in that case a national government, a national central bank would step in. That is what I heard from my European colleagues. And they added at that time that a certain ambiguity is desirable, in the case of the lender of last resort function. They considered it as a constructive ambiguity of the role of the lender of last resort. I am just explaining their position, which I do not share. Because, as Mr. Stanley Fisher commented when he discussed the lender of last resort function on January the 3rd, which I referred to, he supported the idea of a more clear, explicit explanation [U/I] of the role of lender of last resort as being helpful to prevent a crisis.

But there are two different views. One supports the idea of constructive ambiguity, and the other is [U/I], explicit explanation to the public about the role and function of lender of last resort. Thank you.

SCHEID: Could I add one point? I must say, this issue of lender of last resort needs to be discussed very thoroughly. A lot more discussion is needed on this, because you can even imagine situations where the lender of last resort function would provoke a crisis situation. You can certainly imagine such situations. And if you look at Europe, the track record or soundness of the European banking system is not that bad. So, from that perspective, mainly basing itself on a sound supervisory framework, and if necessary resorting to national governments, worked out pretty well. And to some extent, that's a lesson learned from the hedge fund problems or discussions, that private are private risks. And so to some extent, private investors, if they make a misjudgment at the end they have to pay for it. They can earn from it, but it's a two-way street, there are also situations where losses should be possible, individual losses.

UM: There has been considerable speculation that bank consolidation will continue, if not accelerate in Europe. Can I ask Mr. Carre and Mr. Scheid if they agree with this speculation?, and if so, does it pose any risk the economic and monetary system in Europe, if we continue to consolidate banks, both nationally and on a cross-border basis?

CARRE: Certainly...[ASIDE: May I begin?]...I don't know what is the viewpoint of the European Central Bank, but I'll speak first. Consolidation, restructuring are under way right now, because a single market in the financial area is just being achieved. Some directives, such as the ISD, Investment [U/I] Directives, are not implemented all over the European Union. So we are at this particular juncture, where the single currency appears when the single market is becoming effective. Plus the technological change, the technical developments, I think these are the three elements which are shaping the banking structure in Europe of the future. There is not yet any

European pan-European bank. We can see in Belgium that the banking sector has changed considerably these last two years, but not in Germany, not in France. And we do expect some major changes. Don't ask me what they will be. I do not know. And this could raise in the future some problems as far as supervision is concerned. That's clear. But this is a problem for the future for us. The supervisory framework right now seems to us adequate. The set of commonly agreed rules which have been defined by the Council, upon the proposal of the Commission, is adequate. But...[TAPE STOPS]...

Tape 2-Day 2-side B

CARRE:...will be adequate, this is another question. We are thinking about the subject right now. There are several committees assisting the Commission. There is a committee within the European Central Bank. Everybody is trying to think ahead. But it's difficult to foresee right now what will be the banking industry in Europe. I've read everything and the contrary of everything on the subject.

SCHEID: I think can I very much agree with what Mr. Carre just said. Certainly, the reshaping of the banking industry is fully under way, and it will pose challenges to the supervisory agencies. And we need more cooperation at the European level of the banking supervisors. But I should say, it's not only a European problem. You have to see it from a more international point of view, global competition will reshape the banking system worldwide, not only within Europe. So this is a matter of increased competition, which offers new opportunities, and certainly a lot of advantages for economies. But it also poses new challenges to the supervisory agencies. And there is a lot going on in this respect, in strengthening cooperation between national and supervisory agencies. And I think the President of the Bundesbank is going to publish a report later this month, or beginning of next month, on finding ways to improve cooperation. That's another lesson to be drawn from this hedge fund case, that you really need worldwide cooperation in this respect. So, we will certainly see a fundamental reshaping of the banking industries, not only in Europe, but worldwide. And it's also due to technological changes, to be sure. But where it will go exactly depends on the markets.

[PAUSE]

UM: A question for Mr. Yoshimura. As you take a look at the prospect for an international lender of last resort, what type of changes would you foresee in bank regulation that would set the preconditions for that?

YOSHIMURA: Yes, internationally agreed bank regulations are, of course, a necessary component, or having a global lender of last resort. For that purpose, some commonly used benchmark to judge the soundness of the banking system is needed. And actually, there is an agreed so-called core principle designed by the Banking Supervisor's Committee, which is now used by the Fund, IMF. When they have their so-called Article for Annual Consultation, they check, according to this list, the soundness of the banking supervision and banking sector, when they have their annual consultation with member countries. Thank you.

UM: Perhaps a follow-up to the last question, having the right regulatory environment in place is one thing, but, of course, I think having the right framework in place is not going to supply [U/I]. The simple fact of the matter is, how can the IMF ensure that the regulatory [I/A] are actually enforced? And if it can't, [U/I] it can't, unless it replicates the role of domestic regulators, what do you do to minimize the moral hazard problem?

YOSHIMURA: Well, it takes, of course, considerable time to implement the universal regulations. And of course, this is the first step. I mentioned the core principles agreed to by the Bank Committee. Further strengthening of the standard is necessary. We are talking about standards of not only the banking supervision, but also of the other areas, including accounting, and monetary and fiscal policy areas. So how much we can do is a matter of discussion and consideration, but we like to do our best to strengthen and unify those standards. Of course this is the work not only of the IMF, but also of the other financial and international institutions should be involved. And they should be more active than the IMF in some other areas. The role of the IMF is to coordinate all those processes, and the use the results of the discussion in our annual consultation process. And we would like to strengthen this process. But how much we can do is a matter we have to see.

And as to the moral hazard issue, yes, there is a risk of moral hazard. And that is why we emphasize the importance of the involvement of the private sector, which we discussed yesterday. And if we introduce the idea of a contingent credit line, that is to some extent the idea of lender of last resort, in that case the active involvement of the private sector is necessary in tandem with this kind of discussion. Thank you.

UZAN: Question for Paul: how are the market going to judge the credibility of the European Central Bank?

KIMBALL: Well, first and foremost, it will look at its performance on inflation and monetary policy discipline. That would be the first order of review. And the second will be that the stability pact holds. And that is an issue, that if Europe has a cyclical economic downturn, will it maintain credibility in the stability pact process as its currently laid out, to keep markets satisfied with the overall level of convergence on that issue. Even though, it's still at a deficit level...that if the fact that there aren't any exceptions made that are outside the scope of the stability pact. First order on the monetary policy side, second order on the stability pact.

And the third issue for Europe, and it's not a front burner, but it's a back burner issue, is the issue of structural reforms. Europe seems to the outside world to have too much talent and too much of an innately positive economic environment for the returns that it gets out of that environment. And I think that, if I relate back to the question from that gentleman on the banking side, I mean, Europe looks to me like an awful lot like America on the banking side in 1,990--tremendous over capacity, tremendous low return on capital. And that's just that sector, there are many sectors in Europe where there should be a higher return on capital, given the talent of the people, the education level, the internal market, and the contingencies of the other markets that it has. And so that's the longer-term issue for Europe. Will it get its return on capital and its businesses to a level that's consistent with its underlying assets? And that will affect the long-long-term strength of the euro, because it's had an immensely positive impact on the US dollar. I mean, here's a country that's just gone through a very long period of structural current account deficits, and yet our capital markets are strong, and the dollar is steady. So, that's an issue for Europe long-term.

UM: I would like to ask Mr. Scheid: when the European Central Bank increases the monetary supply, what's the channel?, what would be the main channel? For instance, open market operations, or the discount window, or any buying foreign exchange?

SCHEID: The main channel is certainly open market operations. This is the main instrument for providing liquidity to the market.

UM: [I/A] securities?

SCHEID: Sorry?

UM: Securities or [I/A]?

SCHEID: Yeah. You mean...?

UM: Securities.

SCHEID: Yeah, collateral.

UM: [I/A].

SCHEID: Yeah, there are certain, how should I say?, preconditions for institutes for using this instrument in the banking sector.

UM: [I/A] you have to sell, or when you buy.

SCHEID: Yeah, but they have to provide some collateral for using this open market transaction window.

UM: That means lending [I/A]. Open market operations.

SCHEID: No, they are security based.

UM: This question for Mr. Yoshimura: so far as I know, it's Mr. Miazawa's initiative that the setting up of an Asian monetary fund should be considered. I'd like to know first, if this fund were set up, how would the easier moral hazard be handled? Second, how would the relations between this fund and the International Monetary Fund be handled? Thank you.

YOSHIMURA: Well, I do not think that Finance Minister Miazawa explicitly mentioned an Asian monetary fund. But what he proposed is the regional financing mechanism, which is a complement to the International Monetary Fund. This regional financing mechanism is based on solidarity of the regional countries, which the Europeans, for example, already have. And other regions can consider such a kind of regional financing mechanism. So there will be no conflict with the IMF. The IMF, I think, still maintains the central role in international financial system.

As to the moral hazard issue, this is a difficult issue to consider. Again, I have to emphasize the importance of private sector involvement. In any kind of scheme...for example, if we consider the contingence, the credit line idea, using not only the IMF but also the regional financing mechanism, then at that time the proper involvement of the private sector in the form of credit lines from private sector banks, or other types of involvement...we have had a discussion about this matter for a long time, but this is certainly not an easy issue, but we have some ideas we can implement...and we consider these as just measures to promote the involvement of the private sector more positively I think. Thank you.

UM: This is another question for Mr. Scheid. France [U/I], is this purely a French affair, or does the ECB have a role in keeping an eye on this?

SCHEID: We are certainly keeping an eye on it, so it was formally considered with the Governing Council's issue. But of course, more in general, this point of pegging exchange rate regimes vis-a-vis the euro is basically a unilateral decision to be made by the respective countries. So this is the general approach we take on these arrangements...because other countries, let's say the accession countries in Middle and Eastern Europe, might also consider some form of unilateral pegging toward the euro. So basically this is a unilateral decision. In general terms, such arrangements can be helpful in certain situations to put in place sound domestic financial, fiscal, and other policies. But it always depends on the specific conditions in each case.

UM: Has the ECB thought about the connection [I/A] lines of credit [I/A]?

SCHEID: [ASIDE: No...you want...? No, no, please. No, please, go ahead.]

CARRE: You must avoid any misunderstanding. The Council has adopted a regulation on the 23rd of November allowing France to maintain the present arrangements with 14 African states. These arrangements are not of a monetary nature, they are budgetary. In fact, it's the French Treasury which is involved, and not the Bank de France, which is part of the European Central Bank. So that's why the Council decided, after, of course, having consulted the European Central Bank...but France is allowed now to maintain the present arrangements, and only changes in the nature of the scope of these arrangements would have to be signaled and endorsed by the Council, after, again, having consulted the European Central Bank.

But you see, basically, although it's an exchange rate arrangement between fourteen African states and a European one, the burden, if any, lies on the French budget, and not on the Central Bank. As long as the French budgetary authorities are ready to provide an exchange rate guarantee to all European Union exporters, it's up to them. This is exactly what the thrust of these arrangements is. A German exporter, for example, may benefit from an exchange rate guarantee given by the French tax payers. It's great...for the German exporter. [CHUCKLES]

UZAN: Okay, we are going to conclude our session. I would like to thank all of our panelists today. And Paul Kimball and Morgan Stanley and Dean Witter for sponsoring our conference for the last two days. Thank you. [APPLAUSE]

[BACKGROUND DISCUSSION]

EYZAGUIRRE: Good afternoon, thank you very much. We have a very distinguished panel today to discuss this very interesting and fashionable issue of what exchange rate regimes would be appropriate for different emerging markets. As a way of warming things up, and before presenting the members of the panel, I'll take this opportunity to say a few things. [PAUSE]

Well, most of what I'm going to say are just trivial things, but trivial things that authorities often forget. A fact of life is that the domestic rate, unless you want to fool investors all the time, which we know is not possible, has to be approximately R*, meaning the average interest rate of a composite of currencies of the rest of the world, Rho, meaning your country risk, and this term what the market expects will be the future changes of your own exchange rate--that is the relationship between your currency and the composite good made out of the other currencies.

Why do countries peg? Well, they try to get rid of the last term. Therefore, since for most currencies that peg that term is likely to be positive...if you peg to a, let's say quote, unquote, better currency, your likely to enjoy lower domestic rates. [PAUSE]

But if you peg, for a given level of the interest rates abroad, you can not move your domestic rate without affecting the country risk. Authorities usually forget this. For instance, in East Asia, when capitalists where throwing in and demand pressures built up, authorities attempted to raise interest rates, so they encouraged more capital inflows. The other way around, like Brazil trying to cut interest rates at the beginning of the new program within a [U/I], a small bank, without improving the country risk. That's impossible to hold. And the way to affect Rho, is through different measures, say a better fiscal stance, enhanced structural programs, and the like. But what you can not do if you want to [U/I]...you want [NOISE] R unless you change Rho. [PAUSE]

If there's a float you enjoy the possibility of moving R. But if you want to move R, you have to accept that E, that is the exchange rate between your currency and the rest of the composite good, has to change in order to compensate through the last term the change you have made in the first one. Normally, if you raise interest rates, the level of you exchange rate is going to appreciate, and the other way around. Countries also keep forgetting that this relationship holds. And for instance, after floating Brazil was trying to hold the value of the real and to cut interest rates at the same time. That's not possible. [PAUSE]

Well, within, let's say, well managed exchange rate regimes, what are the options? If your domestic currency lacks reputation, that's typically what happens in countries that have suffered a period of hyper inflation, there's no way you're going to convince people that you really have changed, and your currency is going to be as stable as the deutschmark...so if that's the case, and your domestic currency lacks reputation, this term is going to be quite big. And that's going to produce a high [U/I] to domestic rates. That's what Argentina is trying to do. The peg tries to diminish this. But to dollarize puts this in zero. So for a given R, you're going to enjoy the lowest possible domestic rate.

However...and I'm finishing with this, if you can enjoy the luxury of having a credible currency, you can float. And if you can float, you can have both flexible domestic rates, in order to compensate for differences in the cyclical pattern between your economy and the rest of the world, and you can also have a moderate R, because the last term of the equation is not going to be that big.

But I think the crucial question is: can emerging markets have a credible currency? Some of us do--sorry--when we commit ourselves to inflation targets and fulfill them for a number of years. Now I'm going to...Mr. Bernard Delbecque, an Adviser to the Minister of Finance of Belgium. Please, Mr. Delbecque.

DELBECQUE: Thank you, chairman. I am indeed advising the Minister of Finance of Belgium on international affairs, and in this capacity I have been following closely with him the evolution of the crisis in Asia, in '97 and '98, especially when the Minister, [U/I], was the Chairman of the Interim Committee of the IMF. At that time, I must say, the issue of exchange rate regime was not really at the center of the discussion. And in some respects it's quite interesting that the program of this conference has highlighted the importance of this issue. And I believe that our discussion yesterday has also fueled a number of questions.

The collapse of the Russian ruble, and more recently the difficulty of the real, have fueled a new debate. The fact that Argentina is now considered dollarization shows the extent to which the globalization of financial markets has made it more and more difficult for countries to continue maintain a fixed peg. How to maintain even exchange rate stability under floating rates? So the question which arises then is the following: what countries like Brazil, Argentina, Hungary, or Poland choose to protect their exchange rate against international market volatility?

Our chairman has made an interesting introduction to the panel discussion. And in some respects, my talk today will extend what he just said. I've done some research in the field, and I would like to share with you an idea, which is the following: I think that countries that value a high degree of stability for the exchange rate could adopt what I call a target exchange rate regime. What do I mean by that? The authorities who would adopt a target exchange rate regime would make a clear choice in favor of keeping the exchange rate close to a declared target. But at the same time, they would recognize that a successful defense of the target may be too costly, is indeed often too costly. So they would exchange the fact that the exchange rate would depreciate during periods of currency turmoil, but they would accompany the depreciation with some monetary tightening in order to give the markets a signal about their willingness to eventually bring the exchange rate, with the help of the markets, back to its targeted level.

To highlight further, what I see as the characteristic of this regime...let me say first that this regime, targeted rates, differs from target zones, which have been mentioned often in the literature and still morning, in the sense that the behavior of the exchange rate would not be constrained by fluctuation bands. And as you know, if you have fluctuation bands, you leave open the possibility of speculative attacks against the bands. That is one aspect.

The second thing is that targeted rates differ from a managed float, because the authorities declare the target they would like to maintain, which is not the case in the managed float. And in my view, the central rate is there to help markets to form their expectations, and at the same time, because the authorities allow some degree of fluctuation, they would not be constrained, as they are in a fixed exchange rate regime.

Let me try to explain how this system could work. My first remark is that of course the operation of such a regime would depend on the credibility of the declared target. So let us assume for the time being that the target is credible, and that means that market participants believe that the exchange rate could indeed converge and stay at this level. Then under this assumption it can be anticipated that market participants would set the exchange rate equal to the target, almost by definition, as long as the central bank keeps an appropriate level of interest rate in relation to foreign interest rate levels, in relation to the R* that was presented by the chairman. This is the easy case, the credible case.

What about the situation when the markets believe that there could be some change in the declared target? Then you can imagine that there would be some speculation that would give rise to the depreciation of the exchange rate. The authorities would allow this depreciation happen, but they would react by announcing to the market the value they still give to the target, and they would use an active interest rate policy rule, that is, they would increase somewhat the domestic interest rate to show their commitment to the stability of the exchange rate. And some point markets would have to reassess the situation in view of the authorities' apparent commitment to the target, taking into account the fact that a positive interest rate differential favorable to the national currency would create pressure for appreciation. Also following prudent macroeconomic policies, possibly in the context of a stabilization program supported by the IMF, would help boosting confidence, reduce market pressure, and push the exchange rate back towards its target.

In order to get a better view or better understanding of how targeted rates could function in reality, I would suggest that you think of the experience of the wide margin European monetary system, after the widening of the margin in August '93. Following this decision, participating countries continued to give great importance to maintaining exchange rate stability around the parity vis-a-vis the deutschmark. But they allowed exchange rate fluctuation in periods of tension. And a review of this experience...

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DELBECQUE: ...behavior of exchange rates vis-a-vis the deutschmark, and the behavior of short term interest rate differentials vis-a-vis the deutschmark. These graphs show the role of the parity as an anchor for the exchange rate. This is a key role. If you look at a country like Italy, after having left the ERM rejoined it in '96, and the lira managed just to go back to the level of the parity. The same for Finland. Of course there has been a period of severe tension, especially in the summer and the autumn of '93, and at that time most commentators in the press, and most people in the markets believed that the ERM was dead. We know that was not the case. But a new exchange rate regime, in my view, was born this way a little bit by chance. And what was very important was the fact that ministers in '93 accepted to maintain the parity, and valued a return rate of the exchange rate toward the parity. The crisis was short-lived in Belgium. In France it took a longer time to restore the credibility, but the exchange rate finally reverted to its central parity, as you can see in the graph. So my point it the importance of the parity of the target vis-a-vis the fluctuation bands. I am convinced that the system in Europe would have worked the same way without fluctuation bands, or infinite bands. The key point was that we maintained parities.

My second point is in regard to interest rates. Short-term interest rate differentials move parallel to the exchange rates, reflecting the use of this active interest rate policy that I mentioned, and that has been used effectively by central banks in Europe between '93 and the end of last year.

I don't have time to extend this analysis, but I believe that for countries committed to stabilizing their exchange rate at a specific level, and to use monetary policy to this end, to some extent, a targeted exchange rate regime could offer an interesting alternative to pegged exchange rates.

Let me conclude with a final list of advantages of this system compared to fixed rates. First, speculative attacks against the exchange target would discredit less the authorities concerned, since they could claim that the depreciation of their currency is temporary, and possibly not inconsistent with the [U/I] maintenance of the target.

Second, the defense of the currency on the targeted rates does not [U/I] to increase interest rates as high as on the fixed rates. That's an important point. I think that we mentioned globalization and the fact that it was difficult because of large capital flows to maintain pegged rates. The difficulty also is that the authorities are not willing to maintain for a long time the interest rate at the level necessary to keep the exchange rate [U/I]. So in the case of speculative attacks targeted rates help the government to solve the tradeoff between the cost of abandoning the target and the cost of raising the nominal interest rate to defend the currency.

Three, on the fixed pegs the country's exchange rate reserves are tied down to defend the peg. And therefore the speculators are left with a one-way option, this is well-known. On the targeted rate the reserves will be protected.

And finally, targeted rates would tend to reduce speculative tension in the foreign exchange markets. Indeed, if the central bank lets the currency depreciate in a period of tension, the potential for capital gains is diminishing, and the more the exchange has depreciated, the lower the potential for further depreciation, and the higher the potential for appreciation. So the one-way [U/I] becomes a two-way [U/I].

Of course, we would all agree that there is nothing magical, and I certainly don't think that there is anything magical about this proposal. As I said, the success of the operation a such a regime would depend ultimately on the credibility of the target, because it allows fluctuation. And at the end of the day a country that adopted this regime would like to see the same pattern as that observed in Europe. Okay, in terms of tension, one can accept some fluctuation, but we should also demonstrate the possibility of going back to the target. And one should also choose the right level the target. So this means that the authorities willing to adopt such a regime might find it useful to seek external support. Depending on the circumstances this support could come from different sources, the anchor country, and of course, an institution like the IMF, which could play an important role in confirming that the preconditions for targeting a specific level of exchange rate are satisfied. And that the level of the target is appropriate.

So in the case of Brazil, for instance, at this stage it might be wise to wait until the necessary measure have been taken to restore confidence in the government's ability to reduce the fiscal deficit. But once confidence is restored, in my view--this just a personal suggestion--it might be worth considering adopting a regime like this one fixing a target, helping the markets to form their expectations, and supporting this new policy by an active monetary policy role. Thank you.

EYZAGUIRRE: Thank you very much, Mr. Delbecque--I hope I got the pronunciation right this time: Delbecque--for your very thought-provoking remarks, which should be of no surprise to us, given your very strong educational background, including the University of [U/I], which I happen to know, and the University of Pennsylvania, and the fact that Mr. Delbecque worked for the Fund for some years.

Now I have the pleasure to introduce to you Mr. Rogelio Ramirez, who is a citizen of Mexico. Mr. Ramirez also holds a Ph.D. from Cambridge University and is a regular speaker at international conferences, and publishes heavily on developments in Mexico and in the international economy. Mr. Ramirez, please.

RAMIREZ: Thank you very much. I am going to try and simplify my presentation by focusing more strictly on the Mexican experience, which is a short experience with a floating exchange rate since 1,995, and to tell you a bit of the observed performance of this exchange rate and of Mexico's economy. And I'm saying this is the first experience with floating rates, because although Mexico had officially a floating rate, more or less since 1,977, in fact it was not really letting it float. So that when we talk about the experience of Mexico with the floating exchange rate regime, we're really talking more about a verti-floating, or a managed-floating, or a floating regime officially, but in fact a disguised one, being in reality the pursuit of some kind of notional fixed exchange rate or band exchange rate.

And what has happened in Mexico, and the most reason why Mexico is now pursuing a floating exchange rate is the very bad experience that it had with the previous regimes, and the fact that the inauguration of President Zedillo almost coincided with the collapse of what was viewed before as a very strong peso, as you well recall. In fact the most important first statement of the already inaugurated President Zedillo was precisely to qualify the mistakes of the Bank of Mexico and of the previous Minister of Finance, as having committed a great mistake. That was his wording for allowing not only the accumulation of very large current account deficits, but also an overvaluation of the exchange rate.

And this, I think, compelled the president to follow-up a much more freely floating exchange rate. And it wasn't really much of a choice, because Mexico didn't have reserves, and the few reserves that Mexico had, as you can recall, could not be committed to the defense of the exchange rate, according to the agreement with the IMF. So Mexico inaugurated a new floating exchange rate in 1,995. And what we have seen since 1,995 is that the economy shows a much stronger condition in structural terms.

I am digressing a little bit, and I am not focusing on what are the conditions for the financial sector, because I think in these discussions we usually tend to forget that there are also structural conditions that an exchange rate regime has to deliver, namely, growth in output and in jobs. And a country that has these needs, as Mexico does, to produce a million jobs a year just can not forget that a good exchange rate regime has to deliver growth in jobs and in output.

And therefore, since 1,995...and you can see in one of those charts that I presented, GDP has shown very good performance: 5.5% per year in the last 3 years, and I hear that today the Bank of Mexico announced the rate of growth for 1,998 having been 4.8%, which is very good for a difficult year in the international markets. Not only that, but manufacturing output, which had consistently been below the average rate of GDP growth for a long period of time, including since the late '70s, has shown 9.2% annual growth over this last three years, '96-'98. And manufacturing employment, which even in the years of the Salinas administration, when Mexico recorded huge capital inflows, and manufacturing growth was stagnant or even negative, has increased with the floating exchange rate by 4.1% per year. So I think there are very good reasons for Mexico to be relatively satisfied with the floating exchange rate, viewing the performance in the structure of the economy.

Okay, in the background we have a few special considerations to make, one of them is that probably this performance would not have been possible without NAFTA. So NAFTA is a special consideration, and an important one for the aforesaid.

Second, there has been, as you know, reconversion of the Mexican economy since the late 1980s, which precisely created some preconditions for investment in manufacturing industries. And of course, there were some structural reforms that were carried out by the Salinas administration, whose results were evident in the Zedillo administration. But I think the merits of a floating in Mexico...and when we see the Mexican peso overshooting even in the short-term, and even now, with the background of this very good experience, we have to recognize that the Bank of Mexico is under a new regime allowing the peso to overshoot in the short-term. We have seen the peso overshooting in the autumn of 1,998, in the autumn of 1,995, during several episodes the peso has overshot, and the Bank of Mexico has allowed it to overshoot. In the last experience of very heavy turmoil in the markets, you can see that the Bank of Mexico has not lost reserves. In fact, it has made a small gain in international reserves, despite the fact that we have accommodated a very heavy international shock through falling oil prices, and through the effects from the Asian crisis in Mexico's manufacturing activity.

Now, looking into the background, I think Mexico now has a very large size for a manufacturing economy that hardly would allow it to make mistakes with the exchange rate. Mexico's manufacturing is, in terms of exports of medium and high-tech manufacturing, only 4th in the emerging economies group, following China. And it's well, well, well above Brazil in terms of exports of manufactures. For example, in 1,996 Mexico was exporting 51 billion dollars of medium and high-tech products, compared to 13 billion of Brazil. So I think it's also fair to say, Mexico's trade structure is much more similar to the structure of Canadian trade, and Mexico's manufacturing being increasingly integrated with US., make it a lot more similar to Canada than to Brazil, or Argentina, or countries in South America.

And for that reason I think Mexico has a lot to learn from the Canadian regime of floating exchange rates, and also trade policy. And I think that offers a very good scope for Mexico to follow up a pragmatic policy, where, of course, the floating exchange rate is not perfection, is not panacea, it has a lot of problems, as we were just reminded by this very good introduction by the chairman of this panel. But I think in the case of Mexico it's been a good compromise between the play of the market and the objectives of medium term sustainability and growth. Thank you very much.

EYZAGUIRRE: Thank you very much, Mr. Ramirez. I have the pleasure now to introduce Miss. Joyce Chang, former student of both Columbia University and the Woodrow Wilson in Princeton University. Miss. Chang has held a number of key positions in investment banks, including Solomon Brothers, and now in Merrill Lynch. Miss. Chang.

CHANG: Thank you very much. When Marc asked me to speak at this conference, he asked me to comment on what the experience has been in different emerging market regions, and which exchange rate regimes seem to have worked. And so I thought I would pick up on some of the comments made by both of our two previous speakers. It was interesting we hosted a meeting with the Mexican government officials a few days ago, and the policy makers started out the meeting saying, "Well, what the current crisis has taught us is that countries have no choice deciding between floating rate regimes and currency boards, or dollarization of their economies." And Mexico has made the choice of a floating rate regime. And I thought what I would do is revisit that, and see if that's really been the case, because over the past year on thing that has stood out is that if you look at the experience of the convergence economies in the emerging markets currencies, they really have been spared from the volatility. If you look at Poland, Hungary, Greece, and check, they have had a very different experience from the Asian and Latin American countries. And one of the questions that came up as I looked at this, and why they've been able to sustain managed currencies...they've had more success with some of the aspects that our first speakers talked about, widening the band, [U/I] targets, and why has that been the case? And I think it's been a number of different factor. The exchange rate regime should be used as a tool for managing a country's fundamental outlook. I think in the case of Latin America, what has become much more and more used as the anchor...and this has sort of worked in the convergence economies because it is one tool, but you also have some very strong underlying policies, whereas in Latin America I think that you hear time and time again, "The exchange rate will be used in the interim as a tool, until we can get other things put into place on the fiscal side," as far as bringing in other policies. And then in Latin America the political environment is a far greater constraint than in some of the other regions.

So I think one thing that has stood out is...one conclusion that we have come to...when you look at what's happening in Brazil right now, more flexible exchange rate regimes are generally what have worked, but also the whole debate on capital controls is going to need to be revisited, because it does seem, if you go through the experience that Brazil is now having with a free floating rate, that that's something that is going to come up more as an issue...and that we think that that's something they may be pushed towards over the very near term.

So what I thought I would do is just talk about Latin America, picking up on some Rogelio's comments about some of the differences we see between Brazil and Mexico, why the convergence economies have been different, and some of the experiences that the Asian countries went through, and the market response. We end up hearing from investors what they find as credible in the marketplace right now.

But I think that in the case of Brazil, as you look at many of the Latin economies, they face a number key constraints. They are net commodities exporters, and so any time there's any type of terms of trade shock, even for a country like Mexico which has diversified its economy, they're hit very strongly with this. And you can make the argument that they should try to use these instruments to hedge out volatility, but you find that in many of these countries there are key constraints to selling forward oil, to taking any of these measures. So I think that in Latin America it's hard to generalize based on any of these countries, but what you've seen is that the fixed exchange rates have not been that effective, in part because governments have used that as the anchor. And I think that also the structure of these economies has made it much harder for those exchange rate regimes to be effective.

In the case of Brazil specifically, what are we most concerned about right now? I would be very concerned about what they can do to bring down interest rates. And I think that in a country where for the last three and a half years the average interest rate has been 22.6%, when you haven't had the inflationary risk, the concerns that people have about domestic debt refinancing risk...and you haven't also had the concerns that you're basically going on about these risks, you've still had 22.6% inflation. We don't see a situation where they probably can bring down rates very well. And I think that even if you talk about targeting and other options, in practice in Brazil this is not going to happen. And I think that the capital controls and the whole debate over this will probably need to be revisited. And that you will see is that in those countries which have used some forms of controls on inflows, whether it's Chile or even Poland, in letting inflows in the country, the country's experience has actually been relatively positive. And I think that that's one thing that the official creditors will have to revisit very much, the whole debate on whether a country should ever resort to capital controls or other forms of controls. And I think the market tends to sort of jump to conclusions on what this means, but the controls on inflows are ones which we would say have not necessarily been that bad for countries, if you look at the experience of countries when they have tried to open their local currency market to foreign investors.

I think that the other option of going to a currency board or dollarization, if you run out of other choices...if you look at the number of currency boards that have existed, they have declined over the years. In 1,960, for example, there were 38 countries that had currency boards, in 1,970 there were about 20, and then by the late '80s there were only 9. And these have been effective in mostly smaller countries, whereas I think many people in the market tend to view this as a panacea right now for what countries ought to do. What should Argentina and Brazil do in this kind of crisis?, what should Mexico do? One can see that these examples have really been only effective in smaller economies, like a Bulgaria, or a Lithuania, or an Estonia, and that it really has not had much of a success record in a country that is of a much larger size. And I think that in Mexico many people were asking themselves, in the marketplace last year, what have been the benefits of a free floating exchange rate regime. And I think that this year the benefits will be more obvious, for example, Argentina will shrink, Mexico will not, this year. And last year I think that was being debated very much.

So it seems to me that, at least when you look at Latin America, some of the issues that come up very much...the structure of the economies, the dependency on commodities...in political systems that have made it difficult to put in other reforms it's been very convenient to use the exchange rate, first as a mechanism for stability...and basically what can countries do in this kind of environment? The managed rates have really worked in those countries, such as the convergence economies, where they have very strong linkages to the introduction of the euro and to continued [U/I] and headline inflations. And they can work in those kinds of situations, but I would say that in Latin America the practice that has been...something that should be used as one tool for policies has been subsumed into kind of taking over and becoming the anchor. And that's been something that's been proven unsustainable in the case of Brazil, and also in the case of Mexico. And I would say that that's what happened in Russia as well.

Just to go to the Asian examples of what ended up being some of the fatal flaws, and what can be used to address them, I would say that in the Asian countries that really experienced crisis, and there were certainly innocent bystanders like the Philippines, what happened time and time again was that an open capital account, combined with having a weak banking system, really was disastrous. And it seems to me that you come back to the whole issue of what kinds of capital controls can be used effectively, and should some of the arguments that were used against capital controls and against opening the capital account really be revisited in the Asian example.

So it seems to me that there have been examples in emerging markets countries where you can find a compromise in between the two extremes that most emerging markets countries think they're faced with. That's basically worked in some of the convergence economies, but if you look at them from a market perspective, these have been markets that, generally speaking, have not opened up to investors, and have been very careful about just how much they will allow in foreign flows compared to other countries. And it seems to me that much of that framework will need to be revisited, as one looks at what kinds of policies will be advocated for countries to manage their capital inflows.

As we look at some of the dilemmas that are facing the official creditors right now, one of the key issues that seems to be coming up is that some of the risk that banks took on...do we continue to lend to these countries because we want them to be able to pay us back, and to continue to be in the dialogue, seems to be transferred more and more to the official creditors. And I think that we are at a point right now where there are no easy solutions, but more discussion about capital controls and how they might effectively be used, with Brazil being a key country to focus on, is going to be critical in the year going forward.

EYZAGUIRRE: Well, thank you very much, Miss. Chang, I think you have given us a lot of food for thought. I'm looking forward to questions about your remarks. To finish this first round, I have the pleasure to introduce Mr. Carlos Asilis, who has such a long curriculum that it's hard to choose...which aspects to highlight... Mr. Asilis was formerly in academia, he was a brilliant scholar, including in the very stupendous research department of [U/I]. And then he moved to private business where he has been a key player in a number of positions. Now he is a Senior Advisor at Vector Investment Advisors. Mr. Asilis.

ASILIS: Thank you. The subject matter clearly is key. Not just at present, but it's always been essential in macroeconomic management for emerging markets. So, the first issue is, of course, to recognize that to talk about an optimal exchange rate regime in emerging markets presupposes a set of tradeoffs, that were extremely well articulated by the chairman at the beginning of the session. Generally, these tradeoffs are expressed in terms of inflation, and GDP growth or unemployment. I'll talk about this at length in a few minutes. So that's the first issue to recognize.

I'll talk first about the facts in terms of the empirical regularities, so to speak, if one can talk about empirical regularities across various exchange rate regimes. I'll be looking at several regimes, essentially floating [U/I] regimes, pegged, which can be of various types, and currency board regimes. A fourth regime which I will not be talking about is joining a currency union, e.g., the Argentine proposal of fully dollarizing the economy, the euro in the case of Europe, and a dollar zone in the Western Hemisphere. So, broadly speaking there are four types.

Clearly, of these four types of [U/I] regimes the pegged regime has various incarnations. I find the Chilean case to be the most efficient and credible, because it targets a basket of currencies. It is very well implemented, it has a very sound financial system, and it has very favorable initial conditions on the fiscal front. But I mention the Chilean case because I think that one should be somewhat cautious in extrapolating from the Chilean example to other emerging market countries. Because Chile is an [U/I] in terms of the degree of institutional development. Its history of economic performance, the vary sad experiences that it went through in the early '80s, which essentially planted the seed for the creation of a group of very talented economists, and a consensus that ensued in Chilean society at the political, not just at the technical level, has produced the results that we are all witnessing.

So these are the four types of regimes that I'll be talking about. First let's look at the facts. I will draw on an empirical work that a former co-author of mine at the IMF did about a year ago. He's [U/I], an Indian economist who was on the faculty at Princeton prior to joining the IMF. And in this report, this is working paper number 8, written in 1,998, he essentially compiles key macroeconomic performance indicators across various exchange rate regimes. And what does he find? To focus the discussion I'll be looking exclusively at two indicators, no second moments here, just the mean inflation and the GDP rate of growth. If we think of a welfare function, the final target should be to minimize the inflation rate, and to maximize the GDP growth rate. So, is we look at three types of regimes, currency board regimes, pegged regimes, and floating regimes, what does the data show?

The data over the last 20 years, I won't get into the details as to what the sample consists of, I refer you to the report itself...first before I give you the numbers, what it shows is that the currency board system is the superior regime. That's the first result. There are a lot of qualifications I will address, but it is superior to both pegged and floating. Moreover, between pegged and floating the most optimal of the two is unclear. In other words, as far as the inflation rate goes the pegged regime dominates over the floating regime, 23.8% versus 73.9% for the sample period in question. But as far as the GDP growth rate is concerned, the floating regime dominates over the pegged regime. And the numbers there are 1.1% GDP growth rate for the floating regime versus 1% for pegged regimes, excluding a currency board regime obviously.

The report also looks at a subsample of countries that, for the sample period in question, have not applied capital controls. And there the ranking becomes more interesting, because no single regime dominates over the others. And so the discussion turns back to theory once again, as well as to specific country characteristics such as institutional development, the nature of international trade, structural economic features, etc.

Now, before I outline some of the arguments that I want to present, I'll tell you what my recommendation would be. My strong opinion is that fewer pegged regimes, except for countries with very strong institutional development, or with very favorable initial conditions--fiscal variables particularly--and a sound banking system...and there are very few out there, Chile in my book is the strongest economy of the emerging markets in so far as those indicators are concerned, so we can not use the Chilean example as a prototype in applying the model to other emerging countries... So I think the floating regime or a currency board regime, or joining a currency union, but that would have to be qualified in a major way, are the only sustainable regimes in the long term. Pure pegged regimes are not.

Moreover, if I draw on my experience in the private capital markets, this conclusion is reaffirmed. In other words, fixed exchange rate regimes essentially amount to just putting out a target that market participants, particularly large hedge funds, aim at. So they're easy targets more often than not. This is sad, but it is the truth. So I think floating regimes and extreme forms of pegged regimes, currency boards, or joining currency unions, are the regimes that we should be focusing on. With very few examples, I mentioned Chile...I think they're doing exactly what they should be doing, no criticisms there.

Well, the question then becomes, floating versus currency board, or joining a currency union. For starters, joining a currency union or fully dollarizing the economy, as the Argentines are trying to do, I think is a good idea. There clearly is not much of precedent, because you have to sort out the issue of lender of last resort, and this brings us into the realm of legal matters. The Argentines have to relinquish sovereignty in certain areas, particularly with regard to the supervision over the financial system. They absolutely would have to do that for a fully dollarized regime to be sustainable. So there really is no precedent, and there really is no real case of a medium size economy that is fully dollarized in the way in which the Argentines are talking about, the euro of course being an example, but we know how long it took the Europeans, going through two world wars, to talk about having their own currency.

So I really would be discarding at this point, clearly it wouldn't apply to Brazil, joining a currency union. So the issue is currency board. Introducing a currency board is also extremely difficult. And again, I think it would apply to a very limited set of countries. So you can see what my recommendation is taking us to, I think floating is the only solution, really. But there are countries out there for which a currency board is a good idea. They have to a very strong and broad political support for relinquishing sovereignty. The issue here is rules versus discretion. One of the attractive features of a currency board system is that it addresses the timing consistency problem, the issue of credibility, in a very extreme way. Fixed exchange rate regimes, you could argue, do address this issue, but in not as convincing a manner as a currency board regime. So that's the first issue that a currency board regime addresses.

The second issue that a currency board system addresses is that it helps deter the onset of self-fulfilling runs on the currency--multiple equilibria, as professional economists call it. So these are some of the advantages of a currency board regime. The payoff is of course what Nicolas Eyzaguirre mentioned, that if sustained the application of a credible currency board system would lead to lower interest rates.

What are the costs of a currency board system? Here I'm going to defer the discussion of the introduction of a currency board system for two more minutes. I think there's just no chance that the Brazilians can introduce a currency board system. Joyce Chang talked about Brazil to help this discussion somewhat current. I think that one of the costs is, of course, that it can be abandoned just as easily as a fixed exchange rate regime. And Stanley Fisher had a paper in the QJE, Quarterly Journal of Economics, precisely on the issue of dollarization, and the issue that ultimately, since you're dealing with a sovereign entity, even if you fully dollarize your economy, there's always the incentive and the ability and technology to introduce your own currency.

So a currency board is no panacea, that's the first point. The second point is that the size of an economy does matter, if one considering the introduction of a currency board system. And here I think that the increasingly globalized nature of the world economy leads us to a conclusion which is completely antithetical, the opposite of what the professional economists were talking about ten years ago, even five years ago, which is that the more natural candidates for the introduction of a currency board system are larger economies. So in other words, the larger an economy the better the candidate for a currency board system, other things held equal. But then again, I don't think this applies to Brazil. And the reason of course is that if you're a small country, take the case of a Central American country, these countries were afflicted by hurricane Mitch, for instance...very severe macroeconomic consequences in these economies. You would need a realignment of the exchange rate, in so far as you need to account for the wealth effects of a shock of the magnitude that afflicted those countries...and not just the geographical size of those countries, but also the diversification of their economies. So that's the other issue.

The other one, is of course, the issue of lender of last resort, which brings into the realm of legal matters, and since I'm not a lawyer, I won't spend any time on it. The other issue which is obvious but critical is that the credible introduction of a currency board system requires very broad political support for the removal of discretions from currency management. That's essential. The Argentines have it, the Germans have it, because they have gone through very extreme levels of inflation. The Brazilians do not, to the same degree. Yes, they've gone through periods of chronic inflation, I wouldn't call it hyper inflation, but chronic inflation certainly, but the political support is just not there. It was a very heavily indexed economy. They never got to liquefy the government liabilities, which is the problem that we have at hand. Almost 85% of public debt is essentially indexed, 20% to the dollar, and the rest to the overnight rate. So unless they hold interest rates below inflationary levels, which would lead to problems that were already discussed by Mr. Eyzaguirre, they won't be able to liquefy their public debt levels. And unless you do that you can not introduce a credible currency board system. The Argentines did it, of course, they got rid of the real burden of the debt prior to the introduction of the currency board.

It's somewhat disturbing, but before today Carlos Rodriguez, an academic at SEMA...

Tape 3-Day 2, side B

ASILIS: ...so I think Mr. Rodriguez just felt a little excited, but I don't think it's going to work.

So I think that's essentially it. The conclusion is that as a general rule of thumb floating really is the only way to go. Of course, it's not panacea. You have to have a very strong and solid financial system, government authorities should aim to improve the quality and the integrity of their financial system, sound macro policies. And for those countries that have gone through periods of hyper inflation, which carries a lot of pain, then if they meet these other requirements, in so far as stock fiscal variables are concerned, not just flow variables, but stock variables, public debt in particular, then the introduction of a currency board regime can be a possibility. Thank you.

EYZAGUIRRE: Well thank you very much, Mr. Asislis, for your very brilliant analysis. I should point out at this stage that Mr. Asilis is not a national of Chile. Given that we are very much into the discussion, why don't we begin the Q & A now, and then we'll break for coffee. Please, the floor is open. Over there.

UM: ...[I/A], I have a question for you. [I/A] in '82 the capitalists argue in favor different capital controls. Chile used to have it, but it really no longer has it. What's your take on it?

EYZAGUIRRE: Well, here I'm supposed to be the chairperson, not somebody to give opinions, but...since I started already doing that... The reason is quite simple. You are not likely to unfold your umbrella when it's not raining. The prudentials regulations that were established in Chile, were established in a situation where the money was flowing into the country, not just into Chile, but into all emerging markets, to our best knowledge, some of it driven by fundamentals, and a good portion of it driven by heard behavior. So we try to hedge ourselves against contingencies, and the best way that I still can think of, in terms of bailing in the private sector, is having very little short-term debt. Now that the risk [U/I] spreads are high again, to a large extent unfairly, I would say, an innocent bystanders kind of consideration, the former restriction was no longer needed, but the authorities have set the rate at zero. They have not eliminated the rate. Does anyone else want to talk about capital controls?

CHANG: I think it's important to clarify too that controls on capital inflows versus currency controls and capital controls, as they're loosely thrown around, are things that should be distinguished. And if you look at a lot of the economies where they actually have been more insulated from the turbulence...in many countries which really do put restrictions on capital inflows. I think there are ways in which you can talk about capital controls that are not the full-fledged...you know, it doesn't have to be Malasia-like per se. But if you look at, for example, the Middle Eastern economies, or the African economies, or some of the smaller economies where they really have been outside of the flow of global turbulence, they have been less liquid markets, but many of them had some restrictions on capital inflows, which does not mean outright capital controls or currency controls...but it seems to me that if you look at what Brazils' options come down to right now, there will be more of a debate on the coming weeks if not days Because if you look at Brazil's options to let the exchange rate overshoot or reinflate...they've already gone through those two...so that does bring them to capital controls and looking at restructuring the domestic debt.

ASILIS: Just two comments to supplement what Joyce has mentioned, from a different angle completely. I think the issue of capital controls is a tricky one. Clearly, over the long-term, medium-term even, they only bring you bad results. There's a lot of work that has been done on the issue of capital controls. They're clearly bad in the medium-term. In the short-term, like the current juncture in Brazil, one has to be very cautious because they could provide an easy way out for the authorities, who may perceive the imposition of capital controls as a substitute for the improvement of the fiscal outlook for the country. And the adoption of capital controls could be construed by political forces...and one should never underestimate the power of politicians to do damage to an economy for their own self-interest. It could have very detrimental effects. So I think there are issues over the medium-term. If you are in very sound conditions, in a very stable external backdrop, the imposition of a certain type of capital controls, particularly as they affect the short-term capital, may be quite prudent. I think that makes sense, depending on the specific case in question. I wouldn't come up with a universal rule for these types of flows. But for a country that is undergoing a situation of distress, that can be detrimental for the political aspect. Second point, if you look at, and this is purely statistical, empirical studies, econometric studies of sovereign risk premia and their primary determinants, history matters, reputation matters. Default episodes during which capital controls were introduced matter in a highly significant fashion. Actually, default variables always enter with a very high confidence level, and the coefficients are extremely important. I do not recall the exact contribution to the sovereign risk premia, but they're significant and they have a long lasting effect. In other words, the markets have a long memory. So you have to be very careful, I would go on a case by case basis. And again, in the case of Brazil, essentially it's indexed. It's a very complicated situation. So they really have to address the flow problem. The stock problem is very difficult. I think the first line of attack should be to address the flow problem, and see how the markets respond. And perhaps they respond positively, which would make the current stock levels on public debt, for instance, sustainable. I wouldn't resort to capital controls at this point, but as a general rule of thumb.

EYZAGUIRRE: Well, I should say that the sole term capital controls in the case of Brazil terrifies me. We Chileans are very much against controls. Actually, the Heritage Foundation ranked Chile as one of the most liberal economies in the world. It's a very different thing to put a...friendly tax, not quota, but price based on short-term inflows from capital controls. Please do not confuse the two experiences. The floor is open. The gentleman over there...

UM: Thank you. I'm perhaps a bit confused about something, but I want to revisit this question of the dollarization option. The tendency is to see this as some kind of solution here, but the more I think about it, the more it seems to me it raises more problems than it may resolve. First of all, in the sense leaving the country that does this rather open to any and all domestic monetary events in the United States. And the United States has a history, ever since the '60s at least, of chronic balance of payments deficits. The fist Bretton Woods system essentially collapsed over the chronic balance of payments deficits of the United States. Secondly, what good would a dollarized system do to limit short-term capital flows. I mean, if a country goes over to a dollar system, wouldn't it be all the easier just to ship the capital out, when there are other problems in the economy? And thirdly, would it be so possible as you say if a country decided that, if for some reason its dollarized system wasn't working, it could so easily revert to a sovereign currency? It seems to me that that would be a horribly wrenching thing to do. Whoever wants to respond.

EYZAGUIRRE: Why don't we collect remarks a little bit?

UM: I have a couple questions for Mr. Delbecque. I was intrigued by your proposal. I guess I have a few questions though. Firstly, how would you select, presumably an equilibrium exchange rate, as a target exchange rate in the absence of any really generally accepted model of exchange rate determination. How would you choose your target? And presumably over time, in the face of policy shocks, real shocks, domestically or externally, the equilibrium exchange rate would change, and so how would you adjust your target over time, without compromising the credibility of that target? And thirdly, how is your proposal consistent with central banks aiming for price stability?

EYZAGUIRRE: Why don't we start with the questions for Mr. Delbecque? Keep in mind that he's in a bit of a hurry. And the whole panel will be able to intervene on both questions. Mr. Delbecque.

DELBECQUE: The question you are raising is a question that should be raised also in regard to fixed exchange rates regimes. But still, there are countries which consider, for various reasons regarding, for instance, their trade relationships with neighboring countries, and so on, that it's better to have a pegged exchange rate. And then, indeed, you have to find a target, and to take into account a number of considerations like competitiveness, and so on. But the experience shows that this is possible. There exist some models that have been developed to try to find what can be a good exchange rate.

And regarding the possibility of changing the rate or changing the target, I believe that the target rates would perhaps allow doing it more easily than on the fixed rate, because, in fact, fixed rates seem not to be possible any longer, because, as Mr. Asilis says, it's a target for hedge funds and speculators, so we exclude that. And seems that my colleagues here have said that, floating rates seem to be now the credible option for most countries. I can agree with most of the arguments that have been developed, but still some authorities value some sort of stability. And I think that market participants can also appreciate some signals from the authorities on the exchange rate policy, and on the level of the exchange rate. And if you look at the IMF and at the global economy, there is also a need to avoid excessive exchange rate fluctuation, and competitive depreciation. Does are arguments, I believe, to try to see whether there is no other option than floating, taking into account the difficulties that you mentioned. But, for instance, in Europe difficulties we could manage. We had to fix the rates vis-a-vis the euro. How where we able to lock the currency to the euro at the specific rate?, this was done. After all the exchange rate is an important variable, but you have a margin for error. You have other variables that can adjust in the economy, if indeed you miss the target, and you choose the wrong rate. This is possible.

And to conclude, in times of turmoil it is a possibility for the authorities to choose another target. I mean, if it's obvious that there is a need for a devaluation. It happened in France a few times in the '80s. But even though markets have long memories, with the change in government, with the change in policy the authorities can regain credibility, sometimes more easily than one thinks. The point is to give the right signal. And for instance, to have the signal of the IMF for emerging economies might be one thing that authorities should consider, before changing the peg or adopting a target.

EYZAGUIRRE: Does any other member of the panel want to react to the questions?

RAMIREZ: I think that was a very pertinent question. And I think it shows how much economic thinking has evolved, to question things that look nice on paper, but in life they look different. And I think in the 1,990s we see a world with very large capital flows, raising tremendous question marks on very nicely worked out economic models.

I think the exchange rate is one of those very weak anchors on which markets focus. And let's just recall some fundamentals. Mr. [U/I] said, "I've never seen a speculative attack on a currency of a country that has good economic fundamentals." And I think he's right. So we see the world of exchange rates and of economic models starting to break down, precisely where some of the rules of economic fundamentals are not fulfilled. And I think each country has a different degree of fulfillment, each country has its own special conditions, and each country has to find its own way to the exchange rate. I think as a general rule, Milton Friedman was quite right that floating exchange rates were the order of the day, at a particular situation in the world economy. I don't see this particular situation as having changed. I think, in fact, it has very much become accentuated. I remember the meeting we had in the Reinventing Bretton Woods Committee in September 1,994, in which David Malpas was saying Latin America is moving in the direction of fixed exchange rates. And of course, it was not. It was moving in the direction of floating exchange rates, precisely as a result of the large capital flows. So I guess the floating exchange rate is one of the measurements of how imperfect the world, our domestic policies, and our economic thinking all are. The latter can not ever simulate perfectly the functioning of the markets.

CHANG: Some of the issues you brought up with dollarization...you're right, over the longer term what is the exit strategy for some of these countries? That's why I would agree with some of the points that were brought up by Carlos and some of the other speakers. In Argentina, many people when they talk about dollarization think that does mean access to fed discount window, that this is something that would have to go through both congresses, of the US. and Argentina. So I think you do have a lot of buzzwords that are being thrown around very loosely right now. And whether this actually is feasible form a political point of view is a very good question. And the same goes for currency boards right now. Currency boards are options that should be tried when all other options have failed. And that's why there are fewer currency boards now than was the case in the 1,960s, although everybody is throwing it around as a possible solution to the current problems. When a country has completely run out of other options, and has to abandon the government having control over its ability to set policies, you go to a currency board.

And if you ask me in which countries it would make sense to see more of a discussion about a currency board, it would more of what we might classify as the Wild East economies, Russia and the C.I.S. region, where they really have run out of all other options. I don't think that for a number of other countries that should necessarily be considered as the first option. But I think that your points on dollarization, namely, can this really occur politically?, and what does dollarization actually mean as far as some people are assuming it means?

And I think it brings up a number of legal questions as well. You may be able to take the arguments about how you cover the monetary base, but there are then all the legal obligations and contracts, and other things that then need to be taken into consideration, as far as how those are handled, and as far as the legal framework. So I think there has been a lot of oversimplification of both how you would solve problems by dollarizing the economy and by adopting currency boards, because even though currency boards have been extremely effective, what we have seen is a steady decline in the number of countries that actually use them. They have been effective, but they should be adopted really when a country has no other options left.

EYZAGUIRRE: It seems to me that the discussion sometimes switches from, let's say the point of view that would be summarized as: "what matters are fundamentals"--if you're fundamentals are right, whatever your exchange rate regime, you're going to be fine--to the other extreme where the focus of the discussion is: "What is the appropriate exchange rate regime?"

Two comments in this regard. If you have a peg, it's not going to be for free. Okay, you may have good fundamentals, but the fact of life is that you're exposed to shocks, and your fundamentals change. And when your fundamentals change, you have to adapt your economy to a different real exchange rate or slash, level of activity or unemployment. So where you're going to be is a matter of social preference function.

Now, on the other extreme, if you're going to go for a float, do not think for a moment that you can have a float without an anchor. You have to have a strong anchor, like an inflation target. And that means that you are going to have to make painful decisions, whenever you are faced by a shock. And you can not rely upon the movement of the nominal rate to solve your problems, because, as I guess, it was somewhat imbedded in the
reasoning of Mr. Delbecque that if you have a float, and you have a shock, you are faced with a problem of how to avoid an overshooting. And that's not an easy question. Mr. Asilis.

ASILIS: I couldn't agree more with what has just been said. I think that the issue of dollarization and the difficulties of implementing a credible insertion into a currency union are clearly key. At the end of the day, they boil down to the issue of sovereignty. Which brings us to a broader way of looking at why we're holding this session, which is that in this age of globalization, economics is well ahead of politics, which of course was the same case at the beginning of the century. And I think this is a hurdle which is very difficult to overcome. And I don't think it will be overcome in our lifetime. And that's why I think we go back to the issue of floating exchange rates, and we go back to the issue of sound fundamentals.

EYZAGUIRRE: The floor is open. Please, gentlemen.

UM: [I/A] you mentioned a study at the I.M.F [I/A]. How did he isolate the impact of the currency regime on the tradeoff between growth and inflation?, for which I assume you have some kind of utility function, from all other factors that could conceivably have produced those outcomes in each case. That's my first question. And if he didn't in some way try to do it, how would you try to do that?, because I can't imagine a way. And second of all, there are a lot of conferences now about a new financial architecture, I'm just wondering, could you describe to me what a 100% success looks like? I mean, exactly how would exchange rates behave, how would capital and trade flows behave? And if the answer is stability, then give me some notion about what you mean by stability, because I presume it could be quantified, even within ranges of some sort. Please.

ASILIS: Could you please rephrase the second question, I don't quite follow it.

UM: What is a 100% success rate? Describe it to me, characterize how you would know you had achieved it--a new international monetary architecture.

ASILIS: Okay. All right.

UM: What's the goal?

ASILIS: Tough question. Okay. When we're talking about international, we're talking about public goods, and the role of the public sector, right? Because we're talking about the role of international financial institutions, the multilateral's governments, G-7, so we're talking about the public sector role, and a presumably the motivations, externalities, marketing completeness, or market failures essentially.

So which market is failing? The political market is failing. Essentially the world at the micro level has to pay the bill for different collections of populations wanting to be sovereign. So I think this is the primary stepping point. Maybe this is really very general, but this is the way I look at it.

So there is a public role. That's the first point. I think there has to be a political discussion as to how to reform the international monetary system, or whether reform is warranted. Reform is warranted because, clearly, we are repeatedly running into all these walls in these last 36 months.

So what are the issues that may have aggravated these crises? I think the issue of moral hazard is certainly one of them. So before I essentially tell you what the new scheme would look like, one issue that comes up is the issue of moral hazard--the role of the international financial institutions in the bailout of Mexico, for instance. Being in the market at this time, I can tell you that a lot of investors feel that the Russian G.K.O. blowup may not have been as severe had the [U/I] bailout scheme not been there. I'm pretty agnostic looking at [U/I]. But I'm just letting that be. So the issue of moral hazard of the international financial systems in the international economy is one key issue.

The second issue deals with crisis prevention--crisis prevention, and crisis resolution, which brings us to the organization of this conference. So the reform of the international system should be focused on the two issues that we discussed in this conference. As I mentioned yesterday in the session that I participated in, you can not have a foolproof regime. There is no regime that is viable and easily implemented that can eliminate the possibility of crisis, because crisis pervade not only the emerging markets, but also the developed countries, Sweden, Norway, the US., Japan, etc. The issue is to mitigate the probability of crisis. So sound macro policies are clearly key.

The other issue is crisis resolution, which we also talked about yesterday. Having worked at the I.M.F....when you're in the middle of the storm, and when you're stuck with a case like Brazil or Russia, it is not a time to philosophize, or to come up with reforms for financial institutions. Director [U/I] from the US. I think presented a very eloquent discussion of this. You have to calm down the markets at this present juncture. One or two years from now we can talk about reform of the international system. I wouldn't raise this issue or talk about major reforms at this juncture. I think that first you have to stabilize the international financial system, and then we can talk about moral hazard issues, and coming up with new rules of the game. Once the global economy is stabilized, then the [U/I], the G-7 should come up with rules, bailing in the private sector, for instance. We can talk about that also, which addresses the moral hazard issue. We can talk about B.I.S. requirements on credit extension to hedge funds, for example, which we discussed yesterday. So I think a lot can and is being done by the Fed, by the B.I.S., by the G-7, by the I.M.F., but I think the priority at this juncture is bringing about a rapid stabilization of the global economy.

And on the first question, which was on the studies...it was just an empirical tabulation of, essentially, G.D.P. growth and inflation rates under various regimes, across a sample of countries over the last 20 years. They don't really enter into the discussion of fixed versus floating, as far as which is the optimal one from a normative standpoint.

EYZAGUIRRE: Mr. Delbecque.

DELBECQUE: I fully agree with what was just said. Just to put it in a different way, because I think your question is interesting, I think the priority is we would like to avoid a crisis such as the one that occurred in Thailand, a rather small country, in the summer of '97, from occurring again and managing to threaten the world financial system, as it almost did. And the second thing is that we should try avoid the currency crisis from leading to depreciation of 70%. In the literature on balance of payment crisis that Paul Krugman started many years ago, the issue was never that a currency crisis would lead to such a high level of depreciation. The issue was that a peg was vulnerable, and that countries should try to avoid a crisis.

But now there is another issue, namely, the magnitude of the depreciation following a crisis, that threatened, as Mr. Flassbeck said yesterday, the whole institutional economy. And the social price of the crisis has become to huge to be addressed. So the crisis has shown that our system has become quite vulnerable, and that one is to reduce this vulnerability through better prevention of a crisis, and also, I think, to improve the way the I.M.F. handles the resolution of crisis, because it took a while for the I.M.F. during the last two years to come to grasp with the crisis, and to come up with a credible path of recovery for the economies concerned. So the question arises: does the I.M.F. need some other instruments, and that's the issue, for instance, of the lender of last resort. The crisis has really fueled many questions that remain to be addressed. The fact that Stanley Fisher, and this is to his full credit, in January '99 fully addressed the question of lender of last resort, shows that one needs to look at everything having to do with the architecture, in order to prevent such a crisis form happening again in the next century.

UM: [I/A], in Russia, I'm told that a lot of people lost a lot of money, because they believed the I.M.F. on questions like [I/A]. So I ask you, is it not potentially much more dangerous in the interest of seeking confidence, to promote ideas that seem to be contrary to economic fundamentals, as a strategy?

ASILIS: Such as?

UM: Such as [I/A] confidence in this country. We believe that this is an attractive place to invest. We don't believe [I/A]. Then [I/A] investors [I/A] losing trillions of dollars [I/A].

EYZAGUIRRE: This is going to be a never ending discussion. But first, you don't have [U/I]. That is, what would have happened in the world without I.M.F. intervention?

Second, what people deducted from the statements of the I.M.F. in terms of the extent that it was backing Russia, is something I can find no basis for in the actual statements by the I.M.F. Any formal backing like saying, "Put your money there, because there is no risk."

UM: I'm thinking of [I/A].

EYZAGUIRRE: Moral hazard is without doubt a serious problem. But so are overshooting and market failure.

UM: [I/A].

ASILIS: Overshooting or moral hazard?

UM: Yes.

ASILIS: Well, the thing is that overshooting is for the short-term, right? It's today. And moral hazard is systemic. It's maybe today, but also the future. And here we go back to the issue of time consistency. If you don't address the now, the present, there may be nothing to build for the future. It's a tough one, but you have to be pragmatic. You're stuck with economies that are devastated, and you need something upon which to build for the future. It's a very tough issue, I fully agree. But I agree with the approach that is being taken, broadly speaking.

To be balanced on the issue of the I.M.F., my only criticism of the I.M.F. record through these crises in Russia, Brazil, Korea, Thailand, etc.... Two comments only. On Russia, it came out in the press that the staff, particularly Mr. Musa, and I think Mr. Borman, were not all that enthusiastic with the packet that was put together. So I think it would have been constructive...and perhaps as a post-mortem, but what criticisms were raised, and how the process worked, or failed to work should be addressed by the I.M.F. This is my only concern about the I.M.F.--the politicization of how the I.M.F. operates.

EYZAGUIRRE: Sorry, we have three more questions, so let's allow everyone to speak. Why don't we listen to all the questions first.

UM: I just wanted to comment on the gentleman's question. I think he hit the nail absolutely on the head, and that shows in the answers. If we knew what this ideal system would look like, we wouldn't be trying to discuss in so many different fora, and be having such difficulty in moving ahead on the different issues. And from that point of view I think it is totally clear we don't know what the ideal system is. We know where there are some weaknesses, and we're trying to slowly move ahead on these different points. That's the only comment, thanks.

UM: One point is how to assess what is the main role of the I.M.F on this issue. The I.M.F. is not a rating [U/I]. It doesn't send signals to the market. It's an operational institution. With the very notion of conditionality, the goal of the I.M.F. is to implement policy reforms in developing countries. Now, it may succeed, or it many not succeed, but it's not about signaling to the market. So it's a completely different story. So if investors decided that, well, the Russian government might implement policy recommendations from the I.M.F., that's a private sector evaluation. The purpose of the I.M.F. is to try as much as it can for Russia to go on track.

UM: How much conditionality did they demand of Brazil?

EYZAGUIRRE: Please. You may go afterwards. The gentleman over there.

UM: My question is this: it appears throughout this conversation that there seems to be a general agreement that ethics regulation, whether it's a board, or a peg, or a calling peg, or controls of some kind, particularly when instituted under duress, are an attempt to compensate for other policies inadequacies, whether they're political or economic. And in the last most recent set of examples we've had over the last 36 months or so, they haven't been successful, except in the instance where you began to get fundamental underlying change. Obviously this is an attempt to control the overshoot, which is perceived as the greater of the two evils. My question is touches on something Joyce had mention, which is what's the exit strategy? There's a number of people who have commented that Brazil had a window 18 months ago, where it could have declared the Real Plan a victory, gone to a more flexible regime, and escaped before these excessive pressures began. What about this exit strategy? What about recognizing this as a temporizing measure to control the overshoot and to move to an exit strategy? And then does that suggest something to us as policy path for China and Hong Kong, which have positive external accounts? And are they missing a window right now that they should be recognizing as a window that Brazil had 18 months ago?

EYZAGUIRRE: Mr. Ramirez was asking to be heard a moment ago, but after that if any of you want to speak...

RAMIREZ: I wanted to provide some feedback for your question about looking at exchange rate regimes, growth, and inflation. I agree with your skepticism, because it's very difficult to do cross-section analysis with those three variables, particularly when there could be some kind of mutual causation between the exchange rate and growth. But also when we look at growth, let's not forget there is a whole body of growth theory supposedly explaining economic growth. So I would be very skeptical on that issue as well. I totally agree with the timely exit. I think it really belongs more to the political situation of each country...

Tape 4, Day 2-side A

ASILIS: ...in Asia that the UN. was perhaps overvalued versus some sort of equilibrium real exchange rate level that one comes up with.

UM: [I/A].

ASILIS: Oh, I see.

UM: [I/A]...

ASILIS: ...they should do it now. I see.

UM: [I/A].

ASILIS: They don't need the shock absorber right now. I mean, the issue is the timing. I agree with you...

UM: [I/A].

ASILIS: ...for various reasons. One reason is the banking system. The other reason is structural reform--the dual nature of the Chinese economy. I think it's the degree of overvaluation, or overvaluation of the currency, particularly in light of the fast appreciation of some of the regional currencies, including the Japanese yen. It's just not as compelling. And if to that we add on capital market considerations--how capital markets would respond to a devaluation of the [U/I]--I think the conclusion would be an unambiguous no, that they shouldn't do anything right now. So the status quo is the optimal response at this point. We saw what happened on Monday, Europe opened, of course, before the US., European markets sold off tremendously on the back of this very indirect mention in a Chinese newspaper that perhaps the Chinese should envision a change in the exchange rate. So I think on a macro basis it's just not there. The Chinese case is one in which I would apply the targeting principle--you target distortions directly, and, i.e., the banking system. I think the Chinese are moving in a desirable direction, through the creation of this sort of asset management initiatives. And they need to liberalize the economy as well. So I think status quo is the optimal.

The Hong Kong case is a little more complicated, because of the pervasiveness of the endogeneity issue. It's a service based economy. The property market is so key at a macro level, you know, fiscal revenues associated with property market auctions, which have been discontinued in the last six months. And regional currencies which should enter in a major way in any sort of multi[I/A] real effective real exchange rate indicator for Hong Kong. It's a more complicated case. I wouldn't want to discuss it in any major way. I think that their response so far is good. It may not be the optimal one, but I think it's good in terms of putting a stop to the auctions...[STUTTERS]...state property. And just take it from there. See how much deflation and downward flexibility there is in terms of output and factor prices. And there has been some. Property prices have dropped significantly, 70% in some cases. So...

UM: [I/A].

ASILIS: No, I think that just reaffirms the point. Two issues that you mentioned. I'll be very brief. The second issue just proves my point, my only criticism of the I.M.F., which really has nothing to do with the staff. I think it's the politicization of the I.M.F. which is really compromising...not the board, you guys respond to higher entities. [LAUGHTER] So I wouldn't do anything differently, if I were in your shoes. I couldn't. [LAUGHTER] So, no comment on your part. But I think it's the politicization. There's harm being done to the institution. The whole world is paying for it.

On the first issue in terms of China, again I don't want to expand too much on this, but even talking about an exchange rate adjustment, given the currency convertibility restrictions...[U/I] somewhat of a misnomer. So I think I would just stay the course, address micro and structural reform issues.

EYZAGUIRRE: It's a close call, as usual. That's what makes this so difficult. But I very much share Carlos' view. I think this is still a time for the fire brigade rather than for the architects. If that's true in general, it is also true for China and Hong Kong.

CHANG: May I just say, very briefly, that when one talks about China, that one can't look at it on a fundamental basis. You really have to follow all of the previous currency crises, and what the impact would be. Would it just restart everything in Asia? And I would agree that one is at the point where one has to look at the Brazil package as...when you look at the response in the markets from Brazil versus Russia, what the package from the I.M.F. gave...the market was [U/I] to deleverage, so it wouldn't be nearly as devastating as if Brazil had gone through this several months ago. It certainly didn't prevent a crisis. Very few people who heard about the package being announced at the end of November, early December, would have thought that it would be January 13th when the timing would occur. They thought you'd have time to put more of a fiscal program into place. I remember the Brazilians giving their presentation, saying, "We want this to be front loaded because we're going to rebuild reserves back up to 60 billion." And look at where they are today.

But I think that you can very much make the argument that in the case of Brazil that what the package did was give the market time to deleverage. So technicals weren't as bad. So it wasn't as devastating as the Russian crisis had been. And if you look at the whole timing for what China has to do, many people are looking at it in the market place as, "Well, that's the last thing left to go." They're looking at it more like that, than like the fundamental arguments for the timing of when the devaluation should take place. So, that backdrop is almost like the policy makers and official creditors working with them, can't make a decision in isolation about China, and the exit strategy, and the fundamental economic issues, as much as that they have to look at it in the context of this domino effect crises that have occurred, and what impact that's going to have on all players in the market.

UM: [I/A]?

CHANG: No, I think that what it means is that if you look at something like how much involvement there is by foreigners in the domestic debt market in Brazil, I would say it's probably less than 1%, compared to a much higher number last year. And that in the case of Russia, where you had many foreign players that had been leveraged in the market, that was one of the reasons why the effects were so devastating. I think everybody has seen the statements coming out of a lot of the major banks. Most banks are saying they really haven't been hurt that much by the crisis in Brazil, compared to some of the losses that occurred in the third quarter of the year that coincided with the timing of long-term capital. And I think that in Brazil the fundamental problems are still very severe, but the market reaction that occurred last year hasn't been as bad, in part, because you've had a process of deleveraging. I think that what many people can say is that they're surprised by the timing of what is occurred, but not that it occurred. And so if you look at the point that was raised, you can't look at what would have happened if you didn't have the I.M.F. coming up with a package. What you can say is that it did the market time to get positions down, to deleverage, and to not have the technical issues that were in play last August, last September.

UM: That sounds to me like a 41 million dollar prescription for [I/A]. [LAUGHTER]...as a taxpayer I object strenuously. And also that [I/A].

CHANG: Absolutely. The I.M.F. is part of it, that you have had the rate cuts. Where interest rates are at now compared to anyone's forecast a year ago...the number of industrialized countries, and other countries that had successive rate cuts... I don't know, I don't think there's one simple answer to it.

EYZAGUIRRE: Mr. Ramirez.

RAMIREZ: Yes, thank you. With all due respect to our colleague from the Bank of China, I think China merits a much closer look. And you're right in raising this issue, because it has to be effective. China just can not be isolated, it's too large an economy. And of the emerging economies exporting in excess of 50 billion dollars a year, it's the only today that has a fixed exchange rate.

Now, what we have seen from the Chinese indicators is negative growth in electricity... I don't care what G.D.P. growth is, because it really doesn't mean anything--but I think China has a very large sector of people who need jobs. And this is a 700 million people working force with a margin...in terms in of changes in the rate of growth in output, it could be a 100 million with more or less jobs. And definitely I would say it merits a much closer look, and it definitely raises risks. So, yes, you're right. Absolutely.

EYZAGUIRRE: Mr. Chairman, I'm in your hands.

UZAN: Let's conclude the session. Thank you, Mr. Chairman, and all our panelists. We hope to see you next year, and we hope that this conference was useful. There will be coffee outside. Thank you very much.

[APPLAUSE]

[END OF CONFERENCE]

[BACKGROUND CONVERSATION]