# General Discussion:
## Overview Panel

***Chairman: Jacob Frenkel***

***Mr. Frenkel:*** Thank you very much. We can now spend some time on general discussion. It makes no sense for me to summarize the summaries, but we did hear that there is a great consensus, that there is a public policy issue as far as promoting the positive role of financial stability and preventing the negative role of financial instability. There is something which is unexpected in the discussions on exchange rates and this was already mentioned by the overviewers. There is much greater respect for the possibility of flexibility in the foreign exchange market than there was in the past. But there is a distinction between "good fix" and "bad fix." By the same token, there is a new distinction between "good contagion" and "bad contagion." And that is good, because it means that we now have to do some work to make sure to get the good type rather than the bad one. We heard that there is an optimal amount of regulation and it must be almost definitionally less than the maximal amount of regulation. And what governs the difference between that optimum and the maximum is the respect for the marketplace. And the markets are very powerful, should be cultivated and not tampered with, especially when it comes to the pricing of assets, exchange markets, securities markets, and the like. When you have capital markets, those are the things that define the concept of sustainability of current account deficits. The longer the horizon, the more you can enjoy the benefits of some deficits during some time, provided the

present value is the right thing. And I think that there was a consensus also about this. It all comes to the bottom line: that risks must be priced appropriately, otherwise we all fall into the trap of the moral hazard. We heard that we would be wise to look again at deposit insurance. We did learn that not all runs are bad, especially if they pertain to good weather at Jackson Hole. Let me now ask for some remarks. Scott Pardee.

***Mr. Pardee:*** Maybe I'm reflecting on my experience with the original Bretton Woods system, but I would hope that we don't end up with a unanimous view that floating exchange rates are the greatest idea since sliced bread. Every government has to indicate to the market, more or less, where it expects the exchange rate to be in one way or the other. Even Mr. Sakakibara is doing that on an almost daily basis. And from time to time Bob Rubin has to do that in a floating rate between the United States and Japan. We have been focusing on the fiascos, I would suspect, in this conference of countries that had to move away from fixed rates or pegged rates to floating rates under duress. But there are a number of situations in which countries have been able to maintain more or less pegged rates, crawling pegs, rather well over a number of years, and they have not been featured. Some of them are in this room. I think today of Russia, which is doing a good job in managing a crawling peg. The one country we haven't mentioned here is Brazil, which could be the next Mexico, and Thailand, and so forth. But they are also managing a kind of crawling peg. Chile also. So we have got to be careful in just generalizing that, "Oh yes, let's all move to floating exchange rates." Thank you.

***Mr. Frenkel:*** Thank you. In order to avoid misinterpretations of what you said about Brazil being the next Mexico, you did not articulate whether you meant the Mexican crisis or the Mexican recovery. Another footnote to the fact that Mr. Sakakibara needs to remind the market every day about where the exchanges should go, what does it tell us that the markets do not understand or that they understand too well? Please.

***Mr. Berry:*** A question principally for Marty. You ticked off a

number of things that are going very well indeed for the United States, including the weather. A number of speakers—and you included—also said that large, continuing current account deficits were potentially dangerous and difficult. We have a large, continuing current account deficit. Is that a problem for us?

***Mr. Frenkel:*** Mr. Fisher.

***Mr. Fisher:*** I would just like to underscore the comment that Jean-Claude Trichet made about liquidity and the importance of liquidity and then the importance of illiquidity as crisis creating. I think it is something we missed a little bit this morning in what mechanisms are needed to respond to crises. We all know when we look at development economics we talk about developing broad, deep, and liquid markets. But we are not quite as quick to remember that in a crisis what we want to do is restart liquid markets. And I think that that was one of the problems that Thai officials faced as they introduced capital controls in the middle of the crisis, making the market even less liquid than it might otherwise have been. So that is just a footnote and something maybe we missed a little bit in discussing mechanisms for responding to crises is how to keep markets deep and liquid. It's very obvious but, I think, very important.

***Mr. Frenkel:*** Thank you. Yes, please.

***Mr. Hildebrand:*** I would like to pick up your Chinese definition of crisis meaning both danger and opportunity. I would argue that there is much to be said for the opportunity part of the definition. It strikes me that if you look at Europe, in particular, many of the countries that are doing well from a macroeconomic policy perspective are those that have suffered quite severe crises in the past couple of years. Governor Bäckström's presentation yesterday, I think, was very insightful. I don't mean to suggest that there should be no response to crisis by the international community. But it does strike me that there is something to be said for the case that whatever response the international community chooses, it should not eliminate the—for lack of a better definition—cognitive value of a crisis. This goes back to Jeffrey Sachs' point yesterday and this morning

that it is perhaps not always appropriate immediately to rush in for help in times of crisis. In the case of Europe, I would want to mention the examples of Sweden, Ireland, Finland, the United Kingdom, and perhaps even Italy. I would also be intrigued to hear Mr. Trichet's view on whether France can offer some useful insights here in light of the fact that the French experience has arguably tended to be one of muddling through crises as opposed to facing them head on.

***Mr. Frenkel:*** Thank you. Next to you.

***Mr. Visco:*** I wish to just add something to the previous speaker. It seems to me that you are right. It is not only an issue of fixed versus flexible exchange rates, but good fixed versus bad fixed. And perhaps a fixed exchange rate at the end may produce a crisis that might be beneficial. As far as Italy is concerned, the issue, I think, did not much concern the exchange rate regime, but the good or bad policies that were implemented at the time. And I think that the crisis was extremely beneficial in producing incentives to change the bad policies and make them good. In my question, however, I wanted to address an issue which I have heard here and there, which concerns the role of rating agencies both for sovereign risk and for evaluating individual intermediaries. As far as sovereign risk is concerned, I heard Mr. Trichet saying that they may do a good job. My impression is that they often come late. And, in this sense, perhaps, the role of international financial institutions—even if they do not reveal much information at least to government authorities—might be more relevant and more helpful. Thank you.

***Mr. Frenkel:*** Thank you. György Szapáry.

***Mr. Szapáry:*** I fully agree, particularly for small, open economies and emerging markets that exchange rate flexibility is very important. I also agree that the current account deficit and its size are very important. Here, however, one has to be careful not to be lured into believing that a current account deficit that is financed by autonomous capital inflows is good in any circumstance. It has to be financed by capital inflow that is sustainable in the long run. That is essentially, at least in the case of Hungary, foreign direct invest-

ment and perhaps long-term credits, not official, that are financing projects. Very important is, as everybody has mentioned, the fiscal deficit. But here again, and in particular in transition economies, one has to be sure how one measures the fiscal deficit. In many transition countries not everything is reflected in the budget that ought to be included. For instance, if there is a large amount of bad loans in the banking system, it does not appear in the budget now, but it will appear down the road. We have learned that in Hungary. Before we could privatize the banking system, we had to consolidate the banks. The cost of this consolidation burdens the budget for the next many years. But that budget now reflects in a transparent way the true cost to the public of the consolidation. It is also important to include the quasi-fiscal operations of the central bank. In many of the transition economies the central bank performs quasi-fiscal operations. For instance, in the case of Hungary, the exchange losses on the official debt were borne by the central bank. So you need to look at a budget that reflects the real situation. Having said all this, if the fundamentals are good, is the problem solved? Well, if we have a floating exchange rate and the fundamentals are good, capital comes in, the exchange rate appreciates, competitiveness is lost, and we have an excessive current account deficit. So, how flexible should be the exchange rate? This was what Andrew Crockett asked Jeffrey Sachs, which Jeff didn't answer. But there is another problem here. If exports grow fast, wages in the export sector, which are often in the hands of foreign companies who are generous in paying wages—Prime Minister Klaus was referring to that yesterday—will grow fast, which again undermines competitiveness. So what then? I have come personally to the conclusion that controlling capital flows, with the possible exception of short-term capital flows, is not a good idea for two reasons. First, it frightens away people who would do good for the country by way of direct investment or by way of doing business in Hungary. Second, in an economy that is so much integrated into the western European economy as Hungary is, there are too many channels to circumvent controls. The best way, but it is very difficult of course, would be a coordinated approach where one would have all the main players brought into the policymaking: the government, the central bank, the workers, and the employers. One should agree on a coordinated approach with regard to fiscal, mone-

tary, exchange rate, and wage policies. However, here credibility is very important. And in transition economies, credibility is not very high for the government—particularly because there was a need to reduce real incomes following the collapse of the CMEA. The way real incomes were reduced was by surprise inflation, partly brought about by exchange rate depreciation. Now the government has to convince its partners that there has been a regime change, now it really means what it says. It will take time to build up credibility.

***Mr. Frenkel:*** Thank you. Well you've set some of the agenda for the subsequent few years. But one thing is clear: When one does not have much credibility, it is very difficult to make progress on social pacts. Alan Blinder.

***Mr. Blinder:*** I just want to call attention to a big question that was raised many, many times—originally by Andrew Crockett at some length, and it came up again in this panel: the question of instability in markets versus instability in financial institutions. The latter is, in some sense, easier to get your hands around. We have ideas, though they're not perfect, about what policy might do. And furthermore, we have some consensus, I think, that policy probably ought to do something about instability in institutions. But when you get to instability in markets, there is a feeling that it is both impossible to manage and inadvisable to manage, with different weightings from different people. I agree with that, basically. But here is the question: A lot of people think that the financial world is evolving more toward markets and away from institutions, toward price-mediated rather than customer-mediated financial transactions. Mexico '82 versus Mexico '94 is a kind of metaphor for the change, but just a metaphor. A lot of people think it's happening globally. So the question for the panel is: Do you agree that this is happening and, if it is, is this going to make the problem easier or harder to deal with as we look out over the next twenty-five years?

***Mr. Frenkel:*** Thank you. Mickey Levy.

***Mr. Levy:*** Building on this point of prevention is better than a cure. Up until this session I thought that the general discussion under-

stated the crucial role of a central bank in pursuing a credible, stable, zero-inflation policy. Let's consider financial market fluctuations and asset prices or contagion in an environment in which the credible central bank is minding its p's and q's and following a zero-inflation policy. When you have asset-price fluctuations in such a situation, is it fair to call it an asset-price bubble? In my mind, such fluctuations are necessary to clear markets and are healthy and not to be feared. What is the proper role of the central bank in responding to an asset-price bubble when it's already following a zero-inflation policy? I would agree that in such a situation, a runup in the stock valuations would not generate a rise in inflation and should not elicit a change in central bank policy. When I think about all of the "crises" that have been discussed in the last couple days—including Thailand, Mexico, the Japanese asset-price bubble, the U.S. savings and loan collapse, and even the U.S. stock market collapse in 1987—each of them seems to be somehow associated with (generated or aggregated by) a certain degree of central bank policy mismanagement that involved a deviation from a long-run, viable zero-inflation objective—whether that involved pegging a currency, accommodating rising inflation, or somehow losing credibility. Accordingly, in addition to all of the micro-based regulatory reforms that are necessary, a clear lesson for central banks is, looking back on all these episodes of financial instability, how can they be avoided? How can central banks continue to pursue the right policies that create the right environment? In this regard, interpreting Morris Goldstein's checklist of banking crises' leading indicators has an additional dimension: when the yellow caution flag rises to warn of potential financial insecurity, is its source exogenously determined or emanating from policies that central banks themselves are creating?

***Jacob Frenkel:*** Thank you very much. Morris Goldstein.

***Morris Goldstein:*** In thinking about sources of banking fragility, one that we haven't discussed much is the activities of state-owned banks, or SOBs as some like to refer to them.

***Mr. Frenkel:*** This is why we did not discuss them.

***Mr. Goldstein:*** This is a major source of credit losses, or potential credit losses, in some countries, and it is not something that got a whole lot of attention in the Basle Committee's Core Principles. I wonder whether members of the panel would care to comment on how we could get a handle on this, perhaps particularly Governor Trichet in view of difficulties at Crédit Lyonnais. But any suggestions would be helpful.

***Mr. Frenkel:*** Thank you. Don Kohn.

***Mr. Kohn:*** I was going to jump into the middle of this fixed and flexible rate discussion and relate it to that joke about bad news and worse. I think the ideal situation is responsible macroeconomic policy and a flexible exchange rate. But we need to remember that, in many cases, elements of fixity got into exchange rates because people had trouble designing responsible macroeconomic policies, responsible monetary policies; and in particular, there was perhaps a lack of political will to give the central bank the right instructions and give it the independence to carry those instructions out. So it strikes me there may be circumstances in which the bad result of some fixity in nominal exchange rates tied to a responsible central bank might be better than the worst result of flexible exchange rates and destabilizing monetary policy.

***Mr. Frenkel:*** With another reminder that we have really a matrix of 2 by 2: the good type and the bad type of each one of the systems, namely good fix, bad fix, good flex and bad flex, and everything in between. Leif Pagrotsky.

***Mr. Pagrotsky:*** Eddie George said something that I think most of us agree with on macroeconomic risks and other things. I think the fact that macroeconomic risks are the main risks is a positive comment, because those are easier to identify and easier to see in advance—or at least less difficult. It is easier to get early warning on those kinds of risks. In the Swedish case, I must say, though, that we were very disappointed that those organizations that were in a position to be able to see such risks—like the IMF, like the OECD—that watch countries that have these problems, that have had these

problems, never said a word about it. The OECD is an organization that publishes everything. I think that is very good. It is very good for the quality of OECD work. And I would strongly suggest that Jeff Sachs' suggestion that the IMF should publish more of what they are doing is listened to. In Sweden we have decided to make public all advice given by the IMF. We publish all those relevant documents after having listened that the IMF did not object, of course. And I would like to hear whether the United Kingdom and France would support that this become a more common habit to make those reports public. I personally believe that the reports would be better. Consumers that are countries and markets would be better off, if those reports became better. We were very disappointed that the money we paid for membership in these organizations did not pay off when we needed it the most, that they did not serve to give that early warning. Thank you.

***Mr. Frenkel:*** One always regrets that when one is close to landing there is the starting of new directions of takeoffs. But that is what is so beautiful about the future being longer than the past. So we still have lots of hope for active debates in the future. Allen Sinai.

***Mr. Sinai:*** I want to underscore Governor George's first point, which was the macro risk and its effect on the financial side of the economy, and this last comment I think is very, very important. Until this session, it had not really been stressed in other discussions—that macro risk or macroeconomic risk drives financial system problems is very, very important. It certainly was part of the Thailand situation—many, many years of a very strong boom. There is a big business cycle element in the financial side of any economy and the imbalances that can stem from the real side, for example, from the boom and all that it engenders, such as too aggressive private sector financing and higher current account deficits. The policy answer is that I think what Marty and you and several people have said: It is anything that restrains a boom from getting out of hand before it gets too far, which includes price level stability. It is no accident that the enviable performance of the U.S. economy so far is in part due to our expansion, on average the slowest in all of our post-World War II history—at least until the last few quarters. I also have a question

really for the governors, Governor George and Governor Trichet. Please just to remind us why policymakers are so reluctant to let exchange rates go down too far, too fast as some here have suggested, as perhaps the answer rather than intervention. Jeffrey Sachs, for example, and Marty Feldstein indicated this, as might others—letting flexible exchange rates do and go where markets might want to take them.

***Mr. Frenkel:*** Okay, one last remark by Jeff Sachs, but brief if you may.

***Mr. Sachs:*** Just a short comment on Don Kohn's question about bad fixed rates and even worse, floating rates. I think the right resolution in many success cases in the last fifteen years is that there is a timing that fixed rates make a lot of sense at the beginning of a crisis, and then the exit policy which Jacob talked about is the right way to think about it—not all one or the other, but timing to get out of extreme instability. There are a lot of reasons for pegging early on. But don't put it into the law and find a way to get out of it afterward. And then, following Allen Sinai's question about macro risks in financial markets, a very concrete exercise that I would urge on emerging-market central banks, when you do the risk assessment of your banking sectors and the prudential regulation, do the thought experiment of the 25 percent real depreciation to see what it would do to the balance sheets of your banks that have borrowed in dollars and on-lent to real estate, for example. This is *the* most concrete, specific macro risk that most small, open emerging markets face, and that is the risk of the significant real exchange rate change. And it's possible to make a concrete assessment of that on balance sheets of your banks as part of your supervisory exercise. But it's usually not done. So the question isn't to look at a loan and ask whether it's a good loan or not; the question is to look at a loan and say, "Would it still be a good loan if there is a 20 percent real depreciation or a 25 percent real depreciation?" I think you'll learn a lot about where the real risks lie.

***Mr. Frenkel:*** Thank you. And now, without loss of credibility, really the very last remark.

***Mr. Schoenholtz:*** Thank you very much. Just a question for the two governors. In thinking about challenges ahead, monetary union in Europe is probably just around the corner and will lead to major changes in financial markets. Among other things, new questions about sovereign credit may surface. Governments can no longer be assured that they can issue the currency in which they issue debt. Do you expect to see prudential rules change as a result of the financial market evolution after EMU?

***Mr. Frenkel:*** Thank you very much. The proceedings call for three minutes' response by each panelist, but with the theme of multilateral cooperation, we've created a bank. And Marty Feldstein dedicates two minutes to Jean-Claude Trichet; Eddie George dedicates one and one-half minutes to Jean-Claude Trichet; and Jean-Claude Trichet will have everything but a half minute, which he will dedicate to me. So, Marty, please.

***Mr. Feldstein:*** Yes, I'll be very brief and just comment on three of the remarks that have been made. First, John Berry's specific question about the large U.S. current account deficit: Is it a problem? It's about 2 percent of GDP and, with ups and downs, it's been basically on a downward path. My judgment is that 2 percent is not sustainable. Even though it's a lot smaller than the kinds of numbers that led to crises in Mexico and Thailand, it's a very large number of dollars for the rest of the world to be shipping our way. But the dollar is floating, and the adjustment that began a decade-plus ago will continue. And, so I think it is not a potential problem. I think we will continue to see our current account deficit shrink. I think it is a reflection of a more serious underlying problem, and that is the low savings rate. Alan Blinder raised a good question about whether, since we seem to be moving from institutions to markets in a general sense, is that a good thing in terms of the kinds of risks that we've been talking about for the last two days—in particular, substituting bonds and market instruments for bank lending? I thought about that a lot in the context of the 1982 LDC debt crisis; and, although I don't think it's an absolutely black-and-white issue, I do think that it would have been a much more comfortable experience if those had been bonds rather than bank loans. It might have been harder to get

the kind of workout that was possible through the banks, but the potential losses if the collapse had come, would have been much more diffused and would not have affected the financial stability. It would have hurt the holders of those bonds, but it would not have brought down the institutions, the banks. I think I'll just stop there and pass on whatever savings I have to Eddie George.

***Mr. Frenkel:*** Eddie George.

***Mr. George:*** I'll address first the question of what you can do about state-owned banks. Privatize them. Second, there was a question about whether the United Kingdom would publish the IMF's advice? We do. Third, there was a question about whether monetary union being just around the corner would change perceptions of sovereign credit risk, and would that affect prudential regulation standards? The answer is we'll have to wait and see if it really does produce differences in sovereign credit risk. I suspect not, but we'll see. There was a question which I would just like to take more seriously and that was Alan Blinder's question. I think it's a very key question. I certainly think the answer to the first part is, yes we are moving in a general sense toward more disintermediation. And like Marty, I tend to think that that will be rather a good thing. But it's conditional. I think it's conditional on the efforts that we all have to make and which we have discussed a great deal at this conference to ensure that the markets are broader, more liquid, and function better. Then, I think that the price signals that come from the market can be constructive. I think it's hopeful in that sense. I also think, like Marty, that it's hopeful because it actually spreads the credit risk and the exposures to fluctuations in a way which, if they were on balance sheet, through any kind of financial intermediary, would not spread the risk. And that leads to my final comment which relates to the question from Mr. Levy: What can you do if you're pursuing sound policies and you get an asset-price fluctuation? And I think the answer basically is you just have to hold on. We can't expect the world to be a totally ordered, structured place that behaves as we'd all like it to. We in the United Kingdom are confronted with this dilemma now. We've got an exchange rate which is clearly stronger than we think could be sustained in the longer term. We've got that

because of factors which are outside our control, and have a great deal to do with uncertainties about future prospects for the euro, the prospective European currency. And that creates tension between the domestic and the external interests of the economy. You really can't find a perfect solution to that, so you have to hold on until the situation resolves itself. In doing that, you have to focus on the main objective, which is achieving and maintaining long-term price stability and the sustainability of the growth of the economy. Thank you.

***Mr. Frenkel:*** Thank you very much, Eddie. And, to wrap it up, Jean-Claude Trichet.

***Mr. Trichet:*** Thank you very much. First of all, on the floating exchange rate, I would like to signal myself that I associate myself to the caveats, which have been floated. Let's not be too systematic. I don't think that we have criticism with what has been done by Argentina, for instance. It has been said several times here. So we have to be pragmatic. There are cases where obviously the pegging has been extremely useful. There are cases and episodes where it is extremely useful. Let's be very pragmatic and not systematic in this respect. Second, on the question of securitization, which has been floated by Alan, I would echo very much what Marty Feldstein said. I think, myself, as chairman of the Paris Club during ten years, that had we had more bonds and less commercial bank loans, we would probably have been safer, even if the solution of the problems might have been more complicated because we had at the time only two bodies: the London Club and the Paris Club. And this was a very easy way to work out this extraordinary difficulty. But the difficulty would have been less acute, in my opinion, had we been in the situation where we are today. So it's a new challenge, but we are probably in a safer world. With regard to the question of monetary union, I will very much echo what Eddie said. I totally agree on the fact that I don't see exactly why sovereign risk would be changed with monetary union. With regard to the question on the commercial banks by Mr. Goldstein, I would say having myself participated very, very actively in the privatization of five out of the six major commercial banks in France, I'm absolutely convinced that commercial banking is by nature a private business.

***Mr. Frenkel:*** I think this is a brilliant place to stop. Well, we've had very stimulating sets of discussions. Heine once wrote that when the end of the world comes, he will run away to Amsterdam, because this is where things happen last. In our new global world, there is really nowhere to go. And, in a way, there is no alternative and maybe there is no problem. Joe Stiglitz once said that if you have no alternative, you have no problem. So in such a case, we have no problems anymore. Let me use the final minute that I have to echo what many, many individuals here have already said. Thanks to the Federal Reserve Bank of Kansas City for organizing such a beautiful conference, for consistently contributing to this debate, and this is really, over the years, to everyone who has had a hand in it over the past many years should now feel appreciated and thanked. And, of course, to Tom Hoenig, the President; Craig Hakkio, the new Director of Research; and everyone else who has helped to make the "boats float."