Points of Reference for Future Action

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Let me begin with two overriding impressions that I take away from this conference. The first is that, when it comes to the issues we have been discussing, a very large dose of humility on the part of both policymakers and practitioners is fully justified. My second impression I will share with you by means of an anecdote. Some of you know that Fed Chairman Paul Volcker and I have been friends for what is now the better part of 20 years. Every now and then we sneak off and do a little fly fishing for trout. On one occasion Paul and I had just finished a float down the Madison River out in Montana. As we were pulling the boat out, the guide looked at the two of us and asked, "Who caught the biggest fish?" I immediately responded, "I did!" Volcker looked at the guide and said, "What are you talking about? The issue is not who caught the biggest fish. The issue is who caught the most fish." The message here, of course, is that in international finance, as well as in trout fishing, even the right question is very much in the eyes of the beholder. Now, having said that, let me tick off a few reminders that we need to keep in mind.

First, despite all the discussion about capital controls, and capital flows, let us remember that in virtually every significant emerging market crisis that I know of, domestic capital is usually the first thing out.

Second, the point has already been made that we have to distinguish between countries: emerging, industrial, and so on. But I think it also needs to be emphasized, particularly when we talk about emerging market countries, that all of them are small, and most of them are very small, as well as very open. If you look at measures such as the ratio of

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trade to GDP in many of the countries we are talking about, those ratios are much higher than they are in virtually all industrial countries.

Third point: references have been made to various triangles. I want to mention another triangle, the triangle of current account deficits, fixed exchange rates, and weak banking systems. If a country is lucky, it can get away with one. If very lucky, it might get away with two, but it will never get away with all three.

The next point is that when the current account is part of the problem, the adjustment process must involve a substantial shrinkage in the domestic savings gap. That shrinkage in the domestic savings gap, at least as best I can figure it out, can only come about in a context of shrinkage in the domestic economy itself. So, there is no free lunch here, no easy, painless way out.

My next reminder is that in just about every case I can think of, it is undeniable that part of the core of the problem has been short-term debt, especially bank debt in foreign currencies that is on-lent to domestic entities, unhedged, or in the context of insufficient foreign currency revenues. It is also undeniable that weak banks are a big part of the problem in most countries, but I believe it is wrong to say that this is simply a matter of weak supervision. Again, the point has been made that if it was that simple, then how do we explain some of the things that happened in the United States in the 1980s?—and not just in the S&Ls, by the way.

As I look at the situation in the emerging market countries where we have had troubles, it does seem to me that, on the whole, the bulk of the problem has been homegrown. That is not to say that Henry Kaufman, in particular, is not correct when he suggests that some of the problem has been aided and abetted by conditions in international markets and in industrial countries. But I think that by and large the problems have been homegrown.

The next point I want to make, and I will do this in very broad terms, is that "bailing-in" the private sector is not going to be easy. Whether you are talking about collective action clauses in bond contracts, restructurings, or changed bankruptcy laws, any and all of these things are a little bit like climbing Mount Everest with sneakers on. They are not easy to execute, even though they are good ideas. We have to be realistic and understand that under the best of circumstances, achieving more balanced public and private sector responses to sovereign financial crises will take time, which brings me to my last reminder.

That is that, whether we like it or not, periodic bouts of significant financial instability in the international arena will be with us as far out as I can see, even though none of us are clairvoyant enough to anticipate precisely where the next shock will come from. But, in these circumstances, our thinking about the future has to involve some sense of urgency, because that next shock will be there, somewhere.

Where do we go from here? I would start by saying that I really like Ralph Bryant's pragmatic incrementalism. As a matter of fact, I wish I had thought of the phrase. I find myself in sympathy with more than the phrase, with the substance of what Bryant was talking about. Thus, in the context of what I have just summarized, I would say first, ladies and gentlemen, that architecture is not the issue. The issue is engineering and plumbing. If we spend the next three, four, or five years worrying about architecture, events will supersede policy. The issue is this: How do we make existing institutions work better? How do we build on some of the things that we already have and discard some of the things that have not worked particularly well? If we were to set out today with universal agreement on some new architecture, it would probably take five or ten years to get the political support and the infrastructure to get it in place. Forget about architecture, let us focus on the engineering and the plumbing, that is where the issues lie.

My second point is fairly obvious but let me make it anyway. I do think that capital controls really are a very slippery slope. I say that with some humility, because I have in the past talked with some favor about the Chilean model. Sebastian Edwards's paper for me was a bucket of cold water, in terms of reminding me that what you see is not always what you get, in this arena. Several comments were made yesterday about Malaysia and there, too, what you see is not what you get because, among other problems, the private sector found very effective ways around the Malaysian style of capital controls. One can at least conjecture that the presence of the capital controls delayed the necessity for the authorities in Malaysia to come to grips with their own domestic banking sector problems. Being a pragmatist, I guess I also belong to the camp of "Never say never," but I have to say that this new enthusiasm for capital controls worries me.

Now, let me justify never saying never with my own exception. The question of the unsecured, short-term, foreign currency borrowing by banks in emerging market countries, clearly, is critically important. I do agree with Jeffrey Sachs and others who have said that we can get at that problem through prudential supervisory policies on both ends; that is, perhaps, up-front provisions for the banks that make those loans, and up-front provisions for the banks that receive those loans. I would put that under the umbrella of banking supervision and prudential policy, not capital controls, and not just for semantic reasons but for substantive reasons, even though the semantics may escape you.

My third point is that we need structural reforms and institution-building side by side with improved macroeconomic policies, and they take time. Fundamentals are an issue of great importance in most emerging market countries, but there is no doubt about the even more pressing importance of the banking sector issue. But you are not going to fix that issue with enhanced supervision alone, and even if you could, in most of these countries it will take years to develop state-of-the-art supervisory systems and the people to make those systems work. Again, we must be realistic.

One other quick point: All of this has to take place in the context of a phenomenon that no one has mentioned here, asset price inflation. We see case after case of asset price inflation in both industrial and emerging market countries, in a setting in which there is reasonable overall inflationary performance. No one has to my knowledge yet come up with a way to square the circle, with those two phenomena operating side by side in both industrial and emerging market countries.

Finally, on the exchange rate question, two quick observations. First, no matter which exchange rate regime you pick, if you do not have the right policy fundamentals, it is not going to work. And the converse is also true. If you really have the right fundamentals and you sustain them, it probably does not matter which exchange rate regime you pick. But I have come to the view that for most emerging market countries, the prudent course is flexible exchange rates, working toward a more managed exchange rate regime over time. The question of the right regime for industrial countries Mr. Volcker will speak to with great eloquence, so allow me now to turn matters over to Paul.