EVOLUTION OF THE INTERNATIONAL FINANCIAL SYSTEM

Jacques de Larosière

Former Managing Director of the IMF, Governor of the Central Bank of France, and President of the EBRD

Leon Koźmiński Academy of Entrepreneurship and Management (WSPiZ) and TIGER

Distinguished Lectures Series n. 8

Warsaw, 7 June 2002

Andrzej K. Koźmiński, Rector: We are very honored and very privileged to welcome at the Leon Koźmiński Academy one of the most prominent figures in global finance – Mr. Jacques de Larosière, who was elected Managing Director of the International Monetary Fund (IMF) in 1978, then appointed Governor of the Banque de France in 1987, and President of the European Bank for Reconstruction and Development (EBRD) in 1993. In 1998, he joined BNP Paribas in 1998 as Advisor to the Chairman. He is thus probably the best-positioned person to talk about the evolution of the international financial system. He has been kind enough to accept our invitation to speak within the framework of our Distinguished Lectures series.

We have a great audience here, with even three Poland's former ministers of finance – Professor Kolodko and Professor Samojlik, and Professor Kalicki who was Vice Minister of Finance during Professor Kolodko's term of office. All three are professors at our school. We have many other distinguished guests here but I just wanted to stress the importance of today's lecture. The present Minister of Finance probably should also be in attendance, but alas, he is not among us today. Mr. de Larosière, the floor is yours, please.

Jacques de Larosière: Dear Mr. Rector, Professor Kolodko, I am delighted to be here with you this morning. It is a privilege for me to be at the Leon Koźmiński Academy because this is the number one, non-public management academy, not only in this country but also probably in Central Europe. As we all know, it is one of the most dynamic and innovative business schools of the region, which I think is so important for the development of this country and for the development of transition; which is one of the subjects, apart from globalization, that Mr. Kolodko is devoting his life and energy to. Thank you very much Mr.

Rector for your kind words.

The title of my presentation this morning is '**The Evolution of the International Financial System'**

Having participated over the last thirty years or so in the annual meetings of the International Monetary Fund and the World Bank, I thought it might be interesting, from a historical perspective, to roughly sketch the main themes of those meetings as they have evolved over the last decades.

As I recall, in the sixties and seventies, one used to stress:

- the dangers of inflation,
- together with the need to reduce fiscal deficits.

Then, in the eighties, as one had paid little attention to the recommendations on budgetary discipline, the emphasis shifted to the dangers of excessive public debt (domestic and external).

Today, the three dominant themes are:

- the excesses of private sector indebtedness,
- the need to rehabilitate and strengthen the banking systems notably in emerging countries,
- the importance of preventing and eventually dealing with financial crises in a more effective way.

Thus, there has been a shift from the combined concern: "Public budgets/Inflation" to a more systemic preoccupation: "How to avoid the excesses of indebtedness of the private sector and to improve on the functioning of financial institutions?"

In a way, the themes of these annual meetings have become both privatized and globalized. This is because the world has, in fact, profoundly changed over that period. I shall try to briefly outline some of the main traits of this evolution and finally suggest some thoughts for the future.

THE INTERNATIONAL FINANCIAL SYSTEM HAS DEEPLY CHANGED OVER THE LAST TWO DECADES:

In a very schematic way, one can say that the international financial system has evolved in four major stages over the last 150 years:

Until 1914, the gold standard was associated with essentially fixed exchange rates and with a great freedom of capital movements; with the end of the gold standard in the early thirties, the system became compartmentalized: exchange rates were the object of discretionary, and often competitive, changes, and the use of capital controls became more and more generalized. After the second world war, the Bretton Woods system combined stable exchange rates and capital controls; since 1973 and the end of the gold/dollar convertibility, the system evolved towards flexible exchange rates and a general liberalization of capital movements.

How has the system evolved over the last two decades?

The system has been strongly influenced by the positive results of anti-inflationary policies introduced in the eighties and by an unprecedented movement towards liberalization, but also by the lingering consequences of the macroeconomic mistakes of the sixties and seventies.

Anti-inflationary policies have made a great impact.

These policies have had fundamental consequences on the financial system and on behavior. They have put an end to "monetary illusion" and to the perversions of negative real interest rates which were so common in the seventies, and which exerted such a toll on the allocation of resources.

The second factor of transformation has been financial deregulation, liberalization of capital movements and the elimination of exchange controls.

One has moved from a compartmentalized world where capital movements basically "accompanied" physical flows of goods and services, to an open world where capital movements dominate the financial markets by their size and their speed.

The revolution in information technology and in communications has enormously amplified these changes.

But the macroeconomic imbalances of the sixties and seventies continue, through the size of public indebtedness, to influence the reality of today.

Budgetary deficits of the past decades have accumulated in major public debt positions. In a world where inflation measured by prices of goods and services is contained, where capital movements are free, and where most savers can choose the currency of their investment, governments no longer have the freedom to settle their debts in a depreciated currency. States must pay positive real interest rates if they want to borrow. This new and hard reality has led most governments to reduce their fiscal deficits by containing the increases in public expenses, by intensifying fiscal pressure and by engaging in an unprecedented move towards privatization. The objective being, through the reduction of public deficits, to contain, and hopefully to reduce, the burden of the public debt on the economy.

Although this structural rehabilitation of public budgets is far from being completed -particularly in Latin America-, it is starting to show some results. A number of industrialized countries (with the exception of Japan) and emerging countries have now reached a balanced position, and even a surplus in their primary budgets (without debt service payments). Thus, the primary budget position of European Union countries has gone from – 2,2 % of GDP in 1982, to + 5 % in 2000, a swing of more than 7 percentage points. For the United States, the swing has been of the same magnitude (from – 1,7 % to + 5,4 %) over the same period[1].

As a result, in countries where fiscal rehabilitation is not yet completed, budget policy is, for structural reasons, more constrained today than it was in the past, and is not as easily usable as a macroeconomic adjustment instrument. This puts more responsibilities on monetary policy.

THIS NEW SETTING –REDUCED INFLATION OF CURRENT GOODS AND SERVICES, FREEDOM OF CAPITAL MOVEMENTS AND REHABILITATION OF PUBLIC BUDGETS- ENTAILS OR IS ACCOMPANIED BY A PROFOUND CHANGE IN THE FUNCTIONING OF THE INTERNATIONAL FINANCIAL SYSTEM:

[1] Although we are presently witnessing a return to fiscal deficit in 2002 in the US and a weakening of some fiscal positions in the European Union (Germany, Portugal, Italy, France).

Private capital flows are the main source of the world's financing.

In the seventies, net capital flows directed to emerging economies amounted to some 100 billion dollars per year, half of which was coming from official sources.

In 1996 (before the South East Asian crisis), the figures in real terms had tripled. The order of magnitude was 300 billion dollars. But, and this is perhaps more meaningful, almost all of those financial flows were coming from private sources (markets, credits, foreign direct investment). Since the 1997-98 crisis, commercial banks have sharply reduced their net annual flows (they are now negative by some 20 billion dollars) and the official flows are presently less than 20 billion dollars. Over the last two years, the total amount of net external financing is of the order of 150 billion dollars per year, nearly all of which comes from private foreign direct investment, which has been the most stable and resilient element of all.

At the same time, it is the private sector that has become the central player on the macroeconomic scene. It is also the focal point of financial crises.

Whilst the share of public budgets in the GDP's of a number of countries is declining, it is notable that growing current account imbalances are essentially caused by the private sector. The "twin deficits" of the past have been replaced by private deficits. This was particularly clear in South East Asia. For example, the budgets of Indonesia, South Korea and Thailand registered substantial surpluses in the years 1995-96. But those surpluses came with significant current account deficits. It is the financing of those deficits, through an explosion of shorter and shorter external debt, that has triggered the bubbles in asset prices and, eventually, the exchange crisis of 1997.

In other words, because of the excessive growth of credit over the past few years, one has observed a shift from the old couple: "fiscal deficits/inflation of current goods and services" to the new couple: "insufficient private savings/asset price inflation".

This is a fundamental change in the macroeconomic setting. This change puts more burden on monetary policy and, in particular, on the control of the growth of credit.

THIS SITUATION HAS SEVERAL CONSEQUENCES FOR THE FUNCTIONING AND THE SURVEILLANCE OF THE INTERNATIONAL MONETARY SYSTEM:

The banking systems must be rehabilitated, strengthened and better equipped to handle the new risks.

In the nineties, the acceleration of private debt in emerging countries has, in many cases, led to speculative or unprofitable investments accompanied by unsustainable share and real estate prices.

It is not so much financial liberalization that is the problem, but the combination of capital liberalization and vulnerable banking and financial systems incapable of dealing with risks - in particular, currency mismatches- in a professional, sound and non-political manner. That, added to deficiencies in macroeconomic and exchange rate policies, is what lies at the heart of emerging market crises.

An enormous and costly task has thus been taken up by national and multilateral monetary authorities, by regulators, by those in charge of banking surveillance, by rating agencies and, above all, by financial institutions themselves. Alongside the continuation of "fiscal mending", now is the time for rehabilitating, overseeing and recapitalizing financial institutions, in many countries. This will continue to exert a heavy toll on future growth. The experience of the last years shows that cleaning up overextended banks can be extremely costly: typically the burden can be of the order of more than 10 to 20 % of a given country's G.D.P.

Monetary policy is more and more complex.

Monetary policy must not only take into account the trends in monetary and credit aggregates, the movements in prices of current goods and services, but also asset prices and consequently their "wealth effects".

In a financial environment under constant change, where market instruments prevail over bank intermediation, where non-banks proliferate, where corporate defaults are dramatically increasing, and where financial innovation is creating new forms of credits everyday, credit surveillance is a major challenge. As J. Lawrence Laughlin wrote in "Credit of the Nations", some eighty years ago: "inflation of money is the symptom, inflation of credit is the disease".

In a world where consumer psychology is in some countries, and in particular in the United States, so deeply dependent on the stock exchange, and where the value of collateral -which is by definition volatile- has a direct impact on the volume of credit and therefore on consumption, one understands that the task of monetary authorities is particularly difficult. It is all the more so in that inflation is getting very awkward to define. If limited to current goods and services, the definition loses much of its meaning in a world dominated by strong financial markets and where future prices (which can be defined as current cash prices for future consumption of services, and are reflected in asset prices) are particularly relevant. But if extended to financial assets, the definition of inflation raises delicate problems in terms of concept, measurement, and interpretation.

How does one assess the medium-term profitability of a company and its relationship to the value of its shares? Is profitability reduced in accounting terms because information technology investment costs are immediately included in current expenses as they arise? Is it, on the contrary, artificially increased by the accounting methods adopted for the pooling of interests and for stock options? In the aftermath of the collapse of ENRON, should we not overhaul the accounting methods used by a number of corporations (consolidation rules, off-balance sheet transactions, securitization, abuse of special partnership vehicles, treating future -and therefore uncertain- incomes as actual earnings…) which have, too often, lead to illusory profits? In a world where certain investors and analysts are counting on - I should say “demanding” -, each year, a return on equity of more than 15 %, share buybacks by companies can be a tempting way of increasing share values. But this can lead, as we have observed over the past years, to excessive indebtedness.

Those issues were not, a few years ago, usual concerns for monetary authorities.

<u>Finally, exchange rate management is more and more uncertain.</u>

The exchange rate is a result of balance of payments flows and the reflection of market opinion as to the sustainability of current account financing.

It is, in a way, the “circuit-breaker” of the system. In a world where most balances of payments and currencies are still national, where prices of current goods and services are relatively rigid and where capital movements are powerful, free and volatile, the flexibility of that “circuit-breaker” appears indispensable.

However, this flexibility and volatility give rise to consequences, which can be very detrimental to the economic and financial stability of individual countries. Large monetary entities are relatively better protected against these repercussions, especially when they are strongly integrated trade-wise. This is the case of the United States and of the European Monetary Union.

But the problem is more acutely posed to medium-sized and small countries open to the rest of the world. Whether they are wise or not, they can be affected by market euphoria that can bring them, at times, significant inflows of capital. But they can, later on, - even if they are wise - be devastated by capital outflows, which can happen violently at any time following a political crisis, some bad news or a phenomenon of “regional contagion”. We have seen the outburst of such events over the last years.

AVENUES FOR THE FUTURE:

This leads me to deal with the role of the IMF in this more and more globalized environment.

Agreement is unanimous on the need to improve the "preventive" role of the IMF:

Several analysts have argued that some of the recent financial crises - especially the 1997 South-East Asian crisis, the 1998 Russian one and the present Argentine meltdown - could have been, if not prevented, at least mitigated, if the proper warning signals and "adjustment pressure" had been provided early enough by the IMF and by those who are in charge of assessing the economic performance of emerging countries. In particular, it has been observed that not enough attention had been focused at the time on the mounting indebtedness of the private or public sector, on its maturity and currency structure.

However, for such early warning indications to be provided in time, there is a need in the emerging countries for reliable, timely and transparent data. Hence the efforts by the IFIs to provide assistance to countries on data collection and reporting. Hence the encouragement provided by the IMF to member countries to publish article IV reports on their economies. Hence the incentives provided to emerging countries to adhere to the Fund’s program of "special data dissemination standards,” that is intended to provide the market timely and homogeneous economic and financial data. Hence the regular quarterly publication by the IMF of the "Emerging Market Financing" reports. Hence the encouragement to emerging markets to engage in regular meetings and "road shows" with private investors. Hence the collaboration between the IMF and the World Bank to strengthen banking systems, risk management and surveillance functions in LDC's (Less Developed Countries). Hence the need to publish on a regular basis the currency structure of bank loans. And I could go on and on….

But, most important, even if the data is right and timely, there is a need for the political authorities of the debtor country to be willing to adjust early enough and, whenever necessary, to take measures to reform. That is, without doubt, the most difficult and essential prerequisite for a successful preventive policy.

<u>But disagreements persist on the future role of the IMF:</u>

a) Here it might be useful to recall the essence of the <u>Meltzer Report</u> commissioned by the US Congress in 1998, which provides one of the most critical analyses on the role of the IMF.

Basically, the Report recommends:

1. eliminating IMF lending to countries affected by long-term problems. The IMF should not, in the view of the authors of the report, be involved in long-term development assistance (as in Africa) nor in structural transformation (as in the post-communist transition economies). Therefore, the enhanced structural adjustment facility and the poverty reduction and growth facility should be eliminated;
2. limiting IMF's lending operations to the provision of short-term liquidity to solvent member governments when financial markets close. The IMF would therefore play a role of "quasi-lender of last resort" for solvent emerging economies in crisis situations. Liquidity provided by the IMF would be short term, carry a penalty rate (i.e. above the borrower's recent market rate) and be secured by a clear priority claim on the borrower's assets. There would be no need for detailed conditionality since countries eligible to the short term lending would have to be "financially sound".

<u>What are the reactions to the Meltzer Report?</u>

I think one should distinguish two types of situations: helping countries on the road to balance of payments viability, and handling financial crises.

The Fund should continue to provide assistance to countries as long as they demonstrate that they are committed to adjustment:

There is obviously here a major weakness in the Meltzer Report. It is not because a country is facing structural problems (development-wise or transition-wise) that it should not be eligible for IMF balance of payment support.

Helping a developing - or emerging - country to reach balance of payments viability over the medium term is, on the contrary, one of the most important functions of the Bretton Woods institutions. There are, in the history of the IMF, a host of examples that show how the Fund can be effective in its role of providing policy advice and helping the adjustment. Let me mention, in this respect, the remarkable achievements in terms of fiscal discipline and monetary stability that have been obtained in a number of Latin American, Asian, North African or Eastern European countries over the last two or three decades or so.

Of course, there have been relapses and slippages. But if you look at the overall picture on the long term horizon, there is no doubt that the macroeconomic setting of the developing world has become less chaotic, less inflationary, and more conducive to private investment than would have been the case had we not benefited from such an institution.

This process can, in the event, lead to a string of Fund supported programs. The important criterion, here, is to avoid situations where things continue to deteriorate and where IFIs only keep on lending to recoup what the countries owe them. But as long as commitments and tangible results are there, the role of the Fund (be it as a "precautionary" standstill provider) can be easily justified.

In cases of financial crisis, the IMF should enhance its catalytic role vis a vis the private sector and provide clear leadership in terms of needed adjustment:

I must admit that I do not comprehend the logic of the Meltzer Report's recommendations for the Fund's role in crisis management.

Making the Fund the "quasi lender of last resort" seems to me a solution fraught with danger.

The “moral hazard” objection should be taken seriously all the more so because it is often difficult to distinguish a liquidity crisis from a solvency one. Besides, the Fund has only limited resources and, by contrast to a “normal” lender of last resort (i.e. a Central Bank), has no ability to issue money.

And if one assumes that a solvent country loses market access (the only case where the Meltzer Report envisages a lending role by the IMF), one fails to understand how a “penalty” rate applied by the Fund, so as to make its assistance more expensive than the most recent market rate obtained by the country in question (by definition, already significantly dissuasive since it would be a “pre-seizure” rate), could help the interested debtor when one thinks of the potential magnitude of present spreads in crises situations.

The fact of the matter is that, in a crisis situation, regaining market access requires a combination of several “reassurance factors”:

- a program negotiated by the Fund with the debtor country (macroeconomic discipline is always at the heart of the process allowing a country to regain market access). Here, the Fund has a unique role to play, one that no other institution can taker over;
- some financing provided by the IMF, but not necessarily in very large amounts (much depends on the balance of payments requirements, on market sentiment, and on the degree of involvement of the private sector in the problem).

Indeed it seems logical that the IMF should devote more attention and efforts to the private sector involvement (PSI) in debt crises management. In a world where most of the debt is incurred by and owed to the private sector, it is normal and healthy that private creditors be called upon at an early stage to discuss debt restructuring. I know that the problem is more complex than it was in the 80’s (when banks were the main actors) but it remains that private creditors (be they banks or bondholders) can and should be involved in orderly solutions whenever that appears possible. I am not advocating a systematic set of rules leading to compulsory mechanisms and standstills. That is not what is required. But I have argued that the Fund should call on the private sector early in the day and share with its representatives (through the IIF[2] and bond-holders associations or committees, for instance) the rationale behind a Fund program for a particular country, the concept governing its balance of

[2] Institute for International Finance.

payments viability and the financial requirements that are needed (given the limits to "normal" access to IMF funds, limits that should be made public and observed, barring exceptional circumstances). If such a framework was truly discussed between the IMF and the creditors (as it was 20 years ago), it would be easier to address in an orderly fashion the issue of private sector involvement and to address it with a "voluntary" approach and with market related solutions (ex: incentives to participate could take the form of limited guarantees or credit enhancements). In order to facilitate negotiations between the debtor country and dispersed bondholders, it seems appropriate, as has been advocated by the G7, to introduce collective action clauses in bond contracts. But I would warn against putting too much focus on ambitious and heavyweight solutions (like the recent IMF proposal of a "statutory" international bankruptcy system), which would require profound legal changes and new legislation throughout the world. Such a lengthy process does not seem warranted given that once a reasonable restructuring has been agreed by the main "players" (banks and major groups of bond holders), the risk of litigation initiated by some individual recalcitrant creditors ("free riders") is, in fact, extremely limited as shown by the experience of the last ten years (and could be mitigated by collective action clauses).

The real challenge is to combine an agreed framework based on a Fund program with practical, market oriented, case by case solutions. Hopefully there are recent signs suggesting that the G7 (April 20, 2002 -"Action Plan"-) and the IMF are moving in that direction.

<u>As far as the functioning of the international monetary system is concerned, exchange rate management is more and more challenging:</u>
From a systemic point of view, let me say that, aside from multilateral surveillance - which has its limits - and barring any revival of the SDR (Special Drawing Rights, international liquidity creation in cases of global need) - which I presently see as very remote - the Fund could play a major role in the structural stabilization of the exchange rate system <u>if</u> the main players (the G 3) decided to coordinate their policies in a way conducive to more stability. But I do not see this as realistic under the present and foreseeable circumstances.

Concerning emerging countries, I should like to stress the central and crucial challenge they are facing in our globalized and free capital world. In some respects, small virtuous countries are the most affected. What are their options? To impose exchange controls? In some cases they can be useful, although I would hesitate to recommend them as a general and effective solution. In any case, better prudential control on short-term indebtedness of banks and enterprises seems to me advisable in order to reduce "currency mismatches". But from the standpoint of the exchange rate regime, what should they be doing? Should they be pegging their currency more or less rigidly to an external anchor? Should they be adopting a Currency Board? Should they be floating freely? Or should they join with their major trading partners and neighbors and adhere to monetary unions?

In other terms, emerging countries have difficult choices: either they float, which gives them some flexibility in handling their monetary policy but does not shield them completely from the real shocks entailed by excessive exchange rate volatility. Or they attempt to "manage" their exchange rate, which, in times of external pressures - which are bound to happen at some time - is an almost impossible task. Or they "dollarize" or adopt a completely fixed peg to another currency (for instance, through a Currency Board). In the latter case, experience shows that this can only work if:

1. the anchor currency is well chosen in terms of its trade and financial relationship with the pegger;
2. the emerging country performs well in terms of macroeconomic and particularly fiscal management,
3. the economy is sufficiently flexible (wage-wise including the public sector) to adapt to unwarranted changes in the value of the peg.

We have seen, in the case of Argentina, that over the last four to five years, those conditions were not met. Under such circumstances, the IMF sizable financial "package" was of little use, since large imbalances and deflationary forces were building up in the country.

George von Furstenberg[3] has argued that the monetary system "fails to serve the legitimate welfare of emerging market countries where currency crises, asset price deflation and financial economic meltdown tend to coincide. One of the greatest current failings of the international financial institutions and of the G7 is their failure publicly to recognize the needless pain and suffering caused by small countries hanging on to a separate currency that

[3] "One Region One Money", Washington, September 29, 2001 (Fordham University New York).

is being eroded by market forces, and to recommend multilateral alternatives".

So, what are the solutions?

First let me note that it has been established[4] that capital liberalization does not necessarily lead to instability. The most successful emerging countries in this regard - and there are quite a number - have been "those who have combined sustainable macroeconomic policies, a systematic approach to safeguarding financial sector stability and an exchange rate consistent with the other macroeconomic policies".

I believe that countries with weaknesses in their macroeconomic, fiscal conditions, and financial systems should rely more on floating exchange rates. In any case, they should try to mitigate the effects of excessive volatility through determined anti-inflationary policy (i.e. inflationary targeting) and prudential control on external indebtedness of domestic agents[5].

Those with stronger structural and macroeconomic environments who have enough labor market flexibility and who happen to have an intense trade and financial relationship with a large country or a monetary union should consider pegging their currency to such an external anchor. It is probably in that direction that, in the years to come, we will see the international monetary system evolve. Indeed, we already observe, for example, in Central and Eastern Europe, a number of countries converging towards the Euro, which carries substantial advantages in terms of spreads and financial stability[6]

To conclude, let me say that the international financial system will remain fragile and volatile as long as a number of economies are characterized by excessive credit, bad public finances, fragile financial institutions, weak private savings, unviable exchange rate systems and major imbalances in their current accounts. The prospects and modalities of the financing of these imbalances are uncertain and depend on market sentiment and the perception of the risks

[4] Cf. "Capital account liberalization and financial sector stability", IMF, Occasional paper (Washington 2002).
[5] See Morris Goldstein : "Managed Floating Plus ", Institute for International Economics, Washington, DC, March 2002.
[6] George von Furstenberg goes as far as saying: "The strength of trade and finance relations, say of countries in the vicinity of the United States or of Euroland, makes the almost complete financial integration and interest rate convergence that is available upon formally adopting the US dollar or euro more attractive than staying in the halfway house of a "Currency Board".

involved.

In other words, the way to a better future does not rely too much, in my view, on legalistic so-called "architectural" changes regarding debt negotiations, but on the implementation of the classical and more fundamental notion of “adjustment”. This notion - which remains the leitmotiv of thirty years of IMF annual meetings - will continue to be high on the agenda, even if the environment and the sources of imbalances have, as I have tried to show, profoundly changed over the years.

Andrzej K. Koźmiński: The name of the game is “adjustment”. I think we have been very privileged to be able to listen to you. Thank you. I would also like to thank Mrs. France de Larosière who is present here with us today. Thank you, both of you. The floor is open for discussion.

Marek Koziewicz, student Science Club, “Little Tigers”: Do you think that one day, one global institution will control the world’s financial policy? Is there any chance for it?

Jacques de Larosière: It is a dream. I had that dream sometimes in my life and I continue to entertain that vision of the future. But, honestly, I do not think I will ever see that and I do not think that my children will see that and I am not sure that my grandchildren will see it. But it is logical because if the globalization forces that are so well described by my friend Professor Kolodko, if those globalization forces extend themselves much further than they are already extended, -indeed globalization is, as Professor Kolodko has often explained, a gradual process-; it would make a lot of sense to have a unified monetary system. Of course that would entail a form of world political federation. When I see the difficulties that we have, for instance in Europe, to start moving towards more powers devoted to the Union, I measure the political difficulties of getting the European Union and the entire variety of other nations in one monetary, political system. But, as you have implicitly asked in your question, there are a lot of, I would say, logical justifications for such a vision. In the previous experience of a monetary system, which was the one of the gold standard, you had, as I explained, the freedom of capital movements and one monetary system in a number of countries that adhered to the gold standard. Still you had at that time an extreme exacerbation of nationalism, which lead eventually to the disaster of the I World War. We must not be *angeliste*, we must not think that things will come nicely around. The force of nationalism, in some cases unilateralism, is such that it is not easy to put all this together in a democratic framework.

Jacek Tomkiewicz, TIGER: You talked about the conditions for a good functioning currency board. Do you think that Poland is prepared for implementing such a currency board using, of course, the euro as an anchor currency?

Mr. Jacques de Larosière: I think Poland is clearly on the road of accession. So at one point in time Poland will join the European Monetary Union. It is, as you know, not a question of "if", it is a question of "when" and "how" because you have no clauses of opting out like the United Kingdom or Denmark had. In your case, the certainty is that once Poland (and I do not think that is in doubt) will access the European Union it will at some point in time afterwards have to enter the European Monetary Union. Indeed one day it will fuse into the euro. As you know, some prior conditions will have to be met in order to do so because you need to have a period where inflation, interest rates, the behavior of the exchange rate, allow that entrance into the monetary union on the basis of parameters that have been already set. So my answer cannot be a technical answer. I am not going to tell you when after the accession you exactly will be entering the monetary union because I have no knowledge that could let me answer that question.

My general view would be this one. I think Poland has very significantly advanced towards the convergence mechanism. You can substantiate that by a lot of economic and even econometric work. Basically, I think that Poland and other neighboring countries, like the Czech Republic, Hungary, and some others, are now in a closer position convergence-wise to the European Union than countries like Spain or Portugal or Greece were four years before their accession to the European Union. If you measure in terms of inflation, in terms of budgetary deficits, in terms of liberalization of the trade and financial systems, I think one can say that a country like Poland is already more advanced than the other candidates were in those days. I believe that the convergence movement is certainly advancing.

I would say that, personally, I would insist on two things in order to make this entrance into the European Monetary System the quickest possible. I would say that, firstly, you need to confirm and get entrenched the more favorable anti-inflationary expectations that we see in Poland. Inflation is decreasing very significantly and what is important at that point in time is to confirm, to entrench, and to consolidate these lower inflationary expectations. I think that is absolutely of essence. I would put that number one.

The second thing I would recommend, would be to have a fiscal position that is more in line with, let's say, the Maastricht criteria of 3 percent than it is presently. I would insist on the reform of the public sector in terms of its efficiency. I speak of that because we have the same problem in France. Public sectors are often insufficiently efficient, you still have public enterprises that are still inefficient and count on public subsidies etc. There is a great amount of work to be done in terms of mending these systems in depth. If those two things can be done in parallel – anti-inflationary expectations being more and more consolidated and the size of the state reduced and its efficiency increased – then, I think, the entrance into the European Monetary Union after accession is something that could be pretty quickly done. The quicker, the better, because staying too long in a position where you are not yet in but you are already partly in, can be disruptive in terms of market reactions, and in terms of short term capital flows. Once you have those things, then you just do it. That is why I think that it is better to do it relatively quickly than to wait and see.

Grzegorz W. Kolodko, Director of TIGER: I would like to raise two issues. First, I would like to continue the first question that our student raised, and I would link it to your personal life and your own personal experience, as you mentioned your children and grandchildren.

When you graduated from the Institute of Political Sciences in Paris, in 1951, about half a century ago, did you envisage that in half a century there would be the euro and that East European countries would be entering a common euro zone? Or was it as far beyond your imagination as now a global currency is beyond any of your expectations, even for your grandchildren? In this context – a more precise question – do you think that the current trend towards consolidation would lead to the possibility that in 20 or even 50 years we may have much fewer currencies that we have now worldwide? You know that in the IMF there is a gallery of currencies from all over the world – but there are much fewer currencies than the number of countries that we have in the IMF. Or do you think there will be just a few, perhaps dozen or so currencies, because of regional integrations?

My second sub-question is as follows. The first distinguished lecture we have had in our series two years ago was Bob Mundell. He – and he still maintains his point – suggested fixing the exchange rate forever, of US dollars, euro and Japanese yen, which will create in a sense a new monetary system, which would cover more than 60 percent of global GDP. The second point is – and this is also information for our students because time goes so fast – exactly 16 years ago on the 12th of June, Poland rejoined the IMF after giving up its membership in March 1950. When Poland was rejoining the International Monetary Fund 16 years ago, Mr. Jacques de Larosière was the Managing Director of the IMF, and in a sense you brought us back to the international financial community, yet it was still 1986 – the time of the market-oriented reforms under the old institutional arrangements before the transition took momentum, say, 12 years ago. But now we have 182 countries in the International Monetary Fund and you are talking about financial order and institutions of the IMF. But we do not know if we can consider the IMF to be a democratic institution. It is not even like the WTO, it is still much less democratic, than let's say, the United Nations. The IMF is like a business – we have the shareholders - no major decision is to be taken without the USA and not any significant decision is to be taken without a prior agreement from the G7. Do you then believe - from your experience as the head of the IMF, then a statesman, and then the scholar, and a man of the knowledge - the IMF should be a more democratically run institution? Would it facilitate the quest for the new institutional financial order if the IMF had not been subordinated to the needs and visions etc. of the G7 and the USA?

Jacques de Larosière: Thank you very much Professor Kolodko. This is really an invitation to make another speech but I am going to refrain from it so as to keep it short.

I will be very frank. In 1951 when I was young and graduated from the Institute of Political Sciences in Paris, I had absolutely no vision that some 50 years later or even fewer than that, I would be living in a monetary union. I did not envisage that. Therefore you may be right when you say that if I do not envisage now the unified world of international finance, maybe it is because I am as blind and without vision as I was in 1951. Maybe things will happen quicker and maybe my grandchildren will see this globalized world. I am, however, still of the view that it is going to be a very long process because you have in Europe some fundamental links. I feel, when I am in Europe, a citizen of Europe. When I am in Warsaw it is absolutely no different for me than when I am in Florence, Rome or Lyon. I feel completely like a citizen of this region. But I do not feel that I am yet a citizen when I am in some Asian cities for example. I still feel that the world goes about evolution little by little and that you start with the things that are the most, I would say, possible, in your vicinity. But perhaps it could be faster.

Your second question is: “Do you think, like Professor Mundell, that we should be moving towards a consolidated G3 monetary system, where the dollar, the euro and the yen would be pegged and you would have a centralized monetary policy?” It is a bit like the same question. I still feel very skeptical about that because I have never seen the United States, during my entire career, willing to adopt, shape up their domestic monetary, and fiscal policy in order to comply with or make possible the functioning of a fixed exchange system. I have never seen that. It is very contrary to the culture of the United States. A normal United States citizen has really little regard for the external value of the dollar. The dollar is the dollar. The dollar is the center of their monetary vision and to say “We have to change our budget because there is something happening in Europe or in Japan that forces us to be a little more expansionist or a little less expansionist if we want to keep the currency fixed,” is something that is so contrary to their basic culture that I still feel, although I like Mundell’s views, that these projections are extremely idealistic. That is my view.

“Do you think that the IMF is not a democratic organization?” Dear Professor Kolodko, I would not put it that way. I would say the IMF is based on basically commercial laws: that is you pull in a mutual organization, the monies of the shareholders, and they make a contribution to its equity. It is called the quotas – in the old days they had to put in gold in part to make that contribution but now we live in a different world. You put your share in currencies and you vote according to the size of your shares. Is that an antidemocratic way of governing an institution? I do not think so. It is, as you said, a business-like way. If I put in more money I have more votes, if you put in less money you have less votes. That is the way it functions. If you had an IMF which was based, for instance, on the way the General Assembly of the United Nations functions, that is each country has one vote, that is Vanuatu has the same vote as the United States, then I think, first of all, it would not work because no large or even medium size country would ever accept that, and I am not sure it would be more democratic. I think the operational strength of the IMF has always really been dependent on this "one dollar-one vote" system. I think if we have had an institution that has had some positive influence in the world is in part because it functions that way. You said the United States has to be in the big decisions because they have around 20 percent of the voting shares - that is true for the constitutional changes where you need to have an 85 percent majority but it is not true for the normal decisions, that is 99 percent of decisions that are taken on a majority basis. I think it is a bit exaggerated to say that the United States controls everything. What I think is that the United States have a very important role in the IMF because they are the largest economic force in the world and they are not the major shareholder; they are the major individual shareholder. But, the European Union countries, if you put them together, are larger in terms of their quotas than the United States, therefore they are potentially the larger shareholder. If they coalesce, they can become very important in the running of the institution.

How can you make the institution perhaps more inclined to take into account the interests or the needs of some countries that are less represented in terms of their shares? I think that is exactly the sort of thing that governments should be working on; and they have started to do so. I think the Fund over the last 20 years or so has developed a gamut of groupings and facilities that are very much directed towards developing poor countries. Can you do more? It is a question of judgment. I do not think that you can say that the system is flawed.

Andrzej Bolesta, TIGER: I am very happy that you show this kind of citizen-blind attitude, that I speak in support of. The question of more money – more votes and as a result more power is a different issue and obviously an interesting subject. Now please excuse my, kind of, sarcastic opinion. I totally agree with the Meltzer report that the IMF should limit long-term lending to poor countries because this limitation will prevent them from becoming more poor or poorer than they really are. We have a situation like, for example, the case of Mozambique, which pays about 9 million US dollars a day servicing its debts.

My question is about another African country because I think this is an area of my expertise. In 1992 there was an economic structural adjustment program that began in Zimbabwe. The IMF said: "Listen, we give you money but you have to liberalize your market, your economy, and you have to start privatization". That was what Mugabe's government did. However the officials of the IMF did not look at one issue, at one thing. They did not really consider the political results, the political affects of its action. In privatization in Zimbabwe, the only people who could really take part were the government officials. Because of privatization, they got more and more money; they became richer and richer. As far as I know Mugabe's personal wealth is already estimated at about 3 billion US dollars. Of course it is very difficult to count.

My question is then as follows: Didn't the IMF see that actually this whole process, called ESAP – Economic Structural Adjustment Program, was just a kind of way for the Zimbabwean government and corrupted officials to become richer and, as a result, the whole nation became poorer. For me it is important to understand whether this political factor is considered within the IMF structure. It is very important that if economic and financial reform is to succeed, this must be taken into consideration.

Jacques de Larosière: I think you are putting your finger on a very important point which is that liberalization and privatization, that are indeed recommended by the IMF, can be used and misused, and abused by local corrupt politicians. We have seen many examples of that. Does it mean that liberalization is an evil and the Fund should move away from proposing this liberalization and privatization? I do not think so. I think, basically, it is better to have private companies in manufacturing or services sectors, which can do the job without having to rely on taxpayers or on subsidies that are very often allocated to loss-making public companies. I also believe that the IMF, the Washington consensus, if you will, is right in principle and I would engage you to read the little study that I commented on, which is the latest Occasional Paper of the IMF on the results of financial deregulation and liberalization in developing countries, which is done with a lot of economic data. Maybe you can take the example of Mozambique or Zimbabwe or some others and then make a general proposition, but we are here in an Academy where you have to discuss on a wider basis and not use one example to discredit an institution completely. It is true that in some cases the Washington based consensus – working in a liberal fashion – has been abused but I do not think in the long run the prescription is wrong.

I think you are profoundly wrong on one point, which is to say that Meltzer is right; to say that you should never use the IMF to help a country that has structural problems, because I have seen countries, in my nine years of presence in the IMF, that have completely changed in terms of the increase and distribution of their incomes because they have decided to cut down on inefficient public expenditure and proceed with some forms of liberalization. If you look at countries like Morocco, for instance, it is absolutely obvious that the changes they made in the 80's have been conducive to a much better situation. Of course it is not perfect. You have differences in the distribution of revenues but you have a much better basic income and distribution situation than you had before. The Fund (I could justify this with a lot of economic data if we had time), has a string of successes in the developing world that should not be just set aside because it does not follow the arguments that, I would say, you rather brilliantly but also to some extent superficially presented. You have to really know all the facts before you decide on this. Thank you.

Andrzej K. Koźmiński: Thank you very much Mr. de Larosière.