STRENGTHENING THE RESILIENCE OF FINANCIAL SYSTEMS

Panel Discussion

Arminio Fraga
Peter B. Kenen
Jacques de Larosière

THE PER JACOBSSON FOUNDATION

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Foreword

On Saturday, June 4, 2000, the Per Jacobsson Foundation organized a panel discussion, under the sponsorship of the Bank for International Settlements, on "Strengthening the Resilience of Financial Systems," which was held at the Lucerne Culture and Convention Center in Switzerland. Participants were Arminio Fraga, Peter B. Kenen, and Jacques de Larosière, who is also the Chairman of the Per Jacobsson Foundation. Andrew Crockett, the General Manager of the Bank for International Settlements, was invited to preside over the meeting, the proceedings of which are presented in this publication.

The Per Jacobsson lectures are sponsored by the Per Jacobsson Foundation and are usually held annually. The foundation was established in 1964 in honor of Per Jacobsson, the third Managing Director of the International Monetary Fund, to promote informed international discussion of current problems in the field of monetary affairs.

The lectures are published in English. They are distributed by the Foundation free of charge. Further information may be obtained from the Secretary of the Foundation, or may be found on the website at www.perjacobsson.org.

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Opening Remarks

Andrew Crockett[1]

It is a pleasure on behalf of the BIS to welcome you all to this panel discussion, held under the auspices of the Per Jacobsson Foundation. There is no need to introduce to you Mr. Jacques de Larosière, who in addition to being a member of the panel has recently succeeded Sir Jeremy Morse as Chairman of the Foundation. We are also pleased to have with us Mr. Leo Van Houtven, who is President of the Foundation.

Next let me introduce Arminio Fraga, who took over responsibility as President of the Banco Central do Brasil a little over a year ago, and before that was, some time ago, a Deputy Governor. He is also famous for having been, in between those intervals, with George Soros in New York.

And the third member of our panel is also well known. Professor Peter B. Kenen has had a distinguished academic career, most of it at Columbia University but also at Princeton. He is the author of many books and articles, and has been an acute observer of and commentator on the most important international monetary and financial issues for many years.

Jacques de Larosière

Thank you very much, Andrew. Yes, things are going to be very simple. We will deliver three little speeches. We will start with Arminio Fraga, then Peter B. Kenen, and I will close. If you have questions that you wish to pose in writing, you have at the end of these brochures a page for that. So, without further ado, I would now like to invite Mr. Fraga to be the first speaker.

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[1]Andrew Crockett is the General Manager of the Bank for International Settlements.

Some Aspects of Crisis Prevention and Resolution

Arminio Fraga

It's a great honor for me to join this tradition with a group of friends, including in particular Jacques de Larosière, and my teacher, Professor Kenen.[2]

As a central banker about to participate in a Per Jacobsson Foundation panel discussion, I feel that I must stick to my field of expertise and talk about the importance of monetary stability in a new era. I was very pleased to learn, as I prepared for this lecture, that one of my fellow countrymen, Eugenio Gudin, was a founding father of the Foundation. Gudin was also the father of modern macroeconomics in Brazil, and that makes it an even greater honor for me to be here.

My subject is crisis prevention in the context of the need to strengthen the global financial system. I'd like to start with a brief recap of why it is that over the years we have repeatedly found ourselves in trouble and identify, in a simplified way, the root causes of these situations in the emerging markets. Then I will make a few remarks on crisis resolution.

If one looks back at the history of international debt crises, certain regularities emerge. For instance, if we look at the 1980s during the Latin American debt crisis, one could argue that the problem was too much borrowing to finance government budget deficits. If we look at Mexico in the 1990s, one could argue that there was too much borrowing to finance consumption. And if one looks at Asia more recently, you see that even when borrowing is undertaken to finance investment, a crisis may erupt.

[2]I would like to thank without implicating my colleagues, Daniel Gleizer, Pedro Malan, and Sergio Werlang, for comments on a draft and discussions on the subject.

Therefore, one must conclude that the path looking at the use of borrowed funds doesn't seem to lead anywhere.

What is there, though, is the fact that somehow along the way, following these processes, all of these countries ended up with a weak balance sheet, i.e., with a lot of short-term debt. So these are stock stories, not necessarily flow stories. Of course, you need a sequence of what we can call bad flows to get to a vulnerable stock situation.

The deeper question that one then needs to ask is: What is it that led to these weak balance sheet situations? My answer is twofold.

First, weak macroeconomic regimes, and by that I mean unclear, poorly specified monetary and exchange rate regimes and weak fiscal regimes, and all the perverse interactions that one gets between these two. In particular, it seems that managed exchange rates were there in every case. That produced situations which, to use market jargon, were one-way bets, a sure way to disaster.

Second, another common feature is a weak banking environment, and a weak corporate governance environment. Those two weaknesses are, in my view, the deep foundations of vulnerability. That's where crises come from.

If one accepts this view—and the profession seems to be gravitating toward these ideas these days—then there is a lot we can do. One, we can run clean macro regimes. By that I mean sustainable fiscal policies and strong, clear monetary rules, either with a very rigidly pegged exchange rate for certain cases or with a proper floating exchange rate, along with the necessary focus on the part of the central bank on inflation. In this context, inflation targeting seems to be gaining favor these days, particularly as it becomes more and more difficult to understand our old friend money and how it relates to what it is that we central bankers do. So point number one is to run a clean macroeconomic regime.

With a floating exchange rate regime, for instance, markets and businesses will be given the right set of incentives, and that is the crucial element. In this case, it is highly unlikely that a business that is not in some way related to traded goods or services will engage in excessive foreign currency borrowing. Therefore, the probability of currency mismatches and excessive risk taking will be reduced. We could say the same thing about the fiscal side. If the regime is properly designed, there will not be an issue on fiscal dominance, and the incentives will be the right ones at the macro level.

On the banking side, we're all watching these days a very fast evolution of the way we supervise banks and financial institutions in general. My experience in Brazil, where we play the dual role of central banker and supervisor, is that we need to be more global in the way we look at things. Supervision has to take place on a global and consolidated basis. This means that we need to better coordinate the work of supervisory authorities across the world. Complete transparency across boundaries and a clear allocation of responsibilities are needed for this to work well. Here I very much favor the European model, where the authority granting the license is also responsible for supervision. It keeps things simple. But, nevertheless, there will be a fair amount of double effort. I believe most countries will want to supervise the branches of foreign banks in their jurisdiction, particularly if these are important players.

One thing we have all learned—sometimes the hard way—either in government or in the private sector is that if we squeeze something too hard, it moves. It tries to avoid the squeeze. And this is true in banking. The more we end up regulating and supervising banking institutions, the more likely it will be that problems will arise elsewhere. And thus I come to my last item in this short list of points on crisis prevention, which has to do with corporate governance in capital markets.

In my view, it is not enough to get things right in banking, narrowly defined. It is crucial that we also pay attention to capital markets, to how they are structured, to their transparency, to consumer protection, to shareholder protection, and so on. All of that falls under the rubric of governance. Transparency is the key word in this world. International accounting standards are being developed and unified across the world. This is very positive, and if we can succeed in getting the banking and the governance right, we will be covering the relevant universe. This completes the discussion of the second point.

Now markets, being the forward-looking creatures that they are, will tell us that all of this is fine. We may get most of the preconditions right so that we can avoid the sorts of crises that we have seen in the past. But they will want to know, if a crisis arises, how the system will deal with it. And the forward-looking aspect is key. Unless we specify the rules of the game clearly, the game itself may be distorted. So even when discussing crisis prevention, we cannot ignore the design of the crisis resolution model. This is probably a good time to discuss this. I will make a few points on this aspect based on our recent experience in Brazil.

The first point on crisis resolution is that, even though we may succeed in strengthening macroeconomic regimes, banking structures, and capital markets, crises will always happen. This is so because markets adjust their risk taking to the riskiness of the environment. For example, more leverage is present where overall business conditions are deemed safer. As a result, I believe that we will continue to need a lender of last resort in the international economy, and the IMF is there for that purpose. This is a simple point, but one that is not universally accepted.

Now if we do have a lender of last resort, there is the issue of private sector involvement or burden sharing, which has become a hot topic these days. Here my view is that it is not reasonable to expect the private sector to move first. I think of this as a sequential game. The private sector is too scattered to be able, particularly in a crisis situation, to move quickly; the official sector will have to move first (even if just to say it won't lend).

Let us look at some situations with different degrees of seriousness and examine what types of intervention by the lender of last resort and the private markets would be appropriate. First, you may have a situation where the lender of last resort will lend without policy changes to countries that run decent policies, but that were perhaps the victim of a very violent and prolonged market movement. As you know, such things do happen, but we can assume that this would be a rare case.

Second, you have a situation where the lender of last resort would lend with policy changes, but without any private sector involvement. This would be a situation where the country slipped a bit, and this is a very common case. In this case, the lender of last resort would be engaging in a standard IMF program with conditionality.

Third, there could be a situation where it is felt that things got further out in the curve, and some private sector involvement would be needed, but it may not be a situation where the country is insolvent or beyond repair. This is the type of situation in which we in Brazil in early 1999 felt some private sector commitment was necessary. We worked it out in a sequence of conditional commitments first with the IMF and second with the banks (who were at that point the main source of short-term credit to Brazil). This program jump-started a flow of trade and interbank lines and was instrumental in halting a run on the real.

Fourth and finally, there may be cases that are beyond easy repair, where you are going to need private sector involvement ahead of official lending. These are the more dramatic cases, and here we are talking about restructuring, standstills, and some other words that markets don't like but that are a fact of life.

Now if you accept this sequential structure, where the lender of last resort may be looking at different types of situations and trying to decide where each falls in the spectrum of possibilities, one is going to need a lot of surveillance. The lender of last resort must stay on top of things and do it in a proactive, forward-looking way.

Effective surveillance requires transparency of data, and there is universal support for that these days. I don't think transparency is a magic solution to everything, but it is important that we all work on producing data that is accurate, comparable across countries, and provided in a timely fashion. The recent proliferation of standards and codes is a sign that we are making progress in this important area.

I do not, however, support the idea of going beyond data transparency and having the IMF publish its views. It would change the nature of the relationship between the IMF and the country, perhaps turning it into a bureaucratic event. It would move the locus of real difficult, forward-looking discussions out of the limelight, and it could threaten the quality of the surveillance process. Professor Kenen discusses a similar point in his paper.

Another problem with publishing assessment reports is that markets do not work well with discontinuities. This may at first blush seem to recommend more frequent monitoring of countries, and, indeed, that seems like a good idea. But if the monitoring is to lead to a system of discrete ratings, say to slot countries into categories such as those discussed above, then a downgrading by the IMF would in many instances cause a crisis.

In order to avoid this problem, the ratings could be internal; but even that could be tricky, as the danger of an information leak has been known to exist. It would make more sense to avoid discrete ratings altogether, while maintaining a close and fairly continuous dialogue with countries, particularly those straying from sound policies.

Finally, for all this to work better, we need to think about applying to the IMF some principles that we now universally apply to our central banks. The IMF needs to be given a clear mandate to pursue macroeconomic and financial stability, which I believe is what the new Managing Director intends to do. And it should be allowed to do so in a nonpolitical way. I don't see why the views that we defend so strongly in the domestic context—such as central bank operational independence—should not apply also in the international context.

Financial-Sector Reform in Emerging-Market Countries—Getting the Incentives Right

Peter B. Kenen

It is a particular pleasure for me to appear today with Jacques de Larosière and with my former student, Arminio. I should assure you that he did not learn all the sensible things he said today from me.

But I do want to develop one of the issues he raised, and I shall do that as briefly as I can.

The epidemic of financial crises in the 1990s has had one useful consequence. We now have a set of codes and standards by which to judge the quality of the financial system in individual countries. Unhappily, the international community has not yet produced an adequate set of incentives and penalties with which to encourage compliance with those codes and standards. With the crises behind us, moreover, there is real reason to fear that individual governments, left to themselves, will put off the measures required to achieve compliance.

There has been no shortage of suggestions aimed at promoting compliance. You can cull a fairly long list of suggestions from the reports of the various groups convened to consider improvements in the international financial architecture and from other sources. Here are four examples:

- Imposing higher capital requirements on bank loans to borrowers in countries that have not complied with the relevant codes and standards, such as the Core Principles for Effective Banking Supervision and the Special Data Dissemination Standard (SDDS) administered by the IMF.

- Refusing to grant market entry to foreign banks from countries that have not complied with those same codes and standards.

- Requiring compliance with key codes and standards as a precondition for access to certain financial facilities of the IMF—what I will call hereafter the gate-keeping approach, because the more familiar term, *prequalification*, carries additional baggage.
- Including in IMF conditionality specific financial-sector reforms aimed at achieving compliance with key codes and standards during the course of an IMF program.

Some of these steps have been taken; others are being adopted or considered. The Basel Committee on Banking Supervision will base the new capital adequacy accord on better criteria for judging the riskiness of cross-border lending. The IMF will assess compliance—or progress toward compliance—with the SDDS and the Basel Core Principles when judging a country's eligibility for a Contingent Credit Line (CCL). During the Asian crisis, moreover, the IMF required crisis-stricken countries to adopt many far-reaching financial reforms. In its 1997 Letter of Intent, for instance, Thailand undertook to overhaul its accounting, loan classification, and loan-loss provisioning rules; to encourage foreign purchases and takeovers of banks; to introduce a deposit insurance scheme with well-defined limits on coverage; and to take a number of steps aimed at closer supervision of its banking system. These reforms went well beyond the immediate remedial measures required to revive and restructure the Thai banking system. Some of them, moreover, were actually implemented.

Each of these strategies, however, has serious shortcomings, and the use of IMF conditionality makes no sense at all. The first two strategies—use of the capital adequacy regime and of entry rules—cannot persuade governments to undertake reforms unless their commercial banks are hard hit by higher borrowing costs or by their exclusion from other countries' markets and are therefore induced to call on their own governments for tighter supervision. Furthermore, the new capital adequacy accord may not discriminate keenly enough between individual countries, and its ability to foster reform may be diluted by allowing internationally active banks to use their own risk-assessment systems to calibrate capital adequacy.

The third or gate-keeping technique has, I said, been adopted for one special purpose—determining eligibility for a CCL. We cannot know how helpful it might be, however, because no country has applied for a CCL. The failure of countries to do that may tell us more about their views concerning the risk of being approved than the risk of being rejected. But I attach more blame to another feature of the CCL. Eligibility does not imply full IMF endorsement of a country's policies; the country may have to make policy changes when it seeks to draw on its CCL. Hence, countries that might have been expected to apply for contingent credit lines have instead applied for stand-by arrangements, even when they do not plan to use them, because the IMF's approval of a stand-by arrangement conveys outright endorsement of a country's policies. Furthermore, some countries have arranged contingent credit lines with major foreign banks because they do not run the risk of having to alter their policies in order to access those credits.

There is a more serious objection to using compliance with codes and standards as a gate-keeping device. Can the IMF credibly commit itself to refuse financing to a crisis-stricken country because the country has not complied—or made progress in complying—with key codes and standards? It is easy enough to use this gate-keeping device for regulating access to one IMF facility, such as the CCL. A country can decline to ask for the sort of financial assistance provided by that facility. To use it comprehensively would be more difficult. It would be difficult politically, because it could deprive some countries of all access to the IMF. It would be risky as a result, because a country cut off from IMF credit would be obliged to adopt other, systemically damaging, ways of resolving future crises. Finally, it might be very hard to use gate-keeping fairly. How would the IMF treat a country that has been working hard to strengthen a weak banking system, compared to a country that has a stronger banking system but is not doing anything to make it even stronger?

Some recent studies of the IMF, such as the one sponsored by the Council on Foreign Relations, take a different tack. The IMF, they say, should impose higher charges on drawings by countries that have not complied with key codes and standards. There are three objections. The first is one I have just mentioned—the problem of achieving comparability between the quality of a country's financial system at a point in time and the progress it has made in strengthening the system. The second objection derives from the principle of sovereign equality. The IMF has imposed different charges for drawings on different facilities, such as the Supplementary Reserve Facility (SRF) and the Poverty Reduction and Growth Facility, but has never, to my knowledge, imposed different charges on different countries that draw on the same facility. Finally, higher charges may not be very effective in penalizing countries for their failure to comply with key codes and standards. The political cost of reform is bound to exceed any feasible increase in the cost of drawing on the IMF. In short, the threat to refuse financing may not be very credible and the threat to charge more for it may not be very painful.

My fourth example—imposing financial reform via conditionality—has obvious attractions. It is, in effect, to make an offer that few countries can refuse. But it is not the right way to go.

Conditionality has been overloaded. The governments of crisis-stricken countries are being asked to do too much, even without being told to make fundamental changes in familiar institutions or introduce new institutions. Crises create opportunities. Too often, however, the opportunities are squandered because scarce skills and political capital are spread too thinly. From the standpoint of credibility and the rapid restoration of confidence, it may be better to make a few, very visible, policy changes than to make a great many promises that cannot be honored completely.

Furthermore, the overloading of conditionality is responsible for three very serious inefficiencies. It discourages governments from coming to the IMF before running down their reserves and thus raises their need for IMF credit. It lengthens the time required to negotiate IMF programs and thus prolongs uncertainty. And it leads to the overly parsimonious tranching of IMF credit instead of the front-loading that would, I believe, be more effective in restoring confidence.

I have saved for last, however, the most obvious and serious objection. Why wait until crises arrive before we insist on reform, when the main aim of reform is to prevent future crises?

Is there a better way to deal with the problem? Yes, there is—and we may be inching toward it. Before I describe it, however, let me make three observations.

First, financial reform involves much more than making laws and regulations. It is an intrusive process, because it is bound to affect the behavior of firms and households, as well as the structure and functioning of the financial system itself. It is a time-consuming process, because it involves the recruitment and training of people—bankers, traders, accountants, lawyers, and regulators.

Second, financial-sector reform necessarily involves a certain amount of cross-country standardization. Governments, firms, and financial institutions that want to do business in international capital markets must adopt the rules and conventions commonly used by those markets. This does not mean, however, that developing countries must import all of the laws, regulations, and systems of corporate governance used in leading industrial countries. There are, after all, significant differences in the regimes of the industrial countries themselves, and while the differences may be diminishing, they are not going to vanish. Most of the key codes and standards send a simple message. Whatever you do, however you do it, aim for transparency, predictability, accountability, and equality of treatment. These must govern the functioning of the financial sector itself, the regulation of that sector, and relations between the financial sector and the nonfinancial sector.

Finally, we need two sorts of incentives for reform—incentives to pursue reforms at home, and incentives to seek international assistance as soon as a country runs into trouble, rather than waiting until it confronts a full-fledged crisis. To provide both sorts of incentives, I propose a new regime to govern financial-sector reform based on bilateral bargains between the IMF and individual governments.

Consider a formal five-year contract between the IMF and a member government. It would be based on the findings provided by the Financial Sector Assessment Program (FSAP), jointly administered by the World Bank and the IMF, which would be used to identify the reforms most urgently needed in a particular country. Any such assessment should, of course, draw attention to strengths as well as weaknesses. If it is to serve as the basis for designing far-reaching reforms, however, it must be candidly critical. I would therefore question the wisdom of publishing the full text of the assessment. The aim is not to impose market discipline by scaring potential investors but rather to offer advice to the government. But the government would be well advised to publish the principal recommendations in order to explain the rationale for undertaking reforms. The reforms themselves would be designed by the government, with the advice of the IMF and the World Bank and, perhaps, assistance from outside experts. The contract between the government and the IMF would then attach a target date to each reform for adopting the necessary legislation, introducing the relevant regulations, and for establishing new institutions. That way, the IMF would be able to measure compliance, year by year, over the whole five-year contract.

The World Bank would provide technical assistance and, where appropriate, financial assistance, and it should therefore be involved in designing the program and in the subsequent monitoring of implementation. It is nevertheless vital that the program be homegrown—designed primarily by the government involved, which is uniquely familiar with the existing context and the domestic political environment. Proposed reforms should be discussed with the private sector, and they should be widely disseminated and discussed at home before being embodied formally in a contract with the IMF. This process will take time, which is why financial-sector reform should not be pursued in the context of conditionality.

One such five-year contract may suffice to achieve a large measure of compliance with key codes and standards. In some cases, however, two or three consecutive contracts may well be needed, and when this is clear from the outset, it should be stated formally in the initial contract.

A long-term contract of this sort might go even further. It might commit a country to adopt interim measures of the sort suggested in the recent report of the Working Group on Capital Flows established by the Financial Stability Forum. This is what it said:

> Especially when the supervisory regime is not adequate, or supervisory resources are scarce, national authorities might consider a set of more explicit regulations dealing notably with liquidity and foreign exchange exposures.

The report then listed several examples, including these: imposing limits on banks' open foreign-currency positions, reducing reserve or liquidity requirements on long-term foreign-currency debt relative to those on short-term debt, imposing reserve requirements on foreign-currency funding, and requiring banks to hedge their foreign-currency exposures and ensure that their borrowers do so too. The Working Group went on to note that:

> . . . such explicit regulations can be only a partial and transitory substitute for adequate banking supervision. Regulatory requirements generally are less effective when banks are utilizing sophisticated risk management systems for foreign currency exposure. . . . However, such measures may be effective when banks are using less sophisticated risk management systems. They have the advantage that they can be implemented quickly by bank supervisors with resource limitations.

Other official bodies have made similar statements, including the Finance Ministers of the G-7 countries. This is what they said in their report to the Cologne Summit:

> The use of controls on capital inflows may be justified for a transitional period as countries strengthen the institutional and regulatory environment in their domestic financial systems. Where financial sectors and supervisory regimes are weak, safeguards may be appropriate to limit foreign currency exposure of the banking system.

Whenever this matter is raised, however, words like “might” and “may” are used. Let’s use stronger words. Whenever a government enters into a long-term contract with the IMF and has not yet put in place adequate prudential defenses against the accumulation of short-term foreign-currency debt, the IMF should *insist* that the government give high priority to the development of those defenses and, in the interim, introduce one or more of the techniques listed by the Working Group. By the end of the five-year period, it should be able to phase them out. I would also give consideration to using interim measures to discourage the corporate sector from taking on large amounts of short-term foreign-currency debt.

Countries having fixed exchange rates may be especially vulnerable to the accumulation of short-term foreign-currency debt, even those that have adopted institutional arrangements to raise the credibility of their fixed-rate regimes. They may, therefore, be most in need of taking interim measures to limit the foreign-currency exposure of their banks and corporations. The stronger the commitment to a fixed exchange rate, the smaller the apparent risk of foreign-currency borrowing. It may, of course, be possible to defend a fixed exchange rate when it is attacked and thus to avoid the fate of several Asian countries, where the collapse of pegged-rate regimes led to huge depreciations and drove foreign-currency debtors into insolvency. But banks with large foreign-currency debts, including foreign-currency deposit obligations to domestic firms and households, are very vulnerable in turbulent times. Bank runs can and do occur, and they can cause grave damage even when they do not wreck a fixed-rate regime. When exchange rates are flexible, by contrast, the day-to-day variability of the rate itself may be a sufficiently strong deterrent to foreign-currency borrowing or, at least, a strong inducement to hedge foreign-currency debt, and they may obviate the need for using interim measures of the sort suggested by the Working Group.

What would a government gain from entering into a long-term contract of the sort I have described, apart from the manifest benefits of the reforms themselves and the effects of those reforms on a country's access to international markets? There would be one very obvious benefit, and some others might be offered. Suppose that a country found itself in need of IMF assistance in, say, the third year of its five-year contract. It would still have to meet conditions of the sort that the IMF has always imposed—modifications in its macroeconomic policies—but could not be asked to undertake any additional financial reforms. If, however, the country had failed to meet the terms of its five-year contract, it could be required to take remedial measures. By slimming the scope of conditionality, a long-term contract with the IMF would reduce the time it takes to reach agreement with the IMF and thus grant faster access to IMF financing. But I would go one step further. A country with a five-year contract or one that does not need to make major financial-sector reforms should have preferential access to assistance from the IMF—a less parsimonious tranching of IMF credit and, perhaps, *more* IMF credit than it would otherwise obtain. That could be done by allowing the country to draw on the SRF or establishing a new facility for the exclusive use of countries making and keeping long-term contracts with the IMF.

Let me sum up by pulling together some of the points I have made. The device I propose would serve four purposes:

- It would promote financial-sector reform by providing explicit incentives rather than counting on markets to quarantine countries with weak financial systems.

- It would accelerate access to IMF credit by unbundling conditionality and would thus reduce the time it takes to design and approve IMF programs.
- It would encourage but regulate the use of interim measures to fill gaps in banking supervision until better arrangements are put in place.
- It would translate codes and standards into operational reform programs suited to the specific needs and institutional arrangements of individual countries.

I attach the most importance to this last objective, because it is the key for turning principle into practice.

Banking Consolidation in Europe

Jacques de Larosière

I have now the task of saying a few words on banking consolidation in Europe. This subject is not directly linked to what has been said by the two previous speakers, but it is linked in some respects. We often think that larger banks through mergers are a protection of the financial environment. This may be true, but it may not be. And before we can make a judgment on this, I think it is interesting to understand what's going on, and I shall try to deal with the problem of banking consolidation in Europe.

According to the European Banking Federation, at the end of 1998 there were 2,955 commercial banks in Western Europe (namely, members of the European Union (EU), plus Iceland, Norway, and Switzerland). These 2,955 banks had total assets of 9,144 billion euros, ran 99,456 branches, and employed 1.84 million workers.

To this already large number of commercial banks should be added that of other deposit-taking institutions like savings banks, mutual banks, and cooperative banks. All in all, the euro zone (i.e., the eleven members of the European Monetary Union) had more than 7,000 deposit-taking institutions at the end of 1998.

It should, therefore, be no surprise that hardly a day passes without some mergers or other strategic moves being announced by European banking institutions. Last year was a bumper year with four large deals of a unit value in excess of US$10 billion, each of them creating entities with a market capitalization of US$30–55 billion:

- In January 1999, the merger between Banco Santander and Banco Central Hispanoamericano created BSCH;
- After a six-month long battle against Société Générale which started in February, BNP is merging with Paribas, leading to

the first bank in France and the second in the euro zone in terms of market capitalization;

- In October, Banco Bilbao Vizcaya (BBV) and Argentaria announced their intention to form BBVA;
- At the same time, Bank of Scotland launched an unsolicited bid on Natwest, the outcome of which was finally overcome by the competitive offer of the Royal Bank of Scotland;
- In the meantime, Banca Intesa took over 70 percent of Comit;
- Hardly had BBVA been formed, than a possible merger with Unicredito in 2002 is being envisaged.

There is no sign that the consolidation process is abating. Just take a copy of the *Financial Times* dated January 19, 2000. You could read:

- that ABN Amro is about to close one in six of its branches in the Netherlands to redeploy resources to electronic banking. On the same page, you could also read that Citigroup is buying Schroders' investment bank activities;
- that the merger between two Portuguese banks—Banco Espirito Santo and Banco Portugues—was announced (a week earlier Banco Commercial Portugues and Banco Mello had decided to merge).

Then, in early March 2000, came the announcement of the planned merger between Deutsche Bank and Dresdner. But on April 5, the 33 billion euro merger collapsed.

And on April 3, we learned that HSBC—the second bank in the world by market capitalization—was to acquire Credit Commercial de France in an agreed bid.

After two hectic years, the year 2000 has thus already started on a very strong footing, which raises three questions:

- Why are we seeing so many restructuring operations in the European banking sector?
- Which are the different forms taken by these transactions, and is there a predominant one?
- Why haven't we seen more cross-border operations?

I will briefly address these three questions before trying to gauge what all that holds for the future. I am afraid that in the course of what follows I will have to jump time and again from one definition of Europe—the euro zone (i.e., members of the European Monetary Union (EMU))—to another, which may or may not include other EU members, like Britain, or even non-EU members, like Switzerland. This will be for the sake of clarity and accuracy.

WHY ARE THERE SO MANY RESTRUCTURING OPERATIONS?

The Rationale for Mergers and Acquisitions (M&As): Too Many Large National Banks, No Big European Bank

The European banking sector remains very fragmented: deposit institutions, both large and small, are still numerous. Admittedly, the total number of deposit-taking institutions is still three times larger in the United States (22,140) than in the euro zone (7,040), although the two zones are comparable in terms of GDP and population. But, on the one hand, the legal framework in the U.S. (the McFadden Act) pushed in that direction for a long time by preventing multistate banking and, on the other hand, the speed of the consolidation has been faster there than in the euro zone: since 1980, the total number of deposit-taking institutions has fallen by 39 percent in the United States, versus 25 percent here in euroland. According to FITCH IBCA, there were 13 "major"[3] commercial banks in the United States, i.e., a third of the 44 "major" commercial banks operating in the euro zone at the end of 1998. In short, it might be said that the United States has many small banks—and particularly very small—but relatively few large banks, while euroland is rich on both counts. Another way to express the differences between the two sides of the Atlantic is to note that the average headcount in U.S. deposit-taking institutions was 87 at year-end 1997 versus 290 in the euro zone.

The European banking industry is increasingly exposed to global trends. One of them is the *increased competition from American banks* that compare favorably in terms of revenues and costs.

[3]The concept of a "major" bank is a judgmental concept based on a qualitative assessment, by FITCH IBCA, of a number of quantitative criteria the absolute value of which differs from one country to the other.

The following table gives average indications over the years 1996 to 1998 concerning the "major" banks in the United States, the euro zone, France, Spain, and the United Kingdom.

	United States	Euro Area	France	Spain	United Kingdom
(1) Net interest margin	3.22	1.68	0.93	2.66	2.19
(2) Non-interest income	2.65	1.19	0.89	1.36	1.75
(3) = (1) + (2) Total income	5.87	2.86	1.82	4.02	3.95
(4) Operating costs	3.80	1.98	1.26	2.67	2.59
(5) Loan-loss provisions	0.39	0.31	0.24	0.39	0.22
(6) = (3) – (4) – (5) Pre-tax profits	1.67	0.57	0.32	0.97	1.13
(7) = (4) / (3) Cost/income ratio (in percent)	64.8	69.2	69.1	66.4	65.6

- Over the years 1996 to 1998,[4] the average return (as measured by pre-tax profits) on total assets at "major" banks in the euro zone (0.57 percent) has been on average a third of that achieved by U.S. "major" banks (1.67 percent). This poor showing stems basically from lower revenues.
- The net interest margin at "major" banks in the euro zone (1.68 percent) has been on average half of that earned by U.S. "major" banks (3.22 percent). More interestingly, interest margins on both sides of the Atlantic have kept on diverging since the mid-1980s: rising in the U.S., falling in Europe.
- Furthermore, non-interest income at "major" banks in the euro zone (1.19 percent), while rising rapidly in 1998, has been less than half of the U.S. level (2.65 percent).
- All in all, total banking income (net of interests paid to customers) is on average 2.86 percent at "major" banks in the euro zone, a half of what they are at U.S. "major" banks (5.87 percent). But operating costs are significantly higher in the U.S. than in Europe. One can also remark that there are significant differences within Europe: for example, banking income in Spain is more than twice as big as in France.

[4]Source: BIS quarterly report, June 30, 1999.

- The existence of a large sector of noncommercial banks (such as savings banks, mutual, and cooperative banks), plays more than a minor role in accounting for the difficulties encountered by European commercial banks. It is often argued that the non-commercial banks distort competition by not having to pay for the cost of their capital. Furthermore, commercial banks are often forbidden to takeover non-commercial banks, while the opposite is allowed.
- Turning now to the cost to income side of the equation, it appears that the cost to income ratio at "major" banks in the euro zone (69.2 percent) has been on average 4.4 percentage points above the U.S. level (64.8 percent), even though a noticeable convergence has taken place towards the end of the period.
- The price of tougher competition and less efficiency is a less exuberant increase in market capitalization: while the capitalization of U.S. banks has increased fourteenfold from its low of 1990 to 1999, that of euro banks has "only" increased fivefold, despite an historic wave of privatizations (both measures are given in dollar terms). Obviously, the glass can been seen as half empty: if the recovered profitability of U.S. banks is the benchmark, then there must be a lot of room for improvement in Europe.

Another reason for concentration is to be found in *deregulation, disintermediation, and technological innovations* that tend to erode traditional distinctions between financial intermediaries. These very powerful trends open the door to non-bank players like insurance companies, e-brokers, and large retailers (such as Tesco, Sainsbury). E-commerce tends to turn financial products into commodities, i.e., low margin, high-volume products. The same forces also push traditional banks to broaden the scope of products and services they offer to their clients (electronic banking, complementary services to bank account management).

The introduction of the *single currency* only exacerbates further these forces. As a consequence of the euro, the domestic market becomes pan-European. Actually, it had already largely done so for wholesale banking. The same can be expected in retail banking, even though there remain many national specificities (regulatory, tax, legal) that still fragment the market.

For various reasons, economic development argues in favor of an ever larger critical size (in terms of assets or market capitalization):

- Clients of banks (in wholesale banking) have changed in size, because they (corporate, insurance, other banks) have been merging for some time. The wave of mergers in the non-banking sector calls for, or can influence, mergers between banks.
- As long as the costs of managing larger and more complex organizations do not exceed the transaction costs[5] that would otherwise be incurred, size makes it possible to achieve economies of scale, through revenue synergies (cross-selling of products) and/or cost cutting. Conventional wisdom has it that such cost-cutting efforts are required given the increasing costs of state-of-the-art technologies, information technology (IT). It would pay to spread such costs over a larger base in capital-intensive areas like information collection and processing, back-office operations, telecommunications, and custody. Yet, this point may be rather controversial as an essential feature of the IT revolution is the rapid fall in the costs of hardware and software. Some analysts contend that the IT revolution is actually lowering the cost of entry into the banking market.

In a context where margins tend to fall due to excess capacity—as in most European countries—volumes have to be increased.

These general statements need to be qualified. In some areas, a high degree of convergence and integration had been attained even before the introduction of the single currency: the market is already very much pan-European. Most of the cost synergies are, indeed, concentrated in some activities like investment banking, asset management, custody, wholesale payment, or credit cards. But it is not evident that commercial banks with no experience in investment banking and asset management can achieve substantial economies of scale when they extend the range of their activities to new lines of businesses.

Specific partnerships are often seen as an alternative to M&As: they presumably deliver the same technical benefits, while mini-

[5]"Transaction costs" refer to the real costs that have to be incurred to operate through the markets. Ronald Coase explained the existence of firms by reference to transaction costs: firms exist because they help to save transaction costs through a centralized decision-making process.

mizing the traumatic side of mergers. Yet, it can also be argued that the more a bank is tied up in a web of partnerships in a rapidly changing environment, the more it risks running into conflicts of interest and the more it loses degrees of freedom. The jury is still out and will probably remain so for some time.

Be what it may, *most banks seem to favor a twofold M&A strategy*:

- Firstly, they are keen to defend their position in their domestic stronghold against potential foreign competitors, leading them into mergers with national competitors.
- Secondly, in a more offensive way, they seek to establish bridgeheads in the pan-European market by acquiring interests in foreign institutions. Such interests consist of at least large minority positions, but in some cases majority or even full ownership. The aim of such moves is to deter similar ones by competitors and to increase market share.

Needless to say, the general fall in interest rates and the resultant overall rise in share prices have facilitated M&As in making the shares of bidders an attractive currency to the shareholders of the targets. As a matter of fact, most of the deals we have seen are all-share deals.

TYPES OF RESTRUCTURING IN THE EUROPEAN BANKING INDUSTRY

Domestic Mergers Have Been Predominant

By and large, restructuring has taken place at a national level between European retail banks through "friendly" deals. This is actually the only thing on which the different data sources I have consulted can agree: on average, they attribute at least two-thirds of the aggregate value of M&As to national deals. But this aggregate value is a matter of discussion: for 1998, it varies from 110 billion euro, according to Crédit Agricole to US$182 billion, according to *The Wall Street Journal Europe* quoting Thomson Financial Securities. Be what it may, these are large figures. Over the last two to three years, M&As in the banking sector account for a very substantial slice of all M&As in Europe (almost 30 percent on average).

The aim of these national mergers has been presumably to strengthen domestic operators, to breed "national champions" to the point where they can successfully cope with European competition and cross-border mergers.

The following table shows deals with a unit value in excess of US$1 billion,[6] as compiled by Thomson Financial Securities.

Thomson Financial Securities Data	Total		European Targets			Non-European Targets	
	Number of deals	Value in US$ billion	Number of deals	Value in US$ billion	Percent of total value	Number of deals	Value in US$ billion
1990	11	18.8	11	18.8	100.0	0	0.0
1991	9	23.3	7	19.2	82.4	2	4.1
1992	2	9.0	1	5.7	63.3	1	3.3
1993	3	5.2	3	5.2	100.0	0	0.0
1994	3	5.7	3	5.7	100.0	0	0.0
1995	14	40.7	14	40.7	100.0	0	0.0
1996	14	29.6	11	21.7	73.4	3	7.9
1997	25	77.9	20	66.5	85.4	5	11.4
1998	38	181.8	35	176.6	97.1	3	5.2
1999	21	143.0	21	143.0	100.0	0	0.0

Figures compiled by Crédit Agricole give an additional insight. Of all the deals announced or completed in 1998, only a third were domestic, but their aggregate value was 63 percent of the total. In short, what we are seeing is a combination of a few very large domestic operations on the one hand, together with numerous small cross-borders operations, as if banks were testing the ground before embarking on larger cross-border deals.

Indeed, we have seen many cross-border acquisitions of minority interests in large institutions, or a majority interest in minor institutions. The minority interests acquired in major institutions are sometimes very small, sometimes more substantial. The web of cross-holdings resulting from this process is becoming increasingly intricate. To name but a few of these links:

- ING has taken a substantial stake in BHF;
- San Paolo is controlling small banks in France: Banque Vernes, Banque Française Commerciale, Banque Morin-Pons;

[6] Source: Thomson Financial Securities/*The Wall Street Journal.*

- ABN Amro has built up controlling stakes in Banque OBC, Banque Demachy-Worms, Banque NSM, Banca di Roma;
- Deutsche Bank has a small stake in Caritro (Cassa di Risparmio di Trento e Rovereto);
- Crédit Agricole has a substantial interest in Banca Intesa;
- BSCH has a web of relations with San Paolo IMI, Commerzbank, Banque Commerciale Portuguaise, Royal Bank of Scotland, Société Générale; and
- BNP-Paribas has a stake in the Cassa di Risparmio di Firenze.

These forays in foreign territories have encountered mixed results leading sometimes to retreat. Such was the case when:

- Comit sold its French network to Crédit du Nord;
- Dresdner Bank sold Banque Morin-Pons to Banco San Paolo;
- Citibank sold its French network to Banques Populaires and Banque Baecque-Beau;
- Midland sold its French network to the Woolwich;
- While Natwest and Barclays basically stopped their operations in France—which certainly shed light on how lucrative the banking market is in France.

Leaving aside a small number of successful cases, like Dexia, Fortis, and Meritanordbanken, full-scale cross-border mergers do not seem to have yet been great successes. In fact, they look more like small- or medium-sized acquisitions than real mergers. Of course, the recently announced acquisition of the medium-sized and profitable Credit Commercial de France by HSBC brings a new dimension to the issue.

Finally, we have also seen the establishment of new links between the insurance sector and banks. Given the complexity of the "bancassurance" issue, I will just mention it in passing. Insurance companies tend to have higher PEs than banks and they are eager to control distribution channels for their products. Rather than building up a new distribution network from scratch, it makes sense for them to gain access to retail banking networks.

If we try to combine a business-line dimension with the geographic one, we can identify four types of moves:

(a) Large players have acquired local and profitable niches.

- General Electric bought Crédit de l'Est and SOVAC; and
- AXA acquired Banque Anversoise d'Epargne (ANHYP).

(b) Networks that are domestic but diversified in terms of clients and/or products have been the targets of buyers seeking to build on geographic complementarity, to increase market share, to broaden their supply of products, and to achieve economies of scale by merging branch network or information systems.

- Lloyds took over TSB; and
- Credito Italiano and Carimonte formed Unicredito.

(c) International development has been the name of the game for very specialized banks or credit institutions like General Electric Services, Cetelem, and Dexia.

(d) Geographic extension has also played a role in terms of diversification and growth for large universal banks with international ambitions.

- HSBC and ABN Amro have sought to build on a strong local presence in foreign markets;
- By acquiring Bankers Trust, Deutsche Bank is showing its ambition to be a global investment bank;
- BBV and Banco Santander have focused on becoming dominant players in Latin America;
- But a few others like Barclays, Natwest, and Lloyds have streamlined their portfolio of activities and focused on their lucrative domestic market.

WHY HAVEN'T WE SEEN MORE CROSS-BORDER DEALS?

Obstacles to Cross-Border Deals

Throughout Europe, the banking industry continues to be seen as a strategic sector that remains under close surveillance by the national authorities. Regulation, supervision, and lender of last resort operations remain, indeed, national responsibilities. Furthermore, since capital markets continue to be less developed in

Europe than in the United States, the banking sector plays a much greater role (in a ratio of at least 2 or 3 to 1) in the allocation of savings and credit.

On top of that, at a national level, and leaving Germany and Italy aside, the banking market is actually three to four times more concentrated in Europe than in the United States. The top five deposit-taking institutions in each European country easily account for 40 to 55 percent of total banking assets, against 17 percent in the United States. The top 10 institutions share 60 percent to 80 percent of the market, versus 26 percent in the United States.

In banks like in other industries, top managements, staff, and trade unions show some reluctance over full-scale cross-border M&As, although, as we have seen recently, things are changing.

The problem is exacerbated by the absence of a European corporate law, which leaves no choice but to opt for one of the national laws. Along the same vein, the EU lacks a directive on takeover rules inspired, for instance, by the British model and addressing such issues as minority shareholders, trading in bidder's and target's shares, and corporate control. The lack of common rules definitely adds to the many uncertainties that surround M&As.

Large cash transactions are hardly feasible under current conditions. European banks currently trade at an average of 2.5 book value (3–4 in the United States). Even in the least profitable markets, banks trade above book value. If a bank trading at 2.5 book value were to be paid in cash, the acquiring institution would have to amortize the goodwill, the excess of the price over the book value, namely 60 percent, against its shareholder's equity. Few banks are financially strong enough to afford large cash transactions.

In cross-border deals, cost cutting is more difficult to implement for central functions such as information systems and tax systems, which tend to remain national. In particular, Europe remains divided by its payment habits: some countries prefer checks while others favor giros. If the European consumer undoubtedly exists, European banking services remain largely to be invented. The main benefits of M&As are rather to be reaped in the form of asset size, increases in market share, and diversification of revenues.

The web of cross-holdings that exist between European institutions may also be an obstacle to hostile bids. Until the proposals to change the capital gains tax in Germany, there was another obstacle to the unbundling of that web of cross-holdings.

Last but not least, the rapid development of Internet and electronic banking may make cross-border deals less profitable to the extent they involve traditional "bricks and mortar" retail banking networks. It remains to be seen:

- whether traditional banks will add Internet distribution to their panoply (i.e., brand, capital, and customer base), potentially bypassing part of their traditional sales force,
- whether Internet-only providers will seize a very substantial share of the retail banking market (at the cost of adding physical channels and personal touch to their strategy),
- or whether some segmentation will take place.[7]

The answer will depend on cost and creativity (i.e., use of "open finance," "mutual fund supermarkets," "integrated personal financial management," "total balance sheet approach," "dynamic refinancing," "mass customization," and e-commerce portals).

The above-mentioned obstacles or issues are present in all European countries. Further difficulties exist or existed in some countries. In France, for example, the privatization process was not completed until recently; its importance superseded any other considerations for private sector operators. The profitability of private commercial banks is dented by the mutual sector, which is very large in France. And the implementations of synergies in the face of large restructuring is slowed down by the rigidity of labor markets and the sensitivity to layoffs.

CONCLUSIONS

At the end of 1999, Western Europe had almost 50 banks with a market capitalization in excess of 5 billion euros, not to mention a few additional large non-listed institutions. Half of those listed banks had a market capitalization in excess of 15 billion euros. Most of them, if not all of those institutions, would probably claim that Europe is or will be their domestic market. But it

[7] *Net.B@nk*, a virtual bank opened in 1996 in the United States, claims its operating expenses to be half those of comparable traditional banks.

is also notable that no bank in the euro zone has a size, a breadth of services, and a worldwide reach that make it truly comparable to the greatest, and very few, "global" financial institutions of the United States.

Therefore, the challenge for the European banks will be:

- to improve on their efficiency by rationalizing costs and trimming redundant networks;
- to expand growth internally and through partnerships and acquisitions; and
- to strengthen their operations in high value-added areas such as structured finance, corporate finance, cash and asset management, and securitization.

The ambition is for the largest and best run of these banks to offer to their clients global services to cover the whole spectrum of banking requirements.

These goals cannot be achieved by applying automatic rules or doctrines. One reason is that changes are running too fast. As a prominent CEO in London said a few weeks ago: "It is hard to be clear about strategy at a time of rapid change." Fashions are also dangerous: they move from one idea to another without much research or evidence: for instance, a few months ago analysts were stressing the virtues of retail banking, but now they seem to have changed their minds.

The key to success is adaptability. In this respect, the question of M&A versus partnerships is still an open one and depends very much on circumstances.

There are obviously many positive feedback effects between M&As and share prices. Yet the risks of over-extension should not be underestimated, all the more so when cross-border deals are involved.[8] Successful M&As eventually depend very much on the ability of management to conceive well thought-through strategies, to develop synergies, but also to combine cultures and to motivate teams.

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[8]According to a recent report by KPMG (*The Economist*, December 4, 1999), of more than 100 large cross-border deals (banks and nonbanks) around the world between 1996 and 1998, only 17 percent added value, the creation of value being measured by comparing movements in share prices with those of competitors in the first year after the merger.

Merging banks is in fact a very difficult art, with more failures than successes. It requires extreme care, a clear methodology, and a strong leadership from the highest levels of management.

Concerning adaptability, great attention has to be paid to the development of the Internet in financial activities and its impact on banks' strategies.

On-line banking and on-line brokerages are profoundly changing the present institutional setting. The Internet is not only a user-friendly way to offer services to clients, it is also a powerful tool to increase efficiency and to reach new clients with less investment costs than those involved in expanding traditional branches.

The question is not: Will commercial banks *add* Internet facilities to their existing panoply? but: How to become, in all aspects, full financial Internet players? To stay on top, European banks must themselves become Internet banks.

I believe European banks will develop a multi-pronged strategy:

- cross-border acquisitions where synergies can be realized by rationalizing networks and information systems in particular, but also where profitable markets can be reached (for instance, retail networks in those emerging countries where banking systems are still largely inefficient);
- partnerships where it is more efficient to use existing networks in order to market specific services in which one of the partners holds a competitive edge (cf. partnerships by special service companies like Cetelem or Locabail);
- Internet activities, in this respect the recently announced alliance between BBVA and Telefonica and their launching of an on-line banking venture is of significance. I should also stress that e-Cortal and BNP.net are leaders in their respective markets; and
- internal and external growth to eventually become truly global in terms of investment banking. (Here the recruitment of very competent bankers is of the essence.)

So, we have new and exciting challenges ahead of us on the way to European banking consolidation. Saving resources, keeping freedom of maneuver, and reaching out towards profitable markets will, as always, remain the key principles of action.

Questions and Answers

MR. DE LAROSIÈRE: Let us now move to the question and answer session. I already have some written questions. One is for Peter B. Kenen: *Is there a risk that countries will be reluctant to enter a contract with the IMF for reasons similar to those that have led them to shun the CCL?*

MR. KENEN: I don't think so because the problem with the CCL has been uncertainty about the terms on which a country can actually access the facility. There is the possibility that additional conditions may be imposed in the final review before a country can actually draw on the CCL, even though the drawing has been approved in principle. I can't see an analogous problem here. I'm proposing a firm contract with a definite termination date and a seal of approval following that. This would be superior to the CCL arrangement, and I would not then want to impose additional conditions on a country seeking access to a contingent facility.

MR. DE LAROSIÈRE: Another question for Mr. Kenen: *If conditionality is weak in ensuring compliance, why should medium-to long-term contracts with the IMF promote observance, and what is the difference in incentives in the two approaches?*

MR. KENEN: I don't think that the difference resides so much in the incentives. I was objecting to what I called the overloading of conditionality with a wide range of conditions. That process has been going on in the IMF for many years, but it took a quantum leap when the IMF began to take responsibility for the transition from plan to market in Eastern Europe and then took another jump, driving the Asian crisis, with the addition of financial sector reform and a great many other matters that were really extraneous to the Asian crisis.

This process imposes huge burdens on the official sector, which must carry out all of these reforms. Furthermore, the larger the number of conditions, the larger and more effective the political coalition opposing them. It seems to me that conditionality should be narrowed again to what it was, many years ago, when it involved the set of macro measures required to restore confidence and to correct the current account balance when there has been a falloff in capital flows. Most of the other matters now being covered are really not crisis management.

Furthermore, I should like to see conditionality shortened in duration rather than lengthened. There's something wrong when countries remain under IMF tutelage year after year. That's why I want to separate the long-term tasks of financial reform, making it subject to contracts with the IMF—the fulfillment of which will lead to other rewards—rather than bundling it up in conditionality.

Finally, we must find some way of rewarding countries for progress, and fulfillment of these contracts would do that, whereas absolute assessments of financial sector quality are going to be invidious and unhelpful.

MR. DE LAROSIÈRE: I'm now going to ask Arminio Fraga to answer a couple of questions. And he might also care to say a word on Mr. Kenen's proposals from his own standpoint.

MR. FRAGA: *One question was whether there could be any disincentive to sign up for a contract.*

I like Mr. Kenen's idea of a contract very much. It separates the structural from the macro crisis, and it gives each its proper time horizon. I could think of political reasons as a disincentive. Some of the issues are delicate and are best dealt with by the clear initiative of the government. But I think Mr. Kenen solves that in his paper by making it a private contract between the country and the multilaterals.

The other concern that I have has to do with fear of discontinuities, which is not as relevant in this case as it is in some others, but countries that sign up may be signaling something negative.

The second question that I have been asked is whether countries that do well, that cover all the fundamentals, in the end could not become victims of their own success in the following sense: If they do really well, they will develop deep liquid markets, which in turn may be used for hedging purposes by those who want to protect against their exposures in other countries. And in that case, they may become more vulnerable.

I often hear the reverse question, whether a small country will not be the victim of speculation from large financial players. I can speak from my own experience as an investor and as a central banker. In the small country case, investors or speculators are always worried that they may paint themselves into a corner, and they typically don't go in unless they think they can get out. Whereas if you're a large market, you are likely to see a lot of noise and, therefore, you may be subject to herd behavior, bandwagon behavior, and so on. While this is true, I still think that, on balance, doing well (and developing deep liquid markets) is better than the alternative.

The third question is on bank supervision. *The point is made that bank supervision is often politically very difficult to maintain, particularly in small economies, due to connected lending, the political clout of bankers, and so on. Therefore, wouldn't it make sense to go for a supranational or regional supervisory structure?*

This is an interesting idea. In fact, it reflects some of what's behind the experience of Mercosur in getting countries together and working on deeper integration. Many of the benefits come from the discipline that such an arrangement enforces. Indeed, we should welcome anything that can be done to introduce further discipline and transparency into economic policymaking. As I mentioned in my remarks earlier, I sense that supervisory agencies across the world will get closer and closer to one another. I find, for instance, it is very important that there be good access to information across boundaries. These are all issues that point toward closer coordination of bank supervision, and I think that regional supervisory institutions are something that we may see in the future.

MR. DE LAROSIÈRE: Mr. Kenen, you have some more written questions.

MR. KENEN: Yes, this may come to be known as the Lucerne Inquisition. I'll take the following questions:

The first is: *What do I think about the role of the market in encouraging countries to comply with internationally endorsed codes and standards?*

My view is that a report, if it's going to be really useful in helping a country to design a reform effort, must be candidly critical.

And I'm not sure that such a report should be published in full. Now I enjoy the innocent privilege of never having seen a Financial Sector Assessment Program report. I don't know how detailed it is. But candid criticism is essential for subsequent reform. And while a government should be prepared to publish the major findings as a prologue to announcing its own reform program, I doubt that the full report should be published.

The difficulty with publication is that markets are not interested in progress. They are concerned with performance. Hence, we cannot count on markets to reward progress. They're going to say yes or no, rendering an absolute judgment on performance. There is thus the risk that publication will put countries in quarantine, denying them market access. A country deserves that if an adverse report is prepared and the country refuses to do anything about it. But one that solicits criticisms in order to design reforms should not be penalized for doing so. In short, market discipline may be enhanced by publishing a candid report, but at a very risky price to the country concerned.

The next question is: *What is the incentive for a country to enter into a five-year contract with the IMF if this is not part of conditionality—in other words, if there's no money attached—in addition to the obvious advantage of doing the right thing?*

There are two incentives. The first, obviously, is that a country that enters into such a contract and improves its financial sector will have less need to go to the IMF and submit to conditionality. Financial reform is a crisis prevention measure, not a remedial measure. And when a country is less exposed to a crisis, it is at less risk of having to make abrupt changes in policy at the behest of the IMF. Let me add, by the way, that we have tended to put the cart before the horse. We have come to regard IMF assistance as a device for imposing conditionality. That's not what was intended. Conditionality attaches to IMF assistance and should not be more severe than required to justify that assistance.

The second incentive derives from the fact that the stronger the financial system, the more likely that a country will face only a short-term liquidity crisis, not a deep-sealed solvency crisis, and the easier it is then to justify large-scale assistance from the IMF, as opposed to what I called parsimonious assistance and severe conditionality.

MR. DE LAROSIÈRE: I turn again to Arminio Fraga.

MR. FRAGA: Thank you. I have another three questions here.

The first one is: *In a world of floating exchange rates, is overshooting or misalignment a concern? If so, what can and should be done about it?*

This is an issue that has to be dealt with in a somewhat pragmatic way. I favor a system of clean floating. I wouldn't go as far as saying that a central bank should commit itself never to intervene, but I think intervention needs to be something that takes place very rarely. We should also learn that these things—overshooting or misalignment—do happen and companies should structure their balance sheets accordingly. Good prudential regulation and supervision can certainly help here.

Another question is about the political will to follow the basic ideas of macro discipline, sound banking, corporate governance, and high liquidity. How do you do that when you're in the middle of a boom, when things are going well and you're flooded with money?

Indeed, that is another variation on the same theme. Now we're looking at the positive rather than the negative side. My reading of this one is that the odds of a boom like this happening are greatly reduced if you follow a clean and consistent macro regime, because then you have natural mechanisms to respond to that. Interest rates go down, the exchange rate appreciates, helping to cushion the inflows. Also with sound banking and good corporate governance—i.e., if you have transparency and you have proper risk assessment—the odds are you won't be taking the good times too seriously.

My next question is on the CCL and private sector involvement which, in my way of thinking, are part of the same conceptual structure.

I have a problem with discontinuous situations because they tend to create more trouble than not. If you believe in this continuous view of the world and you have a lender of last resort operating with proper surveillance, research, and independence, then you would see at any given point in time countries spread through a continuous line. Some would be doing quite well in terms of their macro and structural policies and would be worthy of a quick flash loan from a lender of last resort. Some other countries would not; they would be further out along a line of evaluation. Then private sector involvement may be needed.

Now that gets tricky for moral hazard reasons. The lender of last resort may be tempted to lend indiscriminately. Just as all the central bankers present here know that we can't say yes in every case—that every now and then we need to say no—I also believe that in the international context the lender of last resort will have to say no more frequently. That is the case where you're going to have private sector involvement first. And this is one more reason to try to depoliticize the process. But I do believe that a lender of last resort, operating under constrained discretion—very much along the lines we see central banks operating—is about as good as we can get here.

MR. CROCKETT: I'm a guest in this panel and not a full-fledged member, so I'll answer the BIS-specific questions briefly.

The first question is: T*he Basel Accord will have serious implications for the financing of small- and medium-sized enterprises. The cost of financing through banks will go up remarkably. Has the BIS realized this, and what measures can be thought of to safeguard sound financing of small- and medium-sized enterprises on a reasonable cost basis?*

I would quibble to some extent with the premise of the question. As I understand it, the purpose of the revised Basel Accord is to harmonize better the capital charges that are made on individual loans with the inherent riskiness of the loans. Therefore, if there is any adverse change toward particular borrowers from banks, that would only be because the previous regime had undesirably favored them.

The second question is: *The financial world is discussing the role and policy of the IMF. Isn't it necessary in a globalized financial world to reconsider the roles and policies of the IMF and the BIS together in better controlling and supervising financial markets worldwide?*

I think I would amend that question to say not just the IMF and the BIS, but all other authorities involved in questions of financial stability, and by that I mean national authorities, and supervisory agencies, as well as other international organizations, the Basel Committee, and the other standard setters.

In other words, in managing financial markets, the IMF needs to coordinate its activities with a wide range of relevant responsible authorities. I think this was, if I might say, the germ of the Tietmeyer report presented to the G-7 that led to the creation of the Financial Stability Forum. There are so many different actors involved in issues of financial stability, and financial systems depend on so many elements—sound supervision of the different parts, transparency in markets, strong infrastructure in the form of accounting conventions and payments and settlement systems—that we need a mechanism to bring together the various agencies, both at the national and international level, to make sure that their efforts are coordinated and consistent. That is how I, as chairman of the Financial Stability Forum, understand one of the main motivations of this group: to make sure that we're all pulling in the same direction.

MR. DE LAROSIÈRE: I have left three questions for myself. First, *is the development of electronic technology and its application in international banking and investment likely to erode the taxation base of industrial countries and consequently lead to a weakness of the international economy and financial system?*

My answer is a careful no, at this stage of our understanding. I don't really think that tax evasion is a function of technology. If I look at my own country, France, for instance, what I recall is that in the 1950s, when we had very high chronic inflation and exchange controls, we had a very significant amount of tax evasion, in particular toward this country, and I can tell you that electronic technology had nothing to do with that because the vehicle of tax evasion was actually banknotes carried out of the country in suitcases.

So I would tend to think that it's not because you have a laptop computer that you're going to have more tax evasion than you would have had some years ago. I don't think that's true. I believe that the extent of tax evasion is very much related to a comparison of tax regimes throughout the world. At a point of difference in tax burden, you have a tendency toward tax evasion, and that is the determining factor. I don't think technology is the determining factor.

So I would paraphrase a sentence of a French minister, the Baron Louis. In 1820 while addressing politicians, he said: *"Faites moi de la bonne politique je vous ferai de la bonne finance!"* If you follow good policies, I will give you good finance. And I would tend to say if you have good fiscal policies, eventually you will have a normal tax collection.

The second question is: *What are the implications, if any, for financial market supervision, of the trend to consolidate financial services and to base them on different technology?*

This is a very interesting and important question. In Europe, for the time being, consolidation is mainly a domestic affair, and if you have mergers of domestic banks, you don't exactly fall under the question that has been put. You have larger institutions to be supervised by national supervisory authorities. Where the question really comes is when you have large institutions of a global nature with large cross-border tendencies toward mergers.

For the time being, you can live with a system where the relevant supervisory authority is that of the headquarters office (if that means something) of that large global institution. However, the more we have cross-border banking institutions, the more we will need to have an intimate relationship between the supervisors of the head office country and the supervisors of the established activities throughout the world of that same institution. Thus, we will need, increasingly, to coordinate the actions of the different and relevant institutions.

We have that problem at hand in Europe. The Treaty of Maastricht has decided, I think rightly, to delegate the supervisory function to each of the 11 individual countries of the euro zone. And, of course, we ask ourselves the question: the more we have cross mergers among European and between European countries, doesn't it make sense to centralize these functions? Since the market is a single market—a one-currency market—doesn't it make technical sense to unify or centralize these functions at the European level?

I think the question is indeed on the table. I don't think it's really posed yet in operational terms because thus far little cross-border activity has taken place on a large dimension. But we may have to look into this and revisit this issue. I still feel that the world of national supervisory institutions will be of the essence, even if there is a more intimate cooperation at the European level, which will be inevitable.

And then I have a last question, which is rather thought-provoking: *With respect to the role of the IMF as a watchdog of the international financial system, who watches the watchdog?*

My answer is twofold: The first watchdog of the IMF is the shareholders of the organization. The IMF is not an institution in itself that has an orbit of itself. Instead, it is heavily controlled by the shareholders. And I think the role of the shareholders as a good watchdog—to see to it that the IMF is indeed doing the right things in the prevention area, as has been discussed today by Peter B. Kenen and Arminio Fraga, and also in coping with the crises—is of the essence.

But there is a second dimension to the question, which is often not really sufficiently understood, and that's the market dimension. The IMF operates in a market because that's the way we all operate today. Governments operate in markets and are severely sanctioned by the markets if they misbehave. And I think the IMF is under that universal rule, and, therefore, it is very important to develop understanding between the IMF and the market.

I will give you an example of this. In 1982, when there was the Latin American crisis, which started off with the Mexican crisis, we were all asking ourselves how to cope with it. We understood quickly that the private sector had to be brought into the picture immediately because the private sector had been the lender to the Mexican government. But we could only bring the private sector into the picture and talk it into new lending and rescheduling if there was an understanding between the marketplace and the IMF.

And I felt very strongly that we couldn't ask people to bring the money in and tell them that we knew better how to negotiate with Mexico and how to organize the conditionality. I thought we had to share this. So what I promoted at that time—and we are finding these things now seeping into the procedures—was to share between the Mexican government, ourselves in the IMF, and the major international banks who were asked to provide the bulk of the financing of the program, the macroeconomic fundamentals of the program. Would three years or five years do the trick? Would that combination of fiscal and monetary policy and exchange rate policy do the trick? Did they agree, did all agree? Were there better ideas?

So we had a one-month sort of think tank where the economists of the major banks brought their value-added into the process, and this was a far-reaching view for 1982. I see that now we're groping toward ideas that are less provocative than those at the time. But under necessity, sometimes you do things that are pretty bold.

The second dimension of the question, who is the watchdog of the watchdog, is therefore to introduce more transparency and a better two-way understanding between the marketplace and the IMF. This is being done more and more.

I think, for instance, that it's very good to have private financial institutions listen, during road shows, or in periodic sessions, to what the countries have to say on their own policies so that they can exchange views on emerging difficulties, preoccupations, and concerns that are finding their way, even under a very euphoric set of circumstances where you've got a lot of capital inflows. But there are warning signs.

I know the IMF is under very strict confidentiality rules, and these are absolutely essential. But there is some way for talking with the people who are in the market without breaching these confidentiality rules. So I think the answer to the question is really double: it's the shareholders and it's the market place.

In conclusion, this has been a most interesting session. The next Per Jacobsson Lecture will take place in Prague on Sunday, September 24, in the context of the IMF/World Bank Annual Meetings. The speaker will be Josef Tošovský, the Governor of the Czech National Bank. And I would like to close now with words of appreciation for my two co-panelists, who have been thought provoking, extremely clear, and concise. They have indeed excited the curiosity and interest of the meeting, as shown by the large number of very interesting questions. I thank you all.

Biographies

Peter B. Kenen

Peter B. Kenen is Walker Professor of Economics and International Finance, and Director of the International Finance Section at Princeton University. A specialist in international economics, he earned his B.A. from Columbia University and his Ph.D. from Harvard. He taught at Columbia from 1957 to 1971, where he served as Chairman of the Department of Economics and, in 1969–70, Provost of the University. He has taught at the Hebrew University in Jerusalem, the Stockholm School of Economics, and the University of California at Berkeley.

Professor Kenen has written several books. They include *British Monetary Policy and the Balance of Payments*, which won the David A. Wells Prize at Harvard; *Asset Markets, Exchange Rates and Economic Integration* (with Polly Allen); *Managing Exchange Rates*; and, most recently, *Economic and Monetary Union in Europe: Moving Beyond Maastricht.* His textbook, *The International Economy*, is now in its third edition. He has edited a number of books, including *Managing the World Economy and Understanding Interdependence*, and was co-editor of the two-volume *Handbook of International Economics.* He has published many articles in scholarly journals, and most of them have been reprinted in two volumes: *Essays in International Economics* and *Exchange Rates and the Monetary System.*

Professor Kenen has been a consultant to the Council of Economic Advisers, the Office of Management and Budget, the Federal Reserve, the International Monetary Fund, and the U.S. Treasury. He was a member of President Kennedy's Task Force on Foreign Economic Policy and of the Review Committee on Balance of Payments Statistics. He is a member of the Council on Foreign Relations, the Group of Thirty, and the Executive Committee of the Bretton Woods Committee; he serves on the Advisory Board of the Institute of International Economics and the Economic Advisory Panel of the Federal Reserve Bank of New York.

He has held research fellowships from the Ford Foundation, the Social Science Research Council, and the German Marshall Fund. He was a Fellow of the Center for Advanced Study in the Behavioral Sciences, a Guggenheim Fellow, and Ford Research Professor at the University of California. In 1983–84, he was a Professorial Fellow at the Australian National University; in 1987–88, he was a Visiting Fellow at the Royal Institute of International Affairs; and in 1991–92, he was a Houblon-Norman Fellow at the Bank of England.

Born in Cleveland, Ohio, on November 30, 1932, Professor Kenen is married and has four children. He lives in Princeton, New Jersey.

Arminio Fraga

Arminio Fraga has been Governor of the Central Bank of Brazil since March 4, 1999.

Previously he was for six years a Managing Director at Soros Fund Management LLC in New York. In 1991 and 1992 Mr. Fraga served as a board member and Director of International Affairs at the Central Bank of Brazil. Mr. Fraga has also worked for Salomon Brothers in New York and for Banco de Investimentos Garantia in Brazil.

Mr. Fraga teaches at the Graduate School of Economics at Getulio Vargas Foundation in Rio, and has taught at the School of International Affairs, Columbia University; at the Wharton School; and at the Catholic University, in Rio de Janeiro.

He received his Ph.D. in Economics from Princeton University in 1985, and his B.A. and M.A. in Economics from Catholic University of Rio de Janeiro in 1981.

Jacques de Larosière

Jacques de Larosière is a Conseiller of Paribas and Chairman of the Per Jacobsson Foundation. He was born in 1929 in Paris. He earned a degree in arts and law at the University of Paris and a postgraduate degree from the Institut d'Etudes Politiques, Paris. He went on to study at the Ecole Nationale d'Administration from 1954 to 1958.

In the course of his distinguished career, Mr. de Larosière has held a number of positions with the French Government, beginning as Assistant Inspector of Finance in 1958. He subsequently served as Inspector of Finance (1960); Chargé de Mission at the Inspectorate-Général of Finance (1961), the Department of External Finance (1963), and the Treasury Department (1965); Deputy Director, Treasury Department (1967); Assistant Director and, later, Department Head, Ministry of Economy and Finance (1971); Director of the Cabinet of the Minister of Economy and Finance (1974); and Director of the Treasury (1974–78). In 1978, he became Inspector-General of Finance.

During 1967–71, Mr. de Larosière was the Chairman of the Economic and Development Review Committee of the Organization for Economic

Cooperation and Development (OECD). In 1976–78, he served as Chairman of the Deputies of the Group of Ten. He became Managing Director of the International Monetary Fund in 1978, which he left in 1987 to become Governor of the Bank of France. While in that capacity, he served as Chairman of the Governors of the Central Banks of the Group of Ten. From 1993 to 1998 he was President of the European Bank for Reconstruction and Development. He is presently Director of France-Telecom, Alstom, and Power Corporation.

In recognition of his distinguished public service, France has awarded him two of the country's highest honors—Commander of the Legion of Honor and Chevalier de l'Ordre National du Mérite. Mr. de Larosière is a member of the Académie des Sciences Morales et Politiques. Mr. de Larosière has also received the highest decorations from Argentina, Brazil, Bulgaria, Germany, Hungary, Italy, Japan, Mexico, Poland, and Russia.

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1968 *Central Banking and Economic Integration.* Lecture by M.W. Holtrop; commentary by Lord Cromer (Stockholm).

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1964 *Economic Growth and Monetary Stability.* Lectures by Maurice Frère and Rodrigo Gómez (Basle).

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