

**Keynote Speech of Stanley Fischer,
First Deputy Managing Director, International Monetary Fund,
at the 5th European Forum Berlin on November 20, 1999**

The euro and the future of the international monetary and financial system

Thank you very much, Mr Chairman. And thanks too to the organizers of this important event for inviting me to participate in this session.

I had thought from the title that we would focus on the euro, but Mr. Martin also put several questions on the reform of the international monetary and financial system on the agenda, and it is natural that I should comment on those questions. However I would like to start with a few of the early questions, the first of which was: is the Euro a credible rival for the U.S. dollar?

The answer to that is yes. In what sense? There is a good article in the *ECB Monthly Bulletin* of August 1999 on the international role of the Euro which analyses this issue, starting from the well-known textbook description of the functions of money as a unit of account, as a means of payment, and as a store of value. The Euro will be a substantial presence in the world economy in all those regards. As the article shows, financial and trade contracts are already being denominated in Euro, not only within the EMU, but also between EMU and other countries. The Euro is certain to become an international unit of account, it will increasingly become a means of payment, and it will be a reserve asset on a substantial scale.

The extent to which that happens depends in the first instance on the size of the European Monetary Union, which after its growth to the East and probably also to the West will likely account for more of world GDP than the United States. The second factor determining the international role of the Euro will be the size of Euro-area financial markets. European private sector financial market participants as well as European financial regulators should have every interest and desire to make those markets grow. Accordingly it is likely that the Euro will gradually gain in importance in international economic relations relative to the dollar.

One reason to say that is another of the questions put to us, "Will the Euro be stable?" is not likely to be an issue. The constitution and the behavior of the ECB suggest that the Euro will be an extremely stable domestic currency, with low and stable inflation. Of course, that does not mean that the value of the Euro will not fluctuate, perhaps considerably, in the international markets. There is a tendency now to talk of the instability of the Euro as if a single European currency is a recent invention, but Europe was operating on the DEM standard well before the introduction of the Euro, and the fluctuations we are seeing now are not very different than those of the DEM before the introduction of the Euro.

Will the growing role of the Euro make a big difference to the operations of the international monetary system? Not on economic grounds. The international system is well equipped to handle fluctuations in currency values, and it is well equipped to deal in more than one currency. There will be nothing special or different about the way the system will operate with two major currencies, one of which has just become a larger reserve asset than it had been before.

Incidentally the last period in which two currencies vied for supremacy in the international system was between the wars, when the dollar was taking over from sterling. The economic disasters of that period give cause for concern, but we should by now have

learned enough about the responsibilities of central banks to prevent deflations and avoid competitive devaluations to ensure we do not repeat the mistakes made in that period.

One respect in which the growing importance of the Euro could make a difference is in economic leadership in the global system. As you know, there has been a great deal of controversy about how the European central banks are to be represented in G7 meetings that include central bank governors. That must be a transitional problem because the national central banks are losing relative importance and the ECB is gaining. In the end the ECB will represent Euro-area central banks in international meetings. The question of European representation on the fiscal side – Treasuries and Finance Ministries – will remain open. Europe's voice, and European leadership, will become stronger only if the number of European representatives declines. That is bound to be a very complicated process, which is tied up with questions about sovereignty in the European context as Europe's political institutions develop.

The outcome of that process will determine the power of Europe's voice in the international system. Incidentally, we are already seeing some of these issues in the IMF. The eight European chairs (out of 24) in the IMF Board have decided to co-ordinate their positions on monetary matters. That may well be logical, but it is hard to know how to react when eight people say the same thing; nor is it obvious why it takes eight people to say it.

Now, let me move on to the question of how the Euro area should deal with currency arrangements for countries planning to join the EU and then EMU. The answer is precisely as they are already doing – pragmatically and eclectically. The Helsinki conference a few weeks ago decided there is no unique monetary path to entrance into Euroland. That is surely right. Some candidates have stable currencies within a currency board arrangement. If as expected the currency board arrangement continues to do well, and there are no signs of disequilibrium in the exchange rate, let them come into the system via their currency board. If there are countries who are floating as Poland is within a wide band, and whose currencies are stabilizing, let them come in that way. That eclectic European approach is thoroughly the right way to go on this issue.

Now let me turn to the questions about reforming the international financial system. I will discuss four lessons that are being drawn from the recent crises. The first is about the primacy of domestic policies. The macroeconomic policies enshrined in the ECB and the European stability pact are valid well beyond Europe. More controversial is the question of exchange rate regimes. It is striking that the countries that had the big crises in the last five years, Mexico in 1994, Russia in 1998, Brazil in 1998/9, and the three Asian crisis countries, Korea, Indonesia and Thailand, all at some point had fixed exchange rates before the crisis. They all switched to floating rate regimes. That is a very important piece of evidence suggesting the vulnerability of pegged exchange rate systems when capital is internationally mobile. Further, countries that were not structurally strong, such as Turkey or South Africa, did not have exchange rate crises of the same type or magnitude even though they were severely buffeted by the international crisis. We have also seen that countries with currency boards, with very hard pegs of the exchange rate, sustained their exchange rates. The conclusion that is drawn is the so-called bipolar approach to exchange rates: for countries with freely mobile capital, the exchange rate should either float or be pegged very hard.

This conclusion is already having an impact on the behavior of the system, mainly because the crisis caused the six crisis countries to switch from pegged to floating rates. However, I am not sure this question is finally resolved, because some Asian countries continue to rethink the exchange rate arrangements they will seek as the crisis period passes.

The second set of lessons relates to the need for greater transparency – of countries' policies and data, and also of IMF policies. Data are being improved through the IMF's SDDS (Special Data Dissemination Standard), and a great deal is being done by the IMF and others to make more transparent what they are doing, mainly by publishing IMF reports on countries, and also by publishing countries' Letters of Intent, the documents in which they describe to the IMF the stabilization and reform programs they intend to implement.

Third, there is also a major effort under way to develop and implement a set of international standards which countries should aspire to meet, for instance accounting systems, securities market regulation, banking system regulation, the way in which fiscal accounts are presented and the transparency of the presentation of data and information on the monetary and financial systems. All these standards are now going into effect. The Basel Core Principles of banking supervision are among the best known and most important of these standards. The importance of the health of the banking system cannot be overstated: it is reflected in the differential impact of the devaluations in Asia and in Brazil. Brazil came through its devaluation in surprisingly good shape. Why? In large part because the banking system did not weaken substantially as a result of the devaluation, whereas banking system weaknesses played a devastating role in the Asian crisis countries.

The fourth area in which we are working, probably the most difficult area in which to make progress, is how to involve the private sector in financing the solutions of financial crises, the so-called "bailing-in" issue. We are working now on four very difficult and different cases, which are Pakistan, Ukraine, Ecuador and Romania. The attempt to involve the private sector has not worked equally well in each case, but we are learning. The general principle has become clear: there will be occasions when countries have been badly managed, when their debts are very large, when it would take large scale public sector assistance to enable them to continue servicing their debts, that the public sector will not provide that financing. In other words, there will be occasions when countries will have to go their private sector creditors and say: we cannot make our scheduled debt service payments, and we need your help, perhaps in the form of new loans, perhaps in the form of a restructuring of the external debt.

Private sector involvement is necessary for two reasons: first, to minimize moral hazard, to get investors to realize and take into account in their investment decisions the real risks of what they are doing; and second, because there is neither the financing, nor the public support, for the international institutions to provide financing on the scale that would be needed to enable countries always to meet their debt servicing obligations.

What is happening in Ecuador today is a very, very important example that the private sector is watching very closely. There is, of course, another major example, the Russian default, the unilateral debt restructuring and devaluation. That example should have driven home the lesson that the public sector will not always be in a position to enable a country to service its external debt, however geopolitically critical the country may be.

We are making significant progress in implementing the lessons of the recent crises in all four of these areas. But we have to recognize that while a great deal can be done by the international institutions, in the end what will determine how well the international system works is the extent to which countries strengthen their own economies. There too we have seen progress, but of course there is much more to be done, and the political incentive to do it has to be maintained even as the world economy returns to greater stability. The IMF's unofficial motto, "Complacency must be avoided", will undoubtedly be heard frequently in the years to come.

Thank you Mr Chairman.

