FROM 19th STREET TO WALL STREET; EARLY REFLECTIONS

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It is a great pleasure to be back at the IFC again, for the first time since I joined the private sector. Most people I meet for the first time since I left the IMF ask me what I'm doing at Citigroup – usually in a tone that implies some doubt that it can be anything useful. The short answer is that I am taking the first six months or so in my new job to familiarize myself both with the main issues that are on the agenda of Citigroup management in New York, and with what it is that the different parts of the Group do. In learning more about Citigroup's worldwide activities, I've found myself traveling even more than I did at the Fund. But I expect – at least I hope – that a few months from now I'll decide where to focus my future activities, and begin to settle down.

As the presence of this audience testifies, the IFC has played an important role in encouraging financial flows to the private and quasi-private sectors in developing countries. And there is more to be done in cooperation with the private sector, including in the development of local capital markets and local currency denominated financing. In these areas as elsewhere, the firms represented here, including my own, also have an important contribution to make.

[1] I am grateful to Stephanie Flanders for assistance, and to my Citigroup colleagues, especially Jeff Shafer, for helpful discussions.

But since many of those topics will be covered during the conference, I will not focus on them today. Rather, I'd like to share some early personal reflections on the transition from the IMF to the private sector. I emphasize the words "early" and "personal". After just over four months in New York, these are not the views of a seasoned member of the private sector – and certainly not those of Citigroup itself.

First, though, let me say a few words about a subject that has lately been much in all our thoughts, here and in New York, and most of all in Buenos Aires – the Argentine crisis.

I. Argentina

The financial crisis that finally erupted in Argentina toward the end of last year ranks among the worst in living memory. Many have described this as the financial equivalent of a perfect storm. But I am not sure whether that is the right analogy, because the outcome was largely a result of policy choices consciously made, one way or the other, over a long period.

The crisis had been widely predicted and anticipated in the preceding months and even years. But that fact can be little consolation to ordinary Argentines as they suffer through its effects. And nor, in fact, was it much help to international policy makers before the crisis hit. More than most, the Argentine case confirms the observation that the capacity to see trouble coming does not necessarily make it easier to prevent.

As soon as the Argentine currency board regime became firmly entrenched, it was clear to everyone that there would be no easy way out – indeed, it was part of the essence of such a regime that there should not be one. Initially the currency board arrangement worked well, both in bringing Argentina monetary stability, and in permitting a rapid growth recovery. The Argentine economy grew very rapidly in the seven years through 1998, even taking into account the recession that accompanied the tequila crisis. Argentina's successful response to that crisis, which involved a fiscal tightening in the context of an IMF loan a few months before the presidential election in 1995, strengthened confidence in the currency arrangement. But it was noted at the time that Argentina had had to undergo a much larger recession, per percent of GDP improvement in the current account, than did Mexico, whose exchange rate had taken much of the burden of adjustment.

The currency board arrangement had strong popular support in Argentina. One IMF Executive Director reported a conversation in the year 2000 in which she asked an Argentinian whether the slow growth and deflation that Argentina was then suffering suggested the currency board should be given up. The answer: "No, we will never again permit our politicians to manipulate the money". And that attitude was widespread. It was also easy to understand given Argentina's inflationary history.

As Argentina's fiscal and external situation worsened in the years leading up to the crisis, there were several periods when the government came under strong pressure to reschedule the country's foreign obligations or devalue. Knowing the high price they would pay for any such reversal, successive Argentine governments made enormous efforts to resist that pressure. I think they were right to do so. And at the time, so did the vast majority of Argentines. I only wish those Argentine governments had been more successful in fighting the adverse debt dynamics that developed in the period following 1998.

This is not the place to discuss what exactly went wrong in Argentina. But let me record the view that what happened had very little to do with Argentina's microeconomic reforms, and everything to do with the very difficult macroeconomics of operating a fixed exchange rate – particularly one pegged to an appreciating currency – when other exchange rates are changing, and when the fiscal situation is deteriorating. It is often pointed out that Argentina's budget deficits were not especially large during the period before the crisis. That is correct, but external financing needs *were* large, and becoming larger, and there was no instrument left to the government to reduce those needs, except fiscal tightening.

Given the support of the Argentinian people and government for the convertibility regime, and given the knowledge that getting out of it would be extremely costly, I believe the IMF was fully justified in doing all it could to avoid the catastrophe that has now taken place. Bob Rubin likes to say that decisions of this kind are a matter of probabilities: they should be judged by the reasonableness of the calculation that went into them, not the outcome. In his view the Clinton Administration was right to support Mexico in 1995, *not* because the program was a success but because there was correctly seen to be a reasonable chance of success at the time the decision was made. Something similar can be said of the IMF's policy toward Argentina.

Even as late as August last year, I believed there was a non-negligible probability that Argentina could turn the situation around if it implemented its announced zero budget deficit policy, and thus that official support could still play a positive role – albeit very far from a guarantee of success. It was a difficult and finely balanced calculation. But I thought the Fund's choice was the right one at the time. And the pain that Argentina is suffering in the wake of its default and devaluation has if anything strengthened that view.

I will not comment in detail on the current state of play between the Fund and Argentina, other than to say that in these circumstances it was inevitable that the adjustment would be both difficult and prolonged. And so it has proved. However, the broad outlines of the way out of a crisis that the Fund has suggested seem to me the right ones. And I hope, for all concerned, that it will not be long before Argentina is able to agree on a plan along these lines to begin to restore financial and economic stability and lay the basis for the return of growth.

Let me turn now to the more personal story of my transition to the private sector.

II. Private Sector Transition

As the old saying goes, "Where you stand is where you sit", so I want to talk about some of the things I have been seeing and thinking about, before I have had time to figure out where to sit and where I stand.

First, shareholder value is king

It should not have come as a surprise to someone like me who has spent his life as a practicing economist to realize that shareholder value is king. I expected that would be true in my new job. But I have been struck by the extent to which maximizing the share price – or shareholder value – is truly the guiding principle by which the institution operates. When I was being interviewed for the job, I asked Sandy Weill what were his main goals for the next few years: "I want to get our share price up" was the answer. Of course, there may be a conflict between the maximization of shareholder value in the short run and in the long run, and it is important to make the right choice if there is a conflict. In any case, it is literally true that shareholder value is the yardstick by which decisions are measured.

Second, financial regulators matter

Spending considerable time dealing with financial sector crises around the world tends to produce a healthy skepticism about the capacity for domestic financial regulators to understand what their respective charges are up to, still less control them. But at my new professional home, it has come as a surprise to see the degree to which official regulators are a constant concern and presence in the firm's day-to-day operations. For instance, some internal memoranda on credit quality are routinely copied to the Federal Reserve – and in discussions about changes in the way we operate, the issue of potential regulatory implications is almost always addressed very early. I have also been very impressed by the constant interaction between my colleagues and the regulators in the design of our risk control process, the next topic I will take up.

Third, the complexities of managing risk are formidable

Risk management is a subject that I am still trying to master. But I have been struck by the sheer complexity of the risk control mechanisms that are needed in a modern financial institution with the breadth and sophistication of Citigroup. As financial instruments have evolved and multiplied, so surely have the kinds of mechanisms needed to manage the risks that accompany them. Quite likely, the number of accidents waiting to happen has grown at about the same rate. We can be certain that even the most sophisticated VAR analysis will miss some type of risk thrown up by the uncertainties inherent in economic life, and that at some point one of those overlooked events will happen. Indeed, that possibility is taken into account in the concept of economic capital, which is calculated assuming a particular probability that the firm will at some point be hit by a loss that is larger than its capital. So, however sophisticated the risk control systems, the IMF's guiding principle, the Fundese equivalent of "touch wood", which is "complacency must be avoided" is an overriding principle.

All of these observations – the lode star of shareholder value, the ever-present hand of financial regulation, and the complexities of controlling risk – have led me to adjust slightly my perspective on an issue I have been thinking about for a long time. That is the question of private sector involvement in the event of crises, or PSI.

III. Private Sector Involvement

The term PSI tends to be used in at least three senses. The first, and most literal meaning is the contribution of the private sector to meeting a country's financing needs – in good times as much as in bad. When a country has access to international financial markets, there is always the question of what share of that country's external financing needs will be met by the private sector. The answer is that private sector finance should be the norm for emerging market countries, and that eventually all developing countries should become emerging market countries – not least because the scale of required capital flows to these countries is beyond anything that the public sector could hope to provide.

This leads to the second sense of PSI, which is non-business-as-usual means of persuading private sector creditors to reduce net outflows of capital from a country facing a capital account crisis. When a bank run mentality has taken hold – when a collective action problem needs to be solved – this kind of PSI can sometimes be worthwhile because it makes sound financial sense for one firm not to run for the exits provided others will not run either. And certainly it makes sense for the IMF to try to create that kind of confidence when it is feasible to do so.

The third sense of PSI is the more straightforward belief that the private sector should bear the full risk of its decisions – and that a system in which investors do not bear that risk is a system that makes financial crises more likely. For if the risk is collectivized while the gains are not, suppliers of financing will take more risks than they should.

How to combine the second and third senses of the term PSI into an effective response to real-world financial crises is the major ongoing challenge facing the international official sector. It is analytically useful to draw the distinction in this regard between problems of liquidity and problems of insolvency – with the first being a potential arena for implicit or explicit coordination, and the second requiring the recognition of losses. But while analytically useful, this distinction is less helpful when applied to sovereign debtors, because for them, the issue is largely political.

It is impressive how far governments will go to seek to avoid default. For instance, in February 2001, the Turkish government faced the choice of undertaking a massive fiscal adjustment so as to continue servicing its debt, or attempting a major involuntary restructuring of its debt. It chose the fiscal adjustment. It can be debated whether governments typically go too far in seeking to avoid a restructuring, but I have been struck by the fact that the willingness of economists outside a country for it to default is almost always far greater than the willingness of the policymakers inside the country to do so – and it is the policymakers who will face the political consequences. It is also true that flows of financing to emerging market countries depend on the belief that governments in trouble will go very far to honor their debts. I believe that the policymakers are right to go far to avoid default – and that is also something I believed while in the public sector. But sometimes they will have to restructure their debts.

The second, bank run prevention, sense of PSI does have real-world application. As long as herding, multiple equilibria and self-fulfilling prophecies are part of the day-to-day functioning of modern financial markets, there will be times when non-standard means of persuasion on the part of the official sector will produce a better outcome for creditor and debtor alike. Korea in late 1998 was one example and no doubt there have been others.

But a great deal hangs on whether the initial assessment of the likely outcome for creditors turns out to be correct. Any such assessment has to include a judgment about the likelihood that the government in question will deliver on the agreed policies. And where sovereign governments are concerned, there can be no guarantees. The Turkish case is instructive: in December 2000 a voluntary agreement by the banks to roll over interbank lines seemed to provide a sensible path to a better outcome. But when some actions by the Turkish government led to a weakening of market confidence in the Turkish program, banks began to pull their lines. And with a changed assessment of the situation, it became harder for the official sector to insist that other banks stay in.

Indeed, from a regulatory or prudential standpoint, it was not obvious that it should do so. For as regulators, the authorities in the countries where the suppliers of capital are located have an obligation to seek to ensure that those firms are managed in the interests of the stability of the home economy. Imposing losses on the institutions under their regulatory control in order to help stabilize a borrowing country is not part of their mandate. Nor should they ask institutions owned by shareholders to take action that is contrary to their shareholders' long-term interests.

The analytic distinction between liquidity and solvency problems is relevant to the design of a possible Sovereign Debt Restructuring Mechanism (SDRM). If the problem is one of liquidity, bankruptcy will not be needed, and a standstill should be sufficient. If the problem is one of insolvency, then losses will have to be taken. For a long time, many in the official sector, including me, believed that legal problems would ensure that this process would be highly disorderly. In the Argentine case, we have not seen much legal action following the default, so perhaps those who asserted we were exaggerating the legal problems were correct.

Even so, I still believe that the lack of a clearly accepted framework for a country to suspend payments pending a viable agreement with its creditors is a serious gap in the international financial architecture that needs to be filled. That debate goes on, and it is not clear where it will end. But wherever it ends, we all owe a debt of gratitude to my successor at the Fund, Ann Krueger for putting the topic high on the international agenda. For I have no doubt that whether or not we end with a formal sovereign bankruptcy procedure, the discussion that has followed her speeches and the outpouring of alternative suggestions make it very likely that the system will be better able to handle future crises.

I believe that the international system is now much less crisis prone than it was a decade ago. That is mainly because so many countries have moved to flexible exchange rates, but also because of the many improvements in financial systems and fiscal systems that have taken place as a result of the international reaction to those crises. But a flexible exchange rate system does not rule out a debt crisis - so inevitably we will still have crises. We need to do as much as we can to reduce their frequency, and their virulence when they occur, and the design of procedures to deal with unsustainable debt burdens has to be part of that effort. And I am sure that some of the participants in this meeting will play a role in the search for viable solutions.

Thank you.