**Mr. Tietmeyer discusses prospects for Latin America in a volatile world**

Presentation by the President of the Deutsche Bundesbank, Prof. Hans Tietmeyer, at The Wall Street Journal's Seventh Annual Conference on the Americas in New York on 2/10/98.

First of all, I would like to thank you most sincerely for your kind invitation to this major conference. The fact that a European central banker is speaking at a conference on the Americas is also evidence of advanced globalisation. We are living in one world, even if some of the conditions differ. Geologists claim that our two continents are moving away from each other, even though it is by rather less than one inch a year. Fortunately, that is true only in a geographical sense. Economically, the continents are moving closer together. For that reason, it is undoubtedly true to say that there can be no oasis of prosperity in today's world - even if Europe looks like an island of stability at present. But, of course, our future, too, depends on the further outlook for the world economy.

The global economy is marked at present by a number of crises and critical situations. The history, forms and implications of these crises have many dimensions. Understandably, there are many questions to which final answers cannot yet be given.

That starts with a precise analysis of the processes involved. Why do the markets react later in some cases and earlier in others? How do the internal weaknesses of countries interact with the operation of the financial markets upon the outbreak of, and during, a crisis?

There are a particularly large number of questions on the economic implications. How quickly and how sustainably can the affected countries overcome the crisis of confidence? How successfully can other emerging markets escape the risks of contagion? How much does the turbulence retard growth in the traditional industrial countries? What are the long-term effects on the global trade and financial structures?

Finally, we have to ask about the lessons to be learned. How can the emerging markets bring their internal structures better into line with their degree of integration into the global economy? What role can international cooperation play in preventing and overcoming crises?

These and other difficult questions are dominating the current international debate. However, some fairly sweeping comments can be heard in the debate. People who say that the financial markets are to blame, that globalisation must be stopped or even reversed. Such views are, of course, too simplistic and inconsistent with the realities involved. But there are indeed legitimate questions to be asked of the global financial system. At all events, the international community would do well to give careful consideration to how it can improve the way in which the financial markets work.

Now, in a tempest it is especially important to maintain a clear sense of direction. For every serious analysis, the following two insights should provide the guiding lights: Global financial markets bring significant benefits overall. Free capital movements are an important and worthwhile achievement.

The free movement of capital has been crucial in promoting the global integration of output and trade. It has been instrumental in bringing about a marked increase in international direct investment and has led to a rapid spread of know-how. Free capital movements have made the world more prosperous overall. Capital is being used more efficiently because the pool for gathering and allocating resources has become larger. And investment decisions are geared more closely to the economic yield of projects. Finally, the free movement of capital has helped policymakers in many countries to maintain internal economic discipline. The fact that there is a comparatively high degree of price stability in many parts of the world is undoubtedly also due to open borders and more competition from abroad. No one should forget those benefits, let alone want to sacrifice them.

On the other hand, it is nevertheless correct to say that the global markets are not easy players and partners. They pose internal challenges which may sometimes be hard. And the international financial markets are prone to exaggerate at times, on occasion with great severity. Nowadays, many market players are very short-termist in their actions, which can considerably heighten risks. There is herd behaviour in both euphoria and in moments of doubt. Above all, financial crises give rise to risks of contagion. Countries may be infected even though they have very few economic links with the original location of the crisis.

Naturally, it is understandable that market players regard a crisis in one country as a reason to re-examine opportunities and risks across the board. Problems are caused, however, if the markets do not make enough distinctions and fail to take adequate account of conditions which are specific to the individual country. I hope very much that the international financial markets will note and take due consideration of the evident structural progress made by many countries over the past few years, especially in Latin America. Apart from that, exaggerations in one direction or the other are ultimately dangerous for the players in the financial markets themselves - as has been revealed yet again precisely here during the past few days.

II

What can be done against financial turbulence? First and foremost, financial crises are not an ineluctable fate. Internal weaknesses or shortcomings nearly always play a considerable role. Conversely, it is also true to say that there is no universal patent remedy.

But this much is certain: long-term domestic stability and, above all, the enduring credibility of internal policies are the best protective measures. Whatever we currently discuss with great seriousness and commitment at the international level, even the best possible architecture for global finance needs sound foundations. Those indispensable foundations are provided by convincing long-term domestic policies on the part of the countries themselves. That means: sound public finances, stable prices, sound banking and financial sectors, and competition and flexibility in the domestic product and labour markets. It cannot be said often enough: internal policies must be in order. That is the starting point for any architecture. They are, so to speak, both the foundations and the supporting pillars.

Greater and, above all, improved transparency is just as essential for monitoring the quality of those foundations and pillars as is regular surveillance by the IMF as part of the Article IV consultations. More than hitherto, the financial sector and its supervision should also be the object of examination, not just classical macropolicy.

Of course, one must not expect that greater transparency and strengthened surveillance by the IMF will mean a perfect world in future. Countries' internal structures are rarely ideal. And that is something which a global financial system has to come to terms with. Therefore, external arrangements among currencies and between a country and the global financial markets are naturally also of importance. However, these must be viable in the real world.

For example, stable exchange rates are undoubtedly desirable. They provide enterprises and financial investors with planning certainty. In certain cases, exchange rate pegging may be useful for that purpose. Moreover, an exchange rate peg may, for a time, help to import stability from outside. Ultimately, however, that borrowed credibility has to be paid back by internal performance. And every country must also know that in today's dynamic world there may easily arise an unavoidable need to adjust the exchange rate - not just the nominal exchange rate but also the real one. And that is the reason why every country has to examine critically whether it has sufficient internal flexibility to hold a nominal exchange rate peg by means of strenuous internal adjustment. Hence, it is questionable whether installing a currency board is wise for a country in transition which still has a considerable road to travel in its development from a centralised command economy to a market economy. A currency board only makes sense if it is credible over a lengthy period of time. And it is credible only if the domestic financial sector is sound enough to stand a temporary monetary contraction if the necessity arises. That scarcely seems to be the case in Russia at the moment.

External arrangements have to be particularly realistic. That is becoming increasingly apparent nowadays in the question of the liberalisation of the financial markets in the emerging economies. Without doubt, liberalising capital movements is the right direction to take. But if the internal financial sector has major problems in handling extensive capital flows in a sound manner, the question has to be asked about the pace and sequencing with which a country opens itself up.

The subject of controls on capital movements is very much to the fore in the debate at present, especially for some of the Asian countries in crisis. At the end of the day, every country has to assess for itself which path it will follow. It is understandable if a country is concerned about becoming too dependent on hot money - at least, as long as the domestic financial sector is not fully developed.

No one should indulge in any illusions, however. Administrative controls are not an easy thing in today’s world. The markets will be permanently on the lookout for ways of circumventing those controls. And, mostly, the markets are more inventive than the controllers. Controls on capital movements also exact a price in most cases. In order to be effective, controls must be comparatively broadly designed. That implies that effective controls also adversely affect desirable capital movements to some extent. And controls on capital movements may have the effect of retarding the strengthening of internal structures. Admittedly, in some cases and for specific areas, it may make sense to buy time for developing suitable domestic structures. But that time also has to be used. Otherwise, buying time might backfire. For instance, controls might encourage corruption and cronyism.

For that reason, even controls of capital inflows represent a certain degree of risk. Even though there are arguments for regarding them, under particular conditions, as a contribution to preventing crises and to limiting the potential for a setback. But controls of capital outflows as a means of crisis management are of a different nature. They may directly attack investors’ confidence. The risk of a crisis escalating might become unpredictable.

III

Whatever shape the future architecture might take, there are two indispensable preconditions for a sound world financial system: countries having a sound domestic policies, and appropriate external arrangements with the other currencies and with the global markets. If these foundations hold, then it naturally make a lot of sense to go one step further and to ask how international cooperation can make the world economy more efficient.

A thorough debate on this issue can be very beneficial if a “New Architecture” or a “New Bretton Woods” does not imply throwing the baby out with the bath water but does mean reforming the existing architecture. Since the general principles of the current system are more or less correct. But they have to be applied coherently. And they have to be generally adopted.

A lot can and should be done. With a growing number of countries participating in the international division of labour and in the global allocation of capital, the world needs more binding rules. A lot of work on defining such appropriate rules has already been done during the past few years. I would just like to remind you of the Basle Capital Accord or of the Core Principles for Effective Banking Supervision. The crucial challenges are to ensure that such rules are actually implemented by the countries and to ensure that the national authorities are in a position to have the required changes put into effect by the market players.

In particular, in order to improve the efficiency of financial markets, clear rules should promote transparency in terms of the positions of both the countries and the players. Recent experience indicates that the issue of greater transparency is actually a matter for both.

So, without any doubt, there is a strong case for close international cooperation. However, there is one condition for its success. In the longer term, cooperation can only be productive if it strengthens and does not weaken its own foundations.

There is the one part of those foundations which it must not attack: countries' internal soundness. It would therefore be short-sighted to urge a country or currency area to relax monetary policy more than is reasonable internally. Sooner or later, that extracts a penalty. This is the lesson to be learned from the current problems in Japan, which have their origin, not least, in a relaxed monetary policy in the late eighties. At that time, Japan understood its low interest rates as a contribution to international cooperation. And pressure to do so came at that time from the United States. The result was the bubble economy. The Japanese financial sector is still suffering from its excessive effects. That is a burden not just for Japan but for the world as a whole.

Moreover, there is the other part of the foundations which international cooperation should not undermine either: the appropriate arrangements among countries themselves and with the financial markets. International action should improve, and not harm, the operation of the financial markets. But that is precisely what happens if there are public bail-outs of investors in the event of a crisis. They encourage moral hazard, thus weakening the efficiency of the markets. Therefore, publicly financed bail-outs ultimately attack the economic basis of legitimacy for free capital markets.

My criticism of some of the IMF's past activities is not new. In the case of Mexico and, to some extent, in the crises of a few Asian countries, financial resources have been thrown into the fire too quickly and too extensively and private investors have not been adequately involved or only fairly late on. Certainly, the IMF has been under considerable political pressure regarding some of its actions. That explains much but does not justify everything. There must be no more rescue operations without the involvement of the private creditors. The IMF cannot and should not be lender of last resort. Fortunately, there is now growing recognition of this.

I do not wish to be misunderstood: we have urgent need of the IMF. For that reason, I cannot agree with the fundamental criticism of the IMF either. We need the IMF, above all, as an international monetary promoter of open borders and free markets and as an advocate of sound and transparent policies on the part of its members. That is the task of the IMF. It has the function of a catalyst. It can assist many countries in following and safeguarding the road to the market economy internally. The IMF can help to make global finance more efficient. Nevertheless, the countries themselves must ensure that their internal financial systems have a sufficiently sound structure. And the IMF can act as an intermediary in the event of a crisis. In doing so, the primary objective should be maintaining access to private capital for countries in crisis. Of course, in such an event financial support by the IMF might play a limited role. But support has to be linked to conditionality which covers the actual causes bearing in mind that the formula for overcoming a crisis might not be the same for every country affected.

This function of the IMF as a catalyst is not a minor role. In today's world, it is a crucial one for which adequate financial resources are essential. The Bundesbank therefore decided yesterday to notify the IMF of its participation in the New Arrangements to Borrow (NAB). The NAB and the GAB are, so to speak, reserve tanks for the IMF in the event of an emergency.

However: The ordinary funding of the IMF by the "front door" is more important and more fitting for its cooperative role than funding by the "back door" through GAB and NAB. For that reason, we welcomed the $11^{th}$ increase in quotas that was agreed last year in Hong Kong. Germany informed the IMF last summer that it accepts this increase. I hope very much that the increase in quotas can soon come into force. However, that will not be possible without the largest shareholder, the United States. It is, above all, here that international responsibility for adequate capital resources of the IMF lies.

## IV

In these troubled times, another forthcoming change is almost being forgotten: the adoption of the euro at the start of next year. I do not know whether one should go as far as Robert Mundell, who has described the introduction of the euro as the most important event in monetary history since the changeover to the gold standard about 120 years ago. It is, at all events, an historic step. It will change Europe economically and politically. And, for the global scene it means the appearance of a new player.

We Europeans agree that the euro must be enduringly stable. To achieve that, we Europeans still have much to do. The internal stability of the euro will help to stabilise exchange rates against other currencies. But, naturally enough, there can be no guarantee that the dollar-euro rate will never fluctuate.

The credibility of the European Central Bank and of the System of European Central Banks will be crucial for the euro. We can take some pride in stating that, on the markets, there is already a notable stock of confidence in the European Central Bank, even though it has not yet taken any interest rate policy decisions of its own. Evidently, the markets are now rewarding the serious and productive groundwork that has been done and the high degree of unanimity so far in the ECB Governing Council. And it may be that the markets are also projecting some of the stability culture that has evolved elsewhere in Frankfurt on to the ECB. The ECB will thus not need an excessively tight initial policy - as is occasionally expected in the markets. The starting interest rate level in January 1999 is therefore likely to be comparatively close to the present low interest rates in the large countries within the euro area.

A stable euro will uphold the tradition and the heritage of the D-Mark. That implies responsible handling of its international role as a reserve and investment currency. It also implies regarding internal stability as a contribution to open external borders. The euro will be an instrument of competition and not of insulation from the outside world.

Admittedly, it will not hold up continental drift in geographical terms. A stable currency cannot do everything. But a stable euro will strengthen the foundations for an orderly world economy and for productive global competition.