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Floor Discussion of "Latin America: How to Achieve Stability and Growth?"

The Studart Paper

György Szapáry, deputy governor of Hungary's Central Bank, did not share governor Nout Wellink's optimism in his opening remarks that we will hopefully learn from experience and have both fewer and shorter crises. "This reminds me," Szapáry said, "of what Bernard Shaw once said, that experience is that wonderful thing that allows us to recognise a mistake when we make it again. All the crises seem to have the same causes."

Szapáry stressed that supervision could not play any positive role once a crisis emerged. "Supervision concentrates on avoiding banking crises and allowing banks to function well in a normal situation. In a crisis, supervision cannot really help, because banks will not be able to function well. Banks are as good as their clients are, while clients are as good as the macroeconomic situation is."

Turning to what central banks can do to prevent crises from happening, Szapáry pointed to three lines of action. "First, it is important to control open positions. Many banks get into trouble when they have excessive open positions. Second, one has to find ways of controlling, or at least monitoring, borrowing by clients from abroad. In fact, you are looking at the open positions of the clients, for which of course you do not have a specific institution set up to control, but you can monitor them and try to impress banks by moral suasion when you see that there is over-borrowing by the companies.

From: Financial Stability and Growth in Emerging Economies
FONDAD, September 2003, www.fondad.org

Third, one increasingly notices that the internal audits of the banks are often not done correctly, but on top of it, the audit companies are not always doing a good job either. We have seen that in the case of Enron, but we also see it in the case of banks. Sometimes banks are hiding problems and the international audit companies do not bring that to the fore. Perhaps a supervisory agency of audit companies could tackle this increasing problem."

Ariel Buira, a former deputy governor of the Mexican Central Bank, confirmed Szapáry's suspicion that banks may be hiding problems. In the early 1990s, Buira had experienced that Mexican bankers did not reveal non-performing loans in the balance sheets. "They just renewed the credit so that it appeared as current and the indicators of performance remained fine. However, this was only possible with a very poor legal and supervisory framework. If you lent to a company that went broke, it was a very long-winded process to recover your loan. If somebody stopped paying a mortgage, it was virtually impossible to recover the loan. But all these issues of the legal framework have been solved. Supervision has been restrained and greatly improved."

With regard to the issue of capital account liberalisation, Buira recalled Mexico's experience in the 1990s. "Mexico always had a fairly open capital account, but when it joined the OECD there was a strong pressure to lift the one or two remaining restrictions. The main one was allowing foreign investors to buy Treasury bills. This made a huge difference in the size of the problem that came later. If the foreign investors had not been allowed to hold Treasury bills, you would not have had the huge build-up in dollar-denominated debt which later became such a crucial element in the emergence of the 1994-95 crisis."

Buira shared Szapáry's scepticism about the role of supervision in a crisis situation. "Once you have a macroeconomic crisis, a banking crisis is inescapable and inevitable. It does not matter how well capitalised and regulated you are, if mortgages are a fourth of your portfolio, it takes all of the banks capital. If the firms you have lent to cannot pay you, again you are wiped out as a bank."

Aert Houben, of the Dutch Central Bank, endorsed Buira's last view pointing to the case of Argentina. "In Argentina you had a very solid banking system, lots of capital, foreign owned banks with state-of-the-art risk management techniques and so on. Clearly it was the macroeconomic regime and the macroeconomic environment that

were driving the crisis."

Houben suggested including another macroeconomic variable in the analysis, the domestic savings ratio. "A low domestic savings rate is a dominant macroeconomic variable in many Latin American countries. That implies that they are dependent on international financial inflows, and therefore are vulnerable to shocks in the international financial sentiment. At the same time, domestic financial markets are not very deep, because they are not generating and intermediating these savings. A complication is, that domestic savings are not easy to steer; it is very difficult to generate more domestic savings. Maybe fiscal policy can play a role here, in pension policies for example, to try and deepen domestic savings and domestic financial markets."

Roy Culpeper, of the Canadian North-South Institute, noticed a clear difference of opinion about the role of foreign banks in developing countries. "Fist, I take it from Rogério's analysis that the presence of foreign owned banks could lead to destabilising competition rather than stabilising competition. This is at odds with what Mr. Wellink was saying in his introductory remarks, that competition from foreign owned banks was much to be encouraged. And Yung Chul Park is making the same point, that the increasing encroachment of foreign owned banks in East Asian economies has played a rather destabilising role. In Canada we always have been rather strict with foreign owned banks. They have never been given much leeway, for precisely the reason that it was thought, and is still thought, that foreign owned banks would undermine the stability of the domestic financial system. There is some real debating material here. It reminds me of Keynes' dictum that 'let's engage in trade and commerce, but ultimately let finance be domestic'."

Culpeper thought that Rogério Studart's reference to unemployment as an indicator of economic performance was an interesting and innovating broadening of traditional indicators. "This is something new, because – as Jürgen Stark commented – financial and price stability are the key objectives. I found it very interesting that Rogério looks at the correspondence between unemployment and non-performance in the banking portfolio. This is encouraging, because the financial sector should worry about the real sector and how it is performing."

Frans van Loon, from the banking and insurance company ING, stressed that the discussion of the financial system needs broadening

beyond that of the banks. “It should include savings in whatever form and domestic capital formation in its broadest definition. Specifically, it should include all contractual savings as an increasing important element for domestic stability: contractual savings from insurance, from pensions systems, from social security, the run-over between public and private savings. In this context, I was struck by Jürgen Stark’s emphasis on the two points of sequencing and the need to strengthen domestic institutions. Jürgen Stark mentioned as domestic institutions the central bank, the judiciary, the courts and all that. Again, one should add contractual savings mechanisms and pension insurance systems.”

Van Loon pointed to the strong interaction in the world of banking between regulation and business, and the impact this has had on banking in Latin America. “In the 1990s, all over the financial world there has been a trend to develop new systems of risk management. They have led to drastic changes in the way we look at risk taking and our daily practice of approving credits. Its influence goes beyond the domestic arrangements in the countries of the advanced banks. The strong foreign dominance of banking in Latin America was also steered from abroad, from Amsterdam, from London, from Frankfurt, based on the new, much more technocratic and very high-quality risk management systems that we have these days. That is somewhat risky, I would dare to say, and may act as a source of instability in financial systems in Latin America.”

Another important new element of the 1990s that should be included in the analysis, suggested Van Loon, is the increasing importance of the so-called stockholder value system. “It is a short-term evaluation, where you are looking at the price of your stock, and the effects of that on stockholder behaviour. Both together are leading to a tendency of risk aversion, which has influenced the willingness to take on credit. This may be another source of instability.”

Amar Bhattacharya, of the World Bank, stressed that if one wanted to draw lessons from the past crises, one should not forget about the role that weaknesses in the international financial system have played in the build-up of vulnerabilities in Latin America. But since Studart’s paper focuses on the domestic aspects, Bhattacharya left that important international dimension aside and dwelled upon the four aspects of domestic financial systems discussed by Studart. “The first is the pace and sequencing of capital and financial

liberalisation. The second is the soundness and consistency of macro policy, in particular that of fiscal policy with exchange rate regimes in an open capital account setting. The third is weaknesses in the financial system, and the fourth is weaknesses in the corporate sector including corporate governance and all the institutional fundamentals mentioned by Jürgen. What I found interesting about the paper is that it shows that the weaknesses in the financial system led to a build-up of vulnerability *before* the Tequila crisis, especially in Mexico and in Brazil, but that it did not do so *after* the Tequila crisis. Indeed, the financial system in Latin America does not contribute to the build-up of vulnerability, neither by a credit boom nor by mismatches in the financial system, whether it be in unhedged open position or in maturity mismatches. That is in striking contrast to what happened in East Asia. So, as other people have argued, it was macroeconomic weaknesses impacting on the banking sector, rather than the other way around. That is a very important point that comes through in the paper and is worth stressing."

Stephany Griffith-Jones, of the Institute of Development Studies, stressed the importance of simultaneously improving the *domestic* and the *international* financial system, and she observed that the progress has been very asymmetric. "There has been important progress domestically, but there has not been sufficient progress internationally. Because things are so integrated, as for instance Frans van Loon just said, this asymmetric progress will continue to be problematic and will make countries vulnerable to crises. This is not to say that the domestic system is unimportant, it is important, but it is only one of the conditions."

Jürgen Stark, deputy governor of the German Central Bank, said that although much progress has been made in crisis prevention, this does not hold true for crisis resolution. "We are far away from consensus on private sector involvement in the resolution of financial crises, as well as on access to IMF funds. I agree that we need symmetric progress both at the domestic and international level. At the national level, strong institutions should be in place. The international institutions only exist to deal with deficiencies at the national level. Therefore, there should be a focus on domestic reforms."

Griffith-Jones said that Jürgen Stark had made a very important point in his comment on Wyplosz' paper when he recognised that capital account liberalisation had been carried out too quickly. She

wondered: "What do we do about it, now that we know we have liberalised capital accounts too quickly? Can we go back? Or do we just make recommendations for the few countries that have not yet liberalised?"

Following up on these questions, Charles Wyplosz, of the Graduate Institute of International Studies in Geneva, said that, like Griffith-Jones, he was struck by Stark's recognition that official views have changed on the point of capital account liberalisation. "This is something which has been discussed in previous Fondad conferences, where some of us were complaining about the push towards liberalisation and we always identified the villains in this push as the Americans, the British and the Germans. This is what seems to be transparent from these G-7 meetings. It is important to realise that of the views that are strongly held today, some will be thrown away tomorrow as wrong. It always baffles me that policymakers give the impression that they have no doubt that what they say today is right. I want to make it very clear. For example, today Stephany asked 'should we go back now on capital liberalisation?' And we are talking in this conference about South-East Europe while right now the EU is putting tremendous pressure on the accessing countries to remove capital restrictions. So this whole process of capital account liberalisation is not going back. However, in my opinion, EU authorities should recommend capital account restrictions for the accession countries."

Stark replied, "Germany has always emphasised the importance of appropriate sequencing of capital account liberalisation. Practically speaking, for the EU accession countries this means that long transition periods should be implemented."

Griffith-Jones agreed with Rogério Studart that there is a trade-off between financial stability and growth, leading to the question of how tight regulation should be. She added another question: "Should there be more counter-cyclicality in regulation given that financial institutions, and banks in particular, are so pro-cyclical? They may become even more pro-cyclical, because they are using these very sensitive risk models which tend to vary strongly with the cycle, and which the new Basel Capital Accord wants to give a prominent role in determining the capital adequacy ratio."

Charles Wyplosz was sceptical about the usefulness of capital ratios. "It is not sufficiently realised that all capital ratios – no matter how good they are – are based on assets, which go wrong during

crises or shake-ups. You can have the best asset ratios possible, but when you need them they will be gone. It is sort of the opposite of what György Szapáry said; you do not need to have regulation in normal times – you need regulation for the worst cases. Therefore, it is almost a hopeless strategy to try to have the good capital ratios. The whole Basel Agreement misses this view completely. If you have an Argentine bank or are holding Argentine assets, the day Argentina is shaking, all of these asset ratios are gone. What you need is Argentine banks holding Dutch or Korean assets and Korean banks holding the others. That is the way to diversify. The first thing you teach students is to diversify, but it is not done and it is not at all creeping into discussions on regulation."

Replying to some of the questions, Rogério Studart said he did not think that the savings rate in Latin America was the problem. "The savings rates in Latin America were not that low, as some speakers suggested. Not the savings rate itself, but rather the allocation of savings to the most productive investment is the problem."

Studart agreed that after the Tequila crisis banking problems did not lead to macroeconomic problems, but rather the other way around. But he warned, "we are getting into a situation of a very stable financial or banking sector, but we are also getting credit stagnation, and that is a problem. We need a system that is both stable and able to provide the credit required for economic development."

With regard to the development of the financial sector in developing countries, Studart believed that progress still has to be made in terms of institutions and institution-building. "If you look at institutions as rules of the games, there have been a lot of improvements. But if you look at institutions as physical institutions, much needs still to be done. Financial institutions and financial markets are required for the system to work well, and that kind of institution-building has not yet progressed enough in Latin America because of a lack of long-term policies. Institution-building is a long-term process, which requires time and stability, especially price stability and macroeconomic stability in the way we thought about it back in the sixties."

The Wyplosz Paper

José Antonio Ocampo, executive secretary of ECLAC, agreed with

the two basic ideas in Charles Wyplosz' paper, that there should be short-run fiscal flexibility with long-run fiscal discipline and that good judgement is better than rules. But he had "significant differences" in the diagnosis and in the recommendation. "In the diagnosis, a problem arises, for instance, by looking at Charles' figure on the debt ratios in Latin America. It is not really fiscal deficits but rather currency crises that drive the debt-to-GDP ratios in Latin America. Latin America had a history of fiscal indiscipline, but that is no longer true. If you look at time series of fiscal deficits for the 1990s, you would see that the deficits have actually been kept at very low levels, except in a few countries. Figure 2 in shows that the debt-to-GDP ratio in Latin America exploded once the debt crisis broke, and not before the crisis broke. And the same thing is true of Argentina. Their debt-to-GDP ratio increased sharply once the crisis broke, not before the crisis broke. So the problem with debt sustainability levels in Latin America is no different from how to avoid a currency crisis. The debt dynamics of Latin America are only secondarily determined by fiscal irresponsibility. Public debt dynamics are not determined by too loose fiscal policy, but rather by exogenous shocks, such as currency crises."

Ocampo observed that the reform policies in Latin America have increased the pro-cyclical bias of both monetary and fiscal policy. "We had sharper business cycles in large part because the reforms have enhanced the pro-cyclical bias of macroeconomic policies. I would be a bit careful about saying that the monetary institutions have been so excellent. If you go around Latin America, you will hear that autonomous central banks have certainly increased long-run flexibility, but probably have also increased the pro-cyclical bias of monetary policies."

Ocampo doubted whether a new institution like the proposed Fiscal Committee was really needed. "We have already achieved a lot more fiscal discipline in Latin America through existing institutions: first, through strong ministries of finance and second, through independent central banks. I was a finance minister in Colombia; I talked with the independent central bank about fiscal policy all the time. In our countries, independent central banks necessarily get all the time involved in fiscal policy and are a countervailing power in the fiscal area. Third, we have a lot of international pressure. Unfortunately, that international pressure is a bit pro-cyclical, including the pressure of the IMF. There is not enough pressure

during booms, and there is too much pressure during crises. Maybe changing the international pressure will actually help to reduce the pro-cyclicality. There may be one institution that is missing in the institutions, which is a strong advisory board to Congress. Think for instance of the role in the US of the Congress Committee on the budget, that is a very important institution that we are missing. The discussion in our congresses is very poor. So we may be missing some institutions, but a fiscal committee is probably not the sort of institution that we are missing."

Ocampo emphasised the importance of democratic discussions about the budget. "I would say that the increasing democratic discussion is better rather than worse. Technocracy is very good when it is part of a democratic discussion process; it is not good when it is free from democratic discussion. Actually one of the good things we have in Latin America today is that we have many technocrats in the public discussion presenting their views on what a correct fiscal policy is. That discussion should be a part of the process."

Yung Chul Park, of Korea University, wondered whether the proposed Fiscal Policy Committee would be involved in decisions on military spending. "Who is going to decide how much military spending there will be and on what hardware? (Not this Fiscal Policy Committee, oh I see, they will only deal with macroeconomics, right.) But there is the problem of income distribution and other targets related to expenditure, which has macroeconomic implications, and so does macroeconomic fiscal policy has microeconomic implications. Also, the politicians will come in and then they may find out that some of these committee members took bribes... So where do we stand on this?"

Park also had a question for Mark Allen, of the IMF. "I am increasingly disturbed by the IMF asking countries to do certain things, because that is what the markets ask for. What is the market, what are market participants? They are my neighbours, they are my brokers and they are my friends doing all kinds of research at the Deutsche Bank, or Citibank and all these banks. You don't think that the IMF has any influence on these market participants' behaviour? If it does not, well, you are in trouble!"

Zdeněk Drábek, of the WTO, fully agreed with Yung Chul Park's last remark, "because often the conclusion of an IMF programme is a precondition for any orderly lending by the private sector". He also agreed with Park's remark about the link between macro and micro

issues. "First of all it is not clear to me how it would be defined, but even if it is, we run into the kind of problems that Yung Chul has just mentioned. Take the example of the Czech Republic, which as of this year is trying to buy fighter planes amounting to 80 billion Czech Crowns. It is bigger than probably the total budget of federal and local authorities together. So obviously they have to go through the parliament. The parliament will be deciding on the purchase of fighter planes, and that is going to generate a debt of enormous proportions for the country. Now I just can't see how this would fit into the scheme of the fiscal policy committee."

Drábek also wondered what the link would be between the Fiscal Policy Committee and the Monetary Policy Committee. "Which of the two decides that their tool should be used as a counter-cyclical instrument, the Monetary or the Fiscal Committee? What incentives would you give to each one of them to operate? How do you ensure that they work consistently? That is another type of question that you will need to answer. It seems to me that it is not only a problem of not having control over fiscal instruments, that Mark Allen has mentioned, but also a problem of how to make these institutions to really operate. I am afraid you will run into very difficult issues."

Brian Kahn, of the Central Bank of South Africa, endorsed Drábek's question about the relationship between the Fiscal Policy Committee (FPC) and the Monetary Policy Committee (MPC). To explain the difficulties that are likely to arise, he mentioned South Africa's recent experience with a sudden change in the exchange rate. "I want to emphasise the issue of exchange rate shocks for emerging markets. Inflation targeting may work well in many countries, but the big test is whether it is sustainable in the presence of exchange rate shocks – which have an impact on the debt-to-GDP ratio. In South Africa in 2001, we had a shock of 40 percent depreciation of the rand against the dollar in a period of three months. You can imagine what that has done to our inflation target. This raises the issue of debt sustainability once you take the real exchange rate as part of the sustainability criteria. That leads to the problem of how do you relate to the two institutions together? What is the relation between the FPC and the MPC? These institutions work at different time horizons."

With regard to military spending, Kahn mentioned that South Africa recently had a similar situation as the Czechs. "There was an arms deal over 20 years, a contractual arrangement of around

25 billion dollars. It was very much a political decision that went through parliament. Obviously, it is denominated in dollars, which means that an exchange rate change would have major implications for the future financing of this transaction. How would the FPC deal with such a situation?"

Wouter Raab, of the Dutch Ministry of Finance, agreed on the importance that Wyplosz attaches to sustainable debt, but disagreed with the need for fiscal discretion. "Fiscal discretion leads to a debt bias in the long run since it is not applied symmetrically during the business cycle. Counter-cyclical policy is only applied in a downturn, not in an upturn. A more pragmatic reason why I am against fiscal discretion is that it is likely to have a pro-cyclical effect. For instance, it is important to realise that a recession usually only lasts some three quarters. We often need one or two quarters to identify a recession, then one quarter to decide on appropriate policy, and at least one quarter to implement this policy. This is why the average stimulus comes into force when the recession is already over. These lags make fiscal policy pro-cyclical, as the US witnessed in 2001. The most we can ask of fiscal policy is to let the automatic stabilisers do their work. The degree of stabilisation these offer depends on the economic structure of a country. I would expect that automatic stabilisers work a bit less in emerging markets than in the EU. Nonetheless, we should look for mechanisms to improve the workings of the automatic stabilisers instead of relying on fiscal discretion."

Raab missed the need for market flexibility in the economy in Wyplosz' paper. "One of the most efficient ways of dealing with cyclical shocks is increasing the flexibility of markets to adapt to changing circumstances. In Argentina, people were applauding Argentina's achievements, but I was struck by the inability to address the unemployment situation. Every macroeconomic system with an exchange rate that is delivering over 10 percent of unemployment with no perspectives of getting it down, is bound to come under serious constraints and pressure when exogenous shocks occur – because of the level of unemployment and constraint on the monetary policy authorities to raise interest rates etc. The credibility of a system that is not able to deliver full employment is at stake. It is more efficient, particularly in Europe, to try and make markets more flexible than work in the direction of fiscal discretion."

Raab wondered whether a panel of independent experts of the proposed FPC would be strong enough to apply strict symmetrical

fiscal policy around the cycle. "In Wyplosz' proposal, the FPC is fully transparent and democratically accountable to parliament. That could lead to a situation where the parliament does not agree with the proposition. If it can sack these people, how independent are they really? The pressure on them will be enormous. For example, how would you apply fiscal constraint in an upturn? Taxes cannot be raised in an upturn because that would raise inflationary pressure. Reducing infrastructural expenditure would just increase the bottlenecks, which are already in place in a situation of overheating. Lowering social benefits, for instance health care, just attacks the social cohesion. At a time when other incomes go up by 5 percent or more, this is a very difficult thing to do and is bound to stir a ferocious political debate. I wonder what the support for such an independent panel could be. If politicians are not keen on taking the responsibility for those actions, who else in society will? So I think you can not do without political leadership here."

Marek Dabrowski, a former deputy minister of Finance of Poland, saw a contradiction in Wyplosz' proposal. "On the one hand, you want to impose some rules on fiscal policy, which I am very sympathetic of. On the other hand, you want to leave quite substantial room for discretion, for counter-cyclical fiscal policy. To solve this contradiction, you look for a magic solution that has some characteristics of the technocratic illusion, that you can find a group of experts who will be able to solve this problem in an optimal way. In the real world, however, you have either a good track record in macroeconomic, monetary and fiscal policy, or not. If you have a good track record, this gives you a bit more room for flexibility and discretion. But then, if you have a good track record, you do not need an additional straitjacket.

In the case of developing and transition economies, discretion is not a good proposal. It is contradictory with a problem Charles addresses in his paper: the problem of expectations. If a country does not have a very good record and resorts to discretionary policy – even if it has certain rules for the discretionary policy – markets do not have to believe in the soundness of such discretion. And if the markets do not believe the soundness of discretion, they will penalise the country in a painful way. In my view, this is what happened in many emerging market crises."

A final criticism of Dabrowski on the Wyplosz proposal was that there is a problem of time lags and time horizon. "In the case of

monetary policy, the longest time lags between monetary changes, interest rates, and inflation effects are 18 to 24 months, and in most countries lags are shorter. But today's fiscal decisions will have an impact on financial sustainability in 10 or 20 years. What should be the time horizon of a FPC? Wyplosz talks about the possibility of revoking, changing the committee, if it does not follow rules. That means it is no longer independent. I cannot imagine that a parliament will stop the term of the committee because it is not tough enough. Probably it will only stop it because it is too tough."

Barbara Stallings recalled that the FPC is not a new idea since it had been proposed a number of years ago by Ricardo Hausmann of the Inter-American Development Bank and was subsequently rejected by the member states. "But if we look at Charles' paper in the spirit, and not in the letter, it offers much to recommend. I think it is very useful to clearly separate at the conceptual level the deficit or surplus issue from the level of expenditure and the taxation, to say nothing of the content of expenditures and taxation. In Latin America there are vast differences, no matter what the deficit or surplus is. There are countries that are raising and spending 30 to 35 percent of GDP and there are countries that are raising and spending less then 10 percent of GDP. This makes a tremendous difference. Not separating out the issue of deficit or surplus from the level of expenditure leads us to gloss over some very important issues in the fiscal area. It is also the case that external actors, whether it is the IMF or the bond markets, are basically interested in the deficit issues. So it gives you more flexibility if you can separate those out and keep those people out of the issues of levels of expenditure and taxes and the contents of expenditure and taxes.

My conclusion is, that we should take Charles' proposal in spirit as opposed to letter. We should concentrate on an advisory board as opposed to some board that could in principle make decisions. It is important to place this advisory board in Congress, to educate the Congress about these kinds of issues. The Congressional Budget Office in the US is a good example. I would second that as a more flexible and realistic version of Charles' proposal."

In his reply, Charles Wyplosz first noted that many critics did not take to heart the importance of separating decisions on the deficit from decisions on the level and structure of spending and taxation. "Take for example the weapon acquisition issue. If the democratically-elected authorities insist that they have to spend

resources on weaponry, this is their absolute right but it is not a technocratic question to ask how this item will be financed. The proper framework has to be one that requires the authorities to answer that question at the same time as the proposal is put to the parliament. One solution – not necessarily the best – may be to raise the debt ceiling, which would then be given to the FPC as a modified target. It is hard to believe that explicitly recognising the debt implication is less desirable than keeping the financing implicit as seems to be the case in the examples described by various speakers. The critics miss the simple point that for such purchases not to endanger debt sustainability, we need accounting procedures that extend over the long run, FPC or no FPC. FPC-type arrangements impose a proper accounting, and that cannot be construed as a weakness of the proposal."

Wyplosz recognised that the question of coordination between the FPC and the MPC is very important. "As noted by José Antonio Ocampo, the debt is largely endogenous to the exchange rate, which lies partly in the hands of the central bank. But let's separate the debate into two questions. The first one concerns the danger of a vicious circle that goes from market fears of debt non-sustainability to currency crashes and to effective debt non-sustainability. This is by now a classic and well understood case of self-fulfilling crisis, driven by expectations. If the markets believe that a debt default is looming, there is little that the central bank can do about it. There is much debate on the merits of an interest rate defense, if only because sharply raising the interest rate also threatens debt sustainability. There is no miracle solution, but any one will have to work on market expectations. The essential merit of an independent and powerful FPC is precisely to anchor expectations. An untested FPC may not always be able to break market concerns, but it is now increasingly recognised that adequate institutions represent our best hope to deal with market jitters. Until a better institutional proposal is put forward, the FPC idea is the one that comes closest to providing protection against this kind of crisis that has repeatedly played havoc throughout Latin America.

The second aspect is the risk that the MPC and the FPC will attempt to act as free-riders on each other. Both must be independent and democratically accountable. Being shielded from electoral pressure, they are unlikely to be major offenders, and both are likely to be exceedingly prudent. This confirms the remark by José Antonio

Ocampo that independent central banks are found to act in a pro-cyclical way. I admit that this is a structural weakness of such institutions, one that will be erased by proper political oversight within the democratic accountability framework. Until that happens, there might well be some degree of pro-cyclicality. Bad as it may be, it is better than runaway inflation and debts, which is what we have seen over the last decades."

Wyplosz finally addressed the "technocratic illusion" problem mentioned by Marek Dabrowski and others. He noted first that the only item removed from the realm of politics is the deficit, not the other more sensitive aspects of the budget. He then observed that, like price stability, debt sustainability requires some limit on the deficit process. "A rule does just that, and no one objects to it. A FPC is only an intelligent, i.e. feed-back rule. So the problem is the feed-back, the fact that someone can realise that blindly applying a rule can be counter-productive. Yet, this has become acceptable for monetary policy, so the real problem is to go one step further in the same direction. What may seem unrealistic today may become reality tomorrow. Just remember when we started to talk about monetary union at a similar table 15 years ago, everybody was laughing, saying it is politically unacceptable. I remember having discussed the idea of independent central banks with the authorities of a number of countries, and people were laughing at me. They said, 'you can't start thinking about that, it is politically unacceptable'. About capital account liberalisation, Jürgen Stark said, 'We changed our mind'. I predict you will change your mind faster than you think."