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To: Members of the Executive Board

From: The Acting Secretary

Subject: **Summary of the Conference on EMU and the International Monetary System**

Attached for consideration by the Executive Directors is a summary of the conference on EMU and the international monetary system, which was held at headquarters on March 17-18, 1997. This paper, together with the paper on preparations for economic and monetary union (SM/97/87, 3/26/97), will be brought to the agenda for discussion on a date to be announced. A conclusion and topics for discussion appear on pages 8 and 9.

Mr. Masson (ext. 37483) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

**Summary of the Conference on EMU and
the International Monetary System**

Prepared by the Research Department

April 9, 1997

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SUMMARY OF THE CONFERENCE ON EMU AND THE INTERNATIONAL MONETARY SYSTEM

1. The conference, which was held at the IMF on March 17-18, 1997 (see Appendix I for the program and Appendix II for the list of participants), indicated a broad consensus among participants on several broad issues, but on a number of questions it was clear that more work was needed to understand the implications of EMU for Europe and the world economy. Indeed, considerable uncertainty is likely to persist even after the start of monetary union, as countries are likely to join in stages and various structural changes might occur as a result of EMU.

2. Most participants considered that EMU was likely to start as scheduled on January 1, 1999, even though there remained some risk of a postponement if key countries were unable to satisfy the criteria on the basis of 1997 data. One cautionary note came from Mr. Regling later in the conference, who stressed that legal concerns and a skeptical German public tightly constrained his government's ability to proceed to EMU on time if there were significant slippages from reference values. Messrs. Camdessus, Frenkel, and Volcker pointed to risks inherent in any postponement, given the uncertainty that a delay would create. It was also generally accepted that the euro would most likely be a strong currency, backed by a monetary policy oriented towards price stability and by conservative fiscal policies, as required by the Stability and Growth Pact. On a different, though related question, there was concern that EMU would see greater movements of exchange rates, some participants pointing to the dangers of instability resulting from a European central bank less concerned, because the external trade of the euro area would be a small share of GDP, about the exchange rate and others to the consequences of a sharp shift of portfolios out of the dollar and into euro-denominated assets. Several participants stressed the difficulties of managing a single currency in the context of inadequate labor market flexibility and uncoordinated national fiscal policies.

3. Participants at the conference considered in some detail the prospects for international economic policy coordination. Two aspects of this question received the most attention: what EMU would mean for the G-7 process, and how the IMF would need to adapt its procedures and relationships with its EU members once the ECB had responsibility for monetary policy and the euro had replaced national currencies. It was clear that considerable additional work was needed, preferably in advance of the starting date for EMU, to understand the policy, institutional, and operational consequences of monetary union and to make necessary adaptations.

I. STATUS OF THE EURO AND ITS POTENTIAL ROLE AS AN INTERNATIONAL CURRENCY

4. The attractiveness of the euro, it was generally agreed, was likely to be determined mainly by the macroeconomic policy stance in Europe, and, in particular, by the success of the ECB in achieving low inflation. On the latter issue, there was general agreement that the ECB

would follow in the steps of the Bundesbank in its dedication to price stability, and be independent of political interference as provided in its statutes. Other factors are also likely to be important in affecting the international use of the euro, and these include the development of integrated, liquid, and efficient European financial markets. Reserve currency use is likely to evolve slowly, but the euro would start as the second most important reserve currency and could, over time, rival the dollar. Truman argued that such a status would not, however, confer on Europe any special economic benefits, no more than has been the case for the U.S. dollar over the past 50 years.

A. Will the Euro be a Strong Currency?

5. This issue generated much discussion, with several participants focussing on portfolio diversification as the primary factor influencing the initial strength or weakness of the euro. Alogoskoufis and Portes, for instance, argued that international investors would immediately want to hold more assets denominated in euro than there existed a supply of such assets. This could be expected to appreciate the euro, causing the EMU countries to run a current account deficit which would increase the supply of euro assets over time, permitting a subsequent depreciation of the currency. Bergsten took a more nuanced view of the prospects for appreciation of the euro, though in his view European currencies were now over-depreciated (perhaps deliberately) against the dollar, making an appreciation appropriate. He stressed that despite his general preference for target zones for the major currencies to facilitate policy coordination, uncertainty surrounding the implementation of EMU would make target zones undesirable initially. This view on target zones was shared by other participants, among them Truman, who was concerned that a focus on exchange rates would deflect attention away from underlying macroeconomic policies.

6. In contrast, the possibility that the supply of assets in euro might eventually increase more than the demand was raised by White and McCauley; this might lead to depreciation, not appreciation, of the euro. Indeed, because of relatively underdeveloped European financial markets, the share of the world supply of assets in EU currencies falls well short of Europe's economic importance. This might well change with EMU, and in addition to redenomination of existing liabilities in EU currencies into euro, foreign issuers might want to borrow in euro if integrated European financial markets meant efficiency gains and hence lower borrowing costs. White and McCauley, as well as Schinasi and Prati, saw the introduction of the euro as a potential driving force for increased securitization, creation of a liquid EMU-wide money market, and development of more integrated and liquid bond markets. All of these things should contribute to the attractiveness of the euro for both international borrowing and lending. While Alogoskoufis and Portes were bullish on the prospects for the euro in this regard, other participants were more agnostic.

B. Volatility

7. Even a strong euro might be subject to considerable volatility—a subject discussed by a number of participants. One influence is the more closed nature of the European economy than that of any country alone, for instance Germany. As Pisani-Ferry pointed out, however, Europe is already closed—the introduction of the euro is not the cause of that—and a core group of EMS countries already in effect operates like an exchange-rate bloc. The issue is whether the ECB would pay more or less attention to the exchange rate than the Bundesbank. He and his co-authors conclude that it will pay less attention, and hence that EMU may increase the volatility of the real effective exchange rate of the dollar in response to shocks, but only moderately. Others argued that, given the paucity of EMU-wide economic indicators at the start of EMU and the practical challenges involved in devising new monetary policy operating procedures, the ECB may have little choice but to place greater weight on the exchange rate in the early stages of EMU. Cohen shared the conclusion that volatility will increase—indeed by a substantial amount—but his results depend on price shocks, not demand shocks, being dominant, and his analysis was questioned by Dixon.

8. Another potential aspect of exchange rate volatility is the relationship between the countries adopting the euro and those EU countries that do not join EMU. A successor to the exchange rate mechanism of the EMS has been designed to link the "ins" and the "outs"—termed the ERM2. This mechanism would involve wide bands and the proviso that exchange market intervention should not endanger the price stability objective of the ECB. It is envisaged that realignments would be jointly decided, done in time to prevent "one way bets" from developing, and would be small enough so that new central rates would be within the old bands of fluctuation. De Grauwe argued that though the above features, and the achievement of a considerable amount of economic convergence, would deter speculation and make less likely the type of crisis that occurred within the ERM in 1992–93, other features might make the ERM2 vulnerable. In particular, the crucial nature of the Maastricht fiscal criteria might make countries vulnerable to shifts in market sentiment, especially if they had high debt levels. For instance, a country whose commitment to entering EMU was thought to be flagging might pay higher interest rates on its debt, widening the budget deficit and setting in motion a self-fulfilling spiral. Another problem facing the ERM2, as he saw it, was the overvaluation of the core currencies relative to the peripheral ones, so that the latter might therefore need to appreciate over time. According to Ghironi and Giavazzi, volatility could be minimized by including as many countries as possible in EMU.

C. The Use of the Euro as Official Reserve Currency

9. Several participants pointed to the attractive features of the euro as a reserve currency, though its use for that purpose would only develop gradually. At the outset, in fact, EMU would reduce the importance of European currencies in world reserves, since as pointed out by Masson and Turtelboom intra-EMU holdings of the currencies to be replaced by euro would no longer be international reserves. Moreover, the bulk of reserves outside the EU

were held by east Asian countries, which were unlikely to want to use the euro as an exchange rate anchor, so substitution of dollars by euros was likely to involve gradual portfolio diversification. Bergsten and Alogoskoufis/Portes argued that the euro would have attractive features relative to the dollar, and over time the euro should constitute a rival to the dollar as a reserve currency: it would be based on a wide economic area with an overall current account surplus and would develop as a vehicle for invoicing trade and for effecting foreign exchange transactions. Nevertheless, the potential for a shift out of dollar reserves was not viewed by participants as a major issue for exchange rates.

D. The Euro and Financial Markets

10. White/McCauley and Schinasi/Prati both saw the introduction of the euro as a catalyst for the development of integrated money and bond markets in Europe. The disappearance of intra-European exchange rates would increase the focus on credit risk in the government bond market. Similarly, the euro would likely lower the cost for private borrowers of raising capital without bank intermediation, which will spur the corporate bond market. How far and how quickly these markets will change will depend on regulatory developments and changes in investor attitudes. Kato and Truman stressed that these developments in European markets would be very welcome; they do not make other markets less transparent or liquid. Moreover, as Kawai noted, parallel moves in Japan towards deregulation of financial markets as well as expansion of trade with Asia might well make the yen more prominent as an international currency; it was by no means certain that the relative importance of the yen would decline after EMU.

11. Even without EMU, technological progress and regulatory changes are already forcing a rationalization of European banking systems. White/McCauley and Schinasi/Prati pointed out that the arrival of the euro will further increase competition among banks themselves and between banks and alternative sources of funds. While this will likely lead to a further consolidation of the sector eventually, White/McCauley suggested that slow regulatory progress and the value of local expertise will retard this process. Hogeweg also stressed that EMU would involve considerable decentralization of central banking activities.

II. INTERNATIONAL ECONOMIC POLICY COORDINATION

A. Relations Between the Euro Bloc and Neighboring Countries

12. Creation of EMU was viewed by participants as having generally positive effects on neighboring countries, provided that the euro was stable and neither too strong nor too weak. However, volatility in the euro would have negative effects on them. It was to be hoped that European integration would increase cooperation between the EU and some neighboring countries, and that the euro might become an important pole for exchange rate stability. In particular, countries of central and eastern Europe (CEEC) and the Mediterranean might limit

their exchange rate fluctuations against the euro as part of a transition to eventual membership in the EU—a possibility suggested by Szapary of the Bank of Hungary. However, Carré argued that they should not prematurely adopt a pegged rate until convergence had been achieved, and pointed out that the ERM2 was designed for existing EU countries, which in most cases were close to qualifying for EMU, and not the CEEC, which were much further away.

13. As for relations with the CFA franc zone, Carré argued that EMU would not cause any substantive change except for the replacement of a peg against the French franc with one against the euro. He and several other participants viewed the arrangement as a budgetary agreement involving the French Treasury, rather than a monetary arrangement which would involve the European institutions. This contention was challenged, however, by Goos, who suggested that this was an exchange rate arrangement which therefore needed to be considered by the Council of Ministers.

B. Coordination Among the Major Currency Blocs

14. Concern was expressed by a number of participants, including Bergsten and Alogoskoufis/Portes, that EMU would involve Europe turning inward and having less interest in international policy coordination. In addition, the Maastricht Treaty raised complicated issues of responsibility for international economic policy and of representation of the EU in international fora. The ECB had clear responsibility for monetary policy, and the Council for formal exchange rate agreements, in addition to providing general orientations for exchange rate policy. There was a gray area between them, which might make the ECB reluctant to adventure into agreements where jurisdiction was unclear. In practice, international monetary cooperation might not be facilitated by the concentration of monetary powers in the ECB, since coordination might need to involve fiscal authorities as well; but here, there was no clear, single interlocutor.

15. While the problem of representation was also acknowledged by Masson, he argued that in a situation of considerable uncertainty concerning the economic structure—knowledge of which was essential to carrying out an intermediate targeting framework, whether for money or inflation—the ECB might be receptive to international coordination initiatives. In this context, it would not be indifferent to the value of the exchange rate of the euro, and might seek exchange rate stability to enhance its credibility and convince public opinion that the euro would be neither too strong nor too weak.

16. Bergsten argued that EMU should in effect lead to a replacement of the G-7 by a G-3 for economic and monetary issues. However, for that to occur, it would be necessary for Europe to have a clear counterpart to the ECB when it came to fiscal policy and exchange rates. Until this occurred, he was concerned that a situation of "benign neglect" would prevail, but that this would be very dangerous because it would slow the responses of Europe to potential crises—a concern also voiced by Truman. King also highlighted this unique aspect of

monetary union: for the first time, the principle of "one country, one currency" had been replaced by "one market, one money"—a point echoed by Volcker. The Managing Director, in a lunch time speech, suggested that the Fund had an important role to play in identifying exchange rate misalignments and in encouraging that the necessary policy adjustments be taken.

III. EMU AND THE RELATIONSHIP BETWEEN THE FUND AND ITS EMU MEMBERS

17. Although it was clear that EMU will not affect the rights and obligations of members under the Articles, the transfer of monetary policy responsibilities to the ECB and the replacement of existing European currencies by the euro raise a number of issues for the IMF. These include how surveillance is to be carried out, whether and how Fund resources should be made available to EMU members, how Fund quotas might be affected, whether the SDR needed to be redefined, and how the euro would be used in Fund operations. It was clear from the discussion that no simple answers were yet available, but that work on these questions was urgently needed. Indeed, Interim Committee Chairman Maystadt, in a luncheon speech, called for a special taskforce to be established within the Fund in order to prepare the changeover to the euro. In particular, he suggested that "[o]ne way to make rapid progress could be for the Fund staff to prepare, possibly after consultations with the European Commission and the European Monetary Institute, a paper accompanied by a questionnaire on the main issues to be addressed in the short, medium, and long term, which could stimulate the discussions within, on the one hand, the Executive Board of the IMF and, on the other hand, the Ecofin Council and the Monetary Committee of the European Union."

18. Both papers on this topic, by Polak and Thygesen, stressed the importance of a continuation of Fund surveillance; indeed, it might be more relevant in the context of a complicated transition to EMU of a subset of EU countries and of the establishment of the ERM2 arrangement. Clearly, Fund surveillance should involve the ECB; modalities for consultations with it as well as the national authorities, which retained responsibilities for other macroeconomic policies, needed to be worked out. In addition, Frenkel stressed the importance of enhanced surveillance of financial markets and capital flows, if, as expected, the euro provides a boost for European and international financial markets.

19. The issue of possible use of Fund resources generated much controversy. Polak argued that, though they were unlikely to draw on Fund resources, individual EU countries might nevertheless be somewhat more likely to come to the Fund after EMU, since monetary bailouts and EU balance of payments assistance would not be forthcoming. He also argued that a member country would still have a balance of payments, and hence the criterion of balance of payments need would still be relevant under EMU, a point challenged by others. Even if relevant, it was not clear how it might be assessed.

IV. THE TRANSITION TO EMU

20. Though the focus of the conference was on the international monetary system after EMU, the issue of the transition to EMU was discussed at a final round table. The participants had differing views of the extent that transition was likely to proceed smoothly, and of the possible pitfalls in the early years after the start of EMU. This round table was also an opportunity to raise the issue of a possible delay of the start of EMU.

21. Larnaudie-Eiffel stressed the progress made in ensuring a smooth transition and in giving legal certainty to the euro when it is created, including outside the EU. He emphasized that the selection of qualifying countries would be part of a transparent process and subject to clear criteria. The precise timetable for the decision on membership in EMU is to be decided soon.

22. Regling reiterated the German position that the criteria would be applied strictly, pointing to the need to satisfy German public opinion that monetary union would ensure stability. Since many countries are still above the deficit criterion, more fiscal measures are needed. Given the use of "creative accounting," in his view there was no more room for interpretation in meeting the criteria. He could not exclude the possibility that Germany might not qualify, which might therefore lead to postponement. However, he reiterated the German government's intention to take the necessary measures.

23. Heikensten and Jenkins highlighted some dangers associated with the transition. Heikensten was skeptical that EMU would operate smoothly with rigid labor markets, and was concerned that EMU might not be a good thing for Sweden if it faced asymmetric shocks. Nevertheless, staying out could pose problems, since in any case, the Swedish financial sector would begin adopting the euro, and volatility of the exchange rate against the euro might pose significant problems. Jenkins argued that transparency and clearly articulated procedures would be essential, a point made earlier by Frenkel.

V. CONCLUSION AND TOPICS FOR DISCUSSION

24. Though the conference by no means gave definitive answers to all the important questions concerning EMU and the international monetary system, it succeeded in clarifying some issues and identifying areas where further work is needed. In general, participants expected that the timetable for EMU would be respected, and that the euro would be associated with good anti-inflationary performance and a credible European Central Bank. As a result, the euro should become an important international currency, second only to the dollar, and, over time, perhaps a rival to it. However, EMU might be associated with increased exchange rate volatility, and it would be important to facilitate, and, indeed, enhance international economic policy coordination. In this regard, the Managing Director has called for greater involvement of the Fund in analyzing equilibrium exchange rates and in advising EU governments in the run up to EMU and during its early years.

25. Considerable preparatory work will be necessary before the implications for the Fund are fully understood, and hence the need for possible changes in the relations between the Fund and its EU members. Interim Committee Chairman Maystadt has suggested the following agenda for that work: preparation of a paper for Executive Board consideration this fall, and discussion of the issues by the Interim Committee during the fall of 1998 at the latest, and perhaps even before, at the spring meetings.

26. Rather than returning to the technical issues that were the main focus of the conference, Directors may wish to comment on the way to proceed with further work in the Fund on the international implications of EMU.

- **Preparation for the institutional changes.** Preparation for changes in the Fund's activities and arrangements necessitated by the formation of EMU is crucial. Directors have the opportunity of a preliminary discussion of a number of these issues in the context of SM/97/87. It is likely that these preliminary discussions will leave many issues unresolved. Do Directors think that it would be appropriate for staff to prepare, in time for Board discussion before the 1997 Annual Meetings, a staff paper treating in greater depth several of the main issues that need to be urgently addressed and the relevant alternatives for dealing with them?
- **The role of the Fund vis-à-vis EMU.** Work on the regional and international implications of EMU will no doubt be an important focus of Fund surveillance on an ongoing basis before EMU occurs and after. In addition to the regular reports on consultations with national authorities and on ongoing staff contacts at the national and supranational level, would it be appropriate to address some of these issues in the World Economic Outlook to be discussed in August 1997, and leading to the usual follow-up report to the Interim Committee at the fall meetings?

**Conference on “EMU and the International Monetary System”
March 17-18, 1997
Washington, D. C.**

Co-sponsored by the IMF and the Fondation Camille Gutt

Monday, March 17

Session 1: Policy Coordination and a Tripolar International Monetary System

Chair: Muhammad Al-Jasser

Papers: Fred Bergsten, “The Impact of the Euro on Exchange Rates and International Policy Cooperation”
George Alogoskoufis and Richard Portes, “The Euro, the EU, and the Global Economy”

Discussants (for both papers):

Barry Eichengreen, Masahiro Kawai, and Jean-Pierre Patat

Session 2: Exchange Arrangements of Other Countries vis-à-vis the EMU

Chair: Alassane Ouattara

Paper: Paul De Grauwe, “Exchange Rate Arrangements Between the Ins and the Outs”

Discussant: Jacques Mélitz

Paper: Hervé Carré, “Exchange Arrangements with Eastern Europe, Mediterranean, and African Countries”

Discussant: György Szapary

Session 3: The Euro as a Reserve Currency and Exchange Rate Volatility

Chair: Hanna Gronkiewicz-Waltz

Paper: Jean Pisani-Ferry, A. Bénassy-Quéré, and Benoît Mojon, “EMU and Exchange Rate Stability”

Discussant: Ralph Bryant

Paper: Paul Masson and Bart Turtelboom, “Characteristics of the Euro, the Demand for Reserves, and Policy Coordination Under EMU”

Discussant: Bandid Nijathaworn

Round Table: Lessons of European Monetary Integration for the International Monetary System

Stanley Fischer (Chair), Jacob Frenkel, Takatoshi Kato, Mervyn King, André Szász, and Edwin Truman

Tuesday, March 18

- Session 4: Euro Financial Markets and the International Financial System
Chair: Daniel Kaeser
Paper: Garry Schinasi and Alessandro Prati, "European Monetary Union and International Capital Markets: Structural Implications and Risks."
Discussant: Gert Jan Hogeweg
Paper: William White and Robert McCauley, "The Euro and European Financial Markets"
Discussant: Age Bakker
- Session 5: The External Dimension of the European Policy Mix
Chair: Michael Mussa
Paper: Daniel Cohen, "How Will the Euro Behave?"
Discussant: Joly Dixon
Paper: Fabio Ghironi and Francesco Giavazzi, "Policy Implications of the Size of EMU for Europe and the United States"
Discussant: André Sapir
- Session 6: Relations among the IMF, the ECB, and Fund/EMU Members
Chair: Jean-Jacques Rey
Papers: Jacques Polak, "The IMF and Its EMU Members"
Niels Thygesen, "Relations Among the IMF, the ECB and Fund/EMU Members"
Discussants for both papers:
Bernd Goos, Jean-Victor Louis, and Francois Gianviti
- Round Table: The Transition to EMU
Massimo Russo (Chair), Lars Heikensten, Paul Jenkins,
Xavier Larnaudie-Eiffel, and Klaus Regling

**List of Participants
(Those on the program)¹**

Muhammad S. Al-Jasser
Vice-Governor, Saudi Arabian Monetary Agency
Saudi Arabia

George Alogoskoufis
Professor, Department of Economics
Athens University of Economics and Business
Greece

Bandid, Nijathaworn
Director, Banking Department
Bank of Thailand
Thailand

Age F.P. Bakker
Deputy Director, Netherlands Bank
Netherlands

C. Fred Bergsten
Director, Institute for International Economics
Washington, DC

Ralph Bryant
Senior Fellow, The Brookings Institution
Washington, DC

Hervé Carré
Director, Monetary Matters
DGII-European Commission
Belgium

Daniel Cohen
Professor, Ecole Normale Supérieure
France

¹This list does not include representatives of IMF Executive Directors' offices or IMF staff.

Paul De Grauwe
Professor, University of Leuven, and CEPR
Belgium

Joly Dixon
Director of International Economic and Financial Matters
DGII-European Commission
Belgium

Barry Eichengreen
Professor, Department of Economics
University of California at Berkeley

Jacob A. Frenkel
Governor, Bank of Israel
Israel

Fabio Ghironi
Department of Economics
University of California at Berkeley

Francesco Giavazzi
Professor, Innocenzo Gasparini Institute for Economic Research
Italy

Baron Jean Godeaux
Chairman, Fondation Camille Gutt
Belgium

Bernd Goos
Head, International Relations Department
Deutsche Bundesbank
Germany

Ms. Hanna Gronkiewicz-Waltz
President, National Bank of Poland
Poland

Lars Heikensten
Deputy Governor, Sveriges Riksbank
Sweden

Gert Jan Hogeweg
Head of the Monetary, Economic and Statistics Department
European Monetary Institute
Germany

Paul Jenkins
Deputy Governor, Bank of Canada
Canada

Takatoshi Kato
Vice Minister of Finance for International Affairs
Ministry of Finance
Japan

Masahiro Kawai
Professor of Economics, Institute of Social Sciences
University of Tokyo
Japan

Mervyn King
Chief Economist and Executive Director
Bank of England
England

Xavier Larnaudie-Eiffel
Director, Cabinet of the Commissioner
European Commission
Belgium

Jean-Victor Louis
Advisor to the Board of Directors and
Head of the Legal Department
Banque Nationale de Belgique
Belgium

H.E. Philippe Maystadt
Deputy Prime Minister and Minister of
Finance and Foreign Trade
Belgium

Robert N. McCauley
Bank for International Settlements
Switzerland

Jacques Mélitz
INSEE-CREST
France

Benoît Mojon
Centre d'études prospectives et d'information internationales (CEPII)
France

Jean-Pierre Patat
Director General of Foreign Affairs
Banque de France
France

Jean Pisani-Ferry
Directeur
Centre d'études prospectives et d'information internationales (CEPII)
France

Jacques J. Polak
Per Jacobsson Foundation
Washington, DC

Klaus P. Regling
Director General, European and International Financial Relations
Ministry of Finance
Germany

Jean-Jacques Rey
Director, National Bank of Belgium
Belgium

André Sapir
Advisor to the European Commission and
Professor, Université Libre de Bruxelles
Belgium

György Szapary
Deputy President, National Bank of Hungary
Hungary

André Szász
Executive Director
De Nederlandsche Bank, NV
Netherlands

Niels Thygesen
Professor, Institute of Economics
University of Copenhagen
Denmark

Edwin M. Truman
Staff Director, Division of International Finance
Board of Governors of the Federal Reserve System
Washington, DC

Paul A. Volcker
James D. Wolfensohn, Inc.
New York, NY