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Richard A. Grasso
Chairman and Chief Executive Officer
New York Stock Exchange

The Honorable William J. McDonough
President and Chief Executive Officer
Federal Reserve Bank of New York

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Questioners: Robert D. Hormats, Vice Chairman
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Introduction

Barbara Hackman Franklin

Good evening. I am Barbara Hackman Franklin. I am very pleased to welcome you to the 359th meeting in the 91st year of the Economic Club of New York. Normally, of course, the club's chairman would be the one to welcome you, but our chairman, Bill McDonough is otherwise occupied on our behalf tonight. And if Bill had to both preside and speak, it would have meant, among other things, that he would have to introduce himself, which might have taxed even his diplomatic skills, which are considerable. So he has asked me to stand in for him and I am honored and delighted to do so. I am especially please because I am told that this is the first time in the history of the club that a person of my gender has presided. (Applause) The first time in 91 years and I think it is time. (Applause) Thank you. This is also or first program in a long while, if ever, at which both speakers are themselves members of the Economic Club and members of the board. Bill McDonough our Chairman and Dick Grasso, one of our trustees. Besides that, each speaker's immediate predecessor in his present post is also a member and is here with us on the dais. Bill Donaldson, whom Dick followed as the Chairman of the New York Stock Exchange and Gerry Corrigan whom Bill followed as President of the New York Fed. If all that seems a little clubby, and even a little New Yorky, well, this is a Club and there is only one New York. (Applause)

Now we turn to our program and the discussion of global markets, global equities. And since our two very distinguished speakers are not exactly strangers to you, I will be brief in my introductions. The first speaker is Richard A. Grasso, Chairman and Chief Executive Officer of the New York Stock Exchange. This is the world's largest equities market with a market capitalization of more than $12 trillion. That is roughly twice the Gross Domestic Products of Japan, Germany, France and the U.K. combined. Dick has spent his entire 30-year career with the Exchange and in June of 1995 made history as the first member of the staff ever to become Chairman and CEO. Under his leadership the New York Stock Exchange has been driving aggressively into global equities markets while also competing relentlessly here at home and investing in cutting edge technologies. Within days of taking over the helm, he traveled to London where he told a group of European executives that he would lure Europe's glamor firms over to the New York Exchange. And then he opened a satellite office in Silicon Valley, or near Silicon Valley in California to woo NASDAQ's technology firms. I must say, Dick, I've come across your footprints around the world and here at home. But there's another side to Dick Grasso. A couple of years ago for a charity event, he put on boxing trunks and gloves and got into the ring with the International Boxing Federation Super Middleweight Champion. It is not entirely clear who won, although I did see a magazine photo of Dick standing triumphant over the fallen champion. Perhaps there is some message here. I am very pleased to introduce to you Dick Grasso. (Applause)

Richard A. Grasso

Chairman and Chief Executive Officer

New York Stock Exchange

Thank you very much, Madam Secretary. And let me join in saying that it may have taken 91 years but they've finally gotten it right here at the Economic Club. So congratulations. (Applause) I'm deeply honored and, needless to say, delighted to be here this evening and most importantly to share this forum with Bill McDonough. I've come to know Bill over the course of many years and have had the privilege of working closely with him. He is truly an extraordinary leader of the New York Fed. We, in financial markets here in the United States and really around the world, are very fortunate to have a person of Bill's vision, leadership, and his steady hand at the New York Fed, particularly in these very troubled times.

Barbara, I will say in response to that very kind introduction that never prior nor since has Roy Jones, Jr. been on the mat. (Laughter) But there never was any doubt who the big winner was that evening – we raised $2 million for the United States Olympic Committee. And I guess it proves that intelligence and being Chairman of the New York Stock Exchange on occasion can be mutually exclusively.

I'm delighted this evening to focus my comments on the issue of global equity markets. Some would suggest, as we sit in this, the last month of an extraordinary year, that the future of global equity markets is already upon us, and I would agree. I believe the globalization that we've talked about for so many years in the financial community arrived on the 17th of November with a listing on the New York Stock Exchange of the securities of the newly created DaimlerChrysler – the first truly global equity ever to trade in New York and simultaneously in 16 other markets around the world. It was for the NYSE a true moment that defines the future of our business.

When market historians look back on 1998, they will see a year in which the Asian Crisis continued – the recent recovery notwithstanding – they will see the collapse of emerging markets in Russia and other parts of the world. They will see sharp declines in the U.S. equity market followed by sharp corrections followed by sharp declines. But most importantly, as they look back I hope market historians will say it was that day in November of 1998 that global equity became a reality, not just in New York, but in markets all over the world. Tonight I'll focus my comments on how that one signature event may tell us something about the shape of global capital, how it will be raised, and most importantly, the customers and products who will play an increasing role in shaping that landscape as we move to the next millennium.

I think the event DaimlerChrysler suggests is a reminder that globalization will be driven by customers, will be driven by the identification of new opportunities. When DaimlerChrysler first approached my colleagues and I at the stock exchange with the idea of a singular worldwide instrument, one that would trade continuously in all markets separated only by currencies and time of day, it was with the basis of a real business objective in mind. The company wanted to avoid creating any artificial separations for its owners, 57% or so of whom were in the German marketplace with about 43% or so in the U.S. marketplace.

For us, and for you as holders, DaimlerChrysler did not want an ADR to separate owners on one continent from owners in another. They simply wanted to create a realization that a true global entity had been created. Had U.S. holders seen some form of artificiality to separating their ownership from the script that trades in the Deutsche Börse, my sense would be they would have liquidated in greater numbers than anyone could have anticipated, particularly given the fact that Chrysler had been a component of the Standard and Poor's 500 Index. And I know we all know what happens when an instrument is exited from the index. On that day, the last day of trading for old Chrysler, some 44 million shares changed hands on the last, the last transaction on the New York Stock Exchange. A single trade, more volume in one security than the average daily volume on the New York Stock Exchange as recently as 1976.

For European holders, the creation of this new global script created the opportunity to compete effectively with capital markets around the world. We worked with Daimler and with our counterparts at the Deutsche Börse, with regulators, depositories, ADR agents here in the United States, and literally a team with the enormous focus driven by the financial advisors to both Daimler and Chrysler to create this watershed event. The security that would trade in the U.S. in dollars, on the Deutsche Börse in Deutsche mark, and in 16 other markets around the world in whatever currency those markets would choose.

We created for the first time a fungibility and a concept where equity could follow the sun. In essence, Daimler removed all of the artificial barriers to an investor's decision to buy, sell, or hold, whether one was an investor in Frankfort, New York, KL, or Singapore. This, I believe, will define as we go forward – this event – the creation of a worldwide singular instrument, how global equity markets will be structured, and how they will compete. We have already seen a number of companies knock on that same door of opportunity following the lead of DaimlerChrysler, and I would not be at all surprised to see a similar instrument for some global mergers that are today in the discussion stage.

On a separate parallel track, within the next two years we will introduce at the NYSE a pilot program for a dozen of our non-U.S. companies that today trade in ADR format only – a pilot program that will allow those securities to trade both in ADR format and in their ordinary shares, creating or replicating the success we have achieved, even though it's only brief, since the creation of DCX and serving as an important springboard for how we shape our markets as we move to the next millennium. I believe that DaimlerChrysler will be looked back upon not just as a company with a global vision but as a company with a global security, with markets around the world, recognizing for the first time that as we move forward there'll be no separation other than that of liquidity, transparency, and the ability of investors to find user-friendly markets. The traditional separations of national boundaries and bodies of water, time of day, will quickly evaporate. We believe we have set in value a model that will serve the U.S. equity markets extraordinarily well as we begin that long talked about competition in the global theater. What is important to us and important to global equity markets is the externalization, the exportation of a model that we've enjoyed in this great country for almost 100 years, the model of ownership – equity capital as opposed to reliance upon debt, the free market principles defining losers and winners and owners being the beneficiaries for those who win. In developed markets, raising equity capital has long been a crucial factor in raising a nation's wealth. In emerging markets, equity capital will play a key role in their economic survival, repositioning, and future growth. Equity capital becomes the tool, ladies and gentlemen, it balances the burden of debt, provides the stability of long-term investment, offers cost efficient access to capital, democratizes participation in economic growth, and leads to the transparency and widespread ownership that we've enjoyed here in the U.S.

These are benefits essential for developed economies. We, in this country, have been very fortunate. Over the last 20 years we have seen our universe of shareholders grow from fewer than 40 million to almost 70 million Americans. At the middle of this decade, almost 70 million Americans today participate on a direct basis in the equities market. When you add to that indirect participation, some 130 million strong, 200 million Americans are today tuned in to the floors of the New York Stock Exchange and other markets, to those journalists who cover the movement of markets on a minute-by minute basis. And how proud we should all be and how fortunate we should feel that today we focus on the movement of equity prices, not on the movement of troops, that what is important is how we focus on building economic wealth, creating, if you will, out of shells of models past, models for the future.

The listing of DaimlerChrysler for the New York Stock Exchange in this, its 206th year of operation, marks a true benchmark event. Seen through the very narrow lens of my marketplace – and I'm thrilled when I heard the secretary's comparator of our market valuation to some economies around the world, and yet we are today only one-half of the world's equity market capitalization, and that's soon going to grow – seen through our very narrow lens, this past decade of the 90s has been extraordinary. We entered it with fewer than 100 non-U.S. companies traded on the floor of the NYSE. We will leave the decade with more than 500, perhaps as many as 600.

We have seen, in the course of this ten-year time frame, companies from all over the world join that growing list of domestic issuers. Of the 48 nations represented on the exchange today, 32 have joined in the last ten years. In the last ten years, two-thirds of the nations represented today have joined our marketplace – countries such as Germany, France, China, Korea, Mexico, and Brazil. Last year alone, one out of every four new listings on the New York Stock Exchange was from outside of the United States. Emerging markets have been tremendous participants in this process. Companies from emerging markets today represent 37% of the NYSE's non-U.S. issuers. Emerging market ADRs this year alone have accounted for more than half the number of new non-U.S. companies to join the Big Board. And we expect in the first quarter of 1999 approximately 20 new emerging market ADRs to join us.

So the mix on the Big Board in this, it's 206th year, is changing to reflect this global realization, this realization of a trend that we only talked about and speculated upon a few short years ago, a trend that started, many believe, with the elections in the U.K. of then Prime Minister Thatcher, and in the United States with the election of Ronald Reagan. Who would have thought, in the course of less than two decades from those two events, that the Soviet Union would dissolve, Germany would be reunified, the New York Stock Exchange in that same time frame would add more than 2,000 of the 3,000 companies it today is privileged to trade? But most importantly, who would have thought that Daimler and Chrysler, two true engines of economic growth and success in the marketplace, great success stories in terms of repositioning businesses would combine to create the first truly global entity?

As I look out, the prospects for globalization have just begun to be realized. In the United States today, we have an enormous opportunity to add great companies, great domestic issuers from markets here in the U.S. If we were to fully tap that opportunity, we would grow our business by less than 10%. If we were to simply tap the top one-third of our international community prospects, we would grow by as much as 80%. And those numbers are before the effect of privatizations. Privatizations yet to be effected can be enormous in changing the landscape of financial services.

One country alone, The People's Republic, whose leader was here last year, and if ever we needed a reminder of how dramatically different the world will be going forward, it was on the 31st of October, 1997 to watch President Jiang Zemin ring the opening bell at the New York Stock Exchange. If ever one needed a real vision of what might be, listen to the words of President Jiang. In the next ten years, he has said publicly, he will privatize perhaps as many as 350,000 state-owned businesses. If 1% of those companies would be of the scale to seek capital in the U.S. and list on the New York Stock Exchange, then just that one country, China alone, a true engine of the next millennium, would more than double the size of our non-U.S. list.

The existence and creation of global equities has just begun. It is an extraordinary time. As we look out, cross-border equity trading beginning to really for the first time take traction. In the last few years, cross-border equities accounted for almost $3 trillion per year. A number of indicators point that the true global investor is going to accelerate that process by perhaps a factor of two in less than five years. We estimate that the single currency about to be created in less than 30 days time now in Europe will become a true catalytic event for major European issuers, principally those in Germany, to seek capital, both on the continent and in the United States. In 1998, we were privileged to bring the world's largest enterprise software company, not the one out in Redmond but the one in Walldorf, Walldorf, Germany, SAP, to the New York Stock Exchange, a paradigm shift in terms of international listings on the NYSE, a $70 billion market cap company. Again, we believe, a benchmark of what indeed can come.

As we look at how dramatic the landscape has changed, one need only realize that privatizations raised only $25 billion in equity as recently as 1990. By 1997, that number grew to more than $160 billion. Many of the programs that have successfully been completed have laid the groundwork for equity offerings outside of home markets. Of course, our equity culture in the U.S. continues to strengthen. Each and every day the universe of Americans participating in the equity market is growing – notwithstanding the peaks and valleys of 1998, because most people, when one takes the time to probe investor attitudes today, most certainly at the consumer level would say we're investing not for next week or next month or next year, we're investing for the education of our children, we're investing for the post-retirement needs that we anticipate to sustain a lifestyle that will no longer be sustainable by those programs of government that traditionally have provided safety nets.

It is not uncommon in this great country of ours today to retire and face the prospect of a dependent parent. Equally not uncommon, that that same retiree will face some sort of burden for the education of one's grandchildren. When you tumble all of that into the equation of why our equity markets are growing at a pace that looks nothing like that first half of the century, it is a very exciting time to be in the global equity business. It is a time when we expect this globalization phenomenon will accelerate far beyond anything we can anticipate today.

If we were to only look at compositions of portfolios as they exist at the end of 1998 and ask ourselves the question about whether investors are truly global in their dedication, the answer is a resounding no. No, because the world as a singular entity divides its GDP roughly into thirds – Pacific Rim, Europe, and the Americas. And yet, here in this, the largest country of ownership, fewer than 5% at the retail level, 12% at the institutional level, of equity composition is in the non-U.S. component.

And so it is a time of just beginning. It is a time when investors will increasingly seek the opportunities to diversify for instruments that are today not even traded in the United States. And how fortunate we are to have leaders in the public arena who recognize that– our Treasury, our Federal Reserve, and the Securities and Exchange Commission. In these last few years, with the vision and leadership and commitment of Chairman Levitt, increasing numbers of international companies have tapped the equities markets, have probed what it would be like to be a U.S. issuer, and have come away firm in their conviction that the U.S. equity market is not only desirable but essential and user-friendly at the same time.

Globalization will thrive. It's only begun. We believe our small corner of that is serving an increasing population of American owners who want non-U.S. instruments, and non-U.S. issuers who want to tap the depth and breadth and liquidity of the U.S. equities market. Success is not an option. We must, to remain competitive, this U.S. capital market; we must build the bridges that will link markets from other parts of the world to this one. We must create safeguards so that investors, particularly U.S. investors who have enjoyed the safety and soundness of our markets, will continue to be protected as they reach out to securities from companies around the world.

And most importantly, we must ensure that all that we do is designed to make certain that the level of participation in equity markets grows, that the success of privatization programs that have yet to be launched is guaranteed, and most importantly, that the capital markets in the United States understand their responsibility to lead in a global sense. We, in the equity arena, have got to recognize there will be stiff competition. It will be healthy competition. It will serve to the benefit of consumers and issuers. And most importantly, and in the end, we hope it will create a worldwide merger of Wall Street and Main Street. Thank you very much. (Applause)

Barbara Hackman Franklin: Thanks very much Dick. I appreciate all of that. Our next speaker is William J. McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York. Bill has held that powerful and prestigious post since 1993.

The New York Fed and its president have unique places in the Federal Reserve System. The nation's monetary policy is, of course, in the hands of the Fed's Open Market Committee. But the president of the New York Fed is the only Fed bank president who is a permanent member of that committee and its vice chairman. It's widely reported that Bill and Chairman Greenspan are very much in sync. Our compliments to you, Bill, for the superb job you've been doing and especially for heading off what could have turned into a crisis of confidence in October. And recently, you'll recall, it was Bill who brought together Wall Street's titans to find a way to avert the collapse of the hedge fund Long-Term Capital Management. We should emphasize that there was no government money in that solution, only a few soft drinks and sandwiches, which I'm told weren't very good anyway.

Earlier in his career, Bill served at the State Department and with First Chicago Corporation and its bank. And just before joining the Fed, he was an adviser to the Inter-American Development Bank, the World Bank, and the International Finance Corporation. He now serves on the Board of the Bank for International Settlements and as Chairman of the Basel Committee on Banking Supervision. Bill, I'm delighted to turn this podium back over to you. (Applause)

William J. McDonough

President and Chief Executive Officer

Federal Reserve Bank of New York.

Thank you Barbara. I suspect I will go down, if at all, in the history of this club as the first chairman of the club to have a lady chair a meeting. Good evening, ladies and gentlemen. I am delighted indeed to be here tonight and to share the podium with my very good friend, Dick Grasso. Dick and I have worked together for many years now and I've come to value greatly both his warm friendship and his thoughtful counsel.

I noticed earlier that Dick talked about the small corner of the New York Stock Exchange and it isn't just his fine Italian name which reminded me that the city of Rome was kind of a small corner of the Mediterranean world which sort of spread its influence elsewhere in a similar method. Dick has spoken eloquently about how equity markets have developed globally over the past several years and some of the concerns he has, but mainly the optimism about the future of those markets. We should remind ourselves that in any well-constructed corporate balance sheet the anchor, the rock, is equity. But tonight I will focus on the global debt markets and the interests of central banks in the stability of those markets.

The role of central banks in the fixed income and related capital markets may not be immediately obvious because one can argue debt markets are a zero sum game – one side of a trade gains what the other side loses. If only it were as easy as that. In fact, trading in the global debt market serves an important purpose and it does not follow that central banks have no interest in the stability of these markets. Quite the contrary. Central banks are, and should be, deeply concerned about the functioning of these markets, their dependability, their liquidity, and their transparency.

Now before explaining why I hold such a view, and therefore why we at the Federal Reserve were so concerned when these markets faltered this past summer and fall, I would like to stand back for a few minutes and highlight how the global capital markets have changed over the past several decades. Now, no one doubts that there has been a sea change in the global capital markets in recent years and the way that business is transacted in those markets. These changes are, of course, rooted in the remarkable technological advances that we have been witnessing. Today, the technology for processing information and making that information widely available has fundamentally altered the way the world channels savings into investment. No longer does the global economy rely primarily on loans from commercial banks to meet its financing and investment needs. Rather, more than ever before the global economy of today looks to funds from the fixed income and related capital markets to intermediate its credit needs. Because the global capital markets have become so important in the credit intermediation process, the economic well-being of us all depends on the orderly flow of funds in those markets. The flow of these funds in turn increasingly relies on price signals generated by trading activity that takes place daily in those markets. The reliance on secondary market trading for price discovery constitutes the fundamental difference between funds from securities markets and loans from banks.

Now let me be a little more specific. In securities markets, investment decisions are driven by prices that arise from a trading process that reconciles different information from a diverse group of investors. In bank loans, investment decisions are based on the bank’s private information about specific borrowers. While a bank makes its own investment decisions, securities markets rely on the consensus of a multitude of investors. When securities markets work well, they provide efficient ways of aggregating information and allocating risks among a wide range of investors.

In order to function well, however, these markets require a trading infrastructure. The infrastructure may consist of an exchange, a network of brokers and dealers, and a clearing system. These markets also rely on a cadre of well-informed investors who confidently judge asset prices and take positions on the strength of their own judgments. If the trading infrastructure fails or investors lose confidence, trading may, and sometimes does, grind to a halt.

The global fixed income markets are unlike equity markets. In equity markets everyone knows something about the trading infrastructure which is centralized in exchanges. Thus, there is no question as to the focal point of trading information. But the importance of fixed income markets which are multiple dealer over-the-counter markets is sometimes hard to appreciate because they are so very decentralized. In the United States, the bond market is where companies have been raising most of their funds in recent years. During the last ten years, for example, U.S. non-financial corporations borrowed a net amount of $785 billion in the form of bonds – three times the net amount that they borrowed from banks. Over the same period, these companies as a group spent $600 billion more to retire stock through buy-backs and mergers than they raised in new offerings.

Accompanying these increased levels of debt market activity has been a continuous process of financial innovation. This innovation has served to unbundle different kinds of risk and thereby to enlarge the menu of risks that investors may choose to bear. For example, interest rate swaps, futures, and options help reconfigure various interest rate risks. Total return swaps and credit spread options are tools for reallocating the payments risk primarily of emerging market debt. Credit default swaps and credit-linked notes are ways to redistribute default risks.

In practice, this unbundling of risk means that a broad range of financial institutions today performs the credit intermediation process eroding the historical comparative advantage of banks and varying credit risk. At various times, some institutions will be underwriting issues while others will be making bridge loans, providing credit enhancements, writing derivative contracts, and taking up riskier components of securities.

Within the United States, the fixed income market is today a market of some $13 trillion, roughly the same size as the total equity market. Trading activity in fixed income instruments is concentrated in Treasury securities. On an average day, over $150 billion in Treasury securities changes hands, about seven times the value of stocks traded daily on the great stock exchange. All of this trading activity serves the very important function of price discovery.

More than any other securities market in the United States, the Treasury market responds forcefully to new information about macroeconomic fundamentals. The days when the most intense trading activity takes place are also the days when major reports are released on such indicators of U.S. economic performance as the employment report, the Consumer Price Index, or the Producer Price Index. These releases allow market participants to digest important new information and to review their expectations about where the economy is going. The interest rates on Treasury securities of varying maturities are the markets' most important signals about the U.S. economy's prospects for growth and its concerns about risks of inflation.

In the rest of the fixed income market, trading in corporate bonds, mortgage-backed securities, and sovereign debt also serves the price discovery process. This trading activity acts to differentiate, for example, a Triple A risk against a Triple B risk, the prepayment risk of mortgages against the prepayment risk of credit card receivables, and the OECD country risk against emerging country risk.

What then is the role of central banks in this new financial landscape where institutional investors and other non-bank financial institutions hold a larger share of assets and a larger share of credit risk than they have ever before and where an increasing share of conventional credit risk is intermediated through the capital markets? I would argue that the role of a central bank in this new environment is very much in keeping with its traditional responsibilities. Central banks in all countries fundamentally care about the flow of credits in their economies, whether this credit flows from banks, non-bank financial institutions, or institutional investors. Now why is that so? The answer, I think, is simple. It is because the credit intermediation process is ultimately what determines how well our economies function and, therefore, how well our economies are able to grow and to allow their citizens to prosper.

When the credit intermediation process does not work well, when there are disruptions to the supply of credit to the economy, as history has amply shown, the cost for our businesses and our people can be enormous in terms of lower output and fewer jobs. A well functioning credit intermediation process is, in short, critical to the sustainability of any economy's success. It is for these reasons that central bankers are interested in the flows of credit from the global securities market just as we have needed to know about the flows of credit from the banks whose operation we are charged with overseeing.

At the end of the day, the flow of credit from securities markets has the same impact on our respective societies as that from banks. Therefore, central bankers have an obligation to understand the nature of these flows and the risks that they raise. Crucial to our obligations to our citizens is the need to be certain that these credit markets work smoothly and that credit flows efficiently from those most willing and able to bear the risks to those most able to put the funds to good use. This is as true for the United States as for any other country – developed or developing.

Now does this mean that central banks believe that capital markets should be supervised in the same ways banks are overseen? Clearly, the answer to that question is a resounding no. That is not our role. In my view, central banks broadly have two main responsibilities with respect to the global debt markets. The first is to enhance the price discovery process by promoting transparencies in their own actions. The second is to ensure that the banks, as providers of liquidity, perform their proper role in supporting the trading process by making sound credit decisions.

In the United States, the Federal Open Market Committee has a pronounced effect on the fixed income market, both through its policy decisions and in the way the Fed conducts monetary policy. Indeed, an important part of the price discovery process is the anticipation of the Federal Reserve's future actions. Because the Fed is such a critical player in the market, it is important that it not create unnecessary uncertainty. That is, the Federal Reserve has a responsibility to be as transparent as possible in the conduct of monetary policy.

Since February 1994, there have been direct and immediate announcements following FOMC meetings of the Committee's policy decisions, which in my view have helped remove uncertainty. In addition, in implementing monetary policy through its trading role, the Open Market desk has made numerous changes in recent years to add clarity and transparency to its day-to-day market interventions. The thrust of these changes has been to reduce uncertainty and to enhance the price discovery process in the Treasury market.

Now as to the Federal Reserve's responsibility for ensuring that banks support the trading process by making sound credit decisions, let's not forget that despite the increase in market players, banks in the United States, as elsewhere, continue to play an extremely important role in financial markets...(recording stops, then resumes)...and structure hedging instruments in those bonds, but they also provide much of the financing that allows market markers to take positions. Dealers in the U.S. bond markets finance themselves through repurchase agreements with bank counterparties. In many cases, banks are also the source of backup liquidity. It is in these ways that bank credit supports the price discovery process. In its role as a bank supervisor, the Federal Reserve has the responsibility to see to it that this credit support does not dry up at crucial times. One of our primary tasks is to be certain that nothing interferes with the credit intermediation process of banks. That is why bank soundness is so important to us.

The events of last August illustrate what can go wrong with financial markets and why we were so concerned when the global credit market seemed to seize up following the announcement by the Russian government of an effective devaluation of the ruble and of an effective debt moratorium. These actions were so unexpected that they shocked investors all over the world. In the United States, the correction of stock prices in the wake of Russia's announcement was not of exceptional size or concern and had even been anticipated by some astute observers. The correction began to take place about a month earlier. But the abrupt and simultaneous widening of credit spreads globally, by both corporate and emerging market sovereign debt, was an extraordinary event beyond the expectations of investors and financial intermediaries. The abrupt shift in investor behavior, in fact, served to intensify price movements and to undermine confidence in market dynamics. It was not just the re-balancing of portfolios that was of concern in those days and weeks following the Russian government's announcements, but also the rush away from risk altogether. In short, it was this seizing up of the credit intermediation process that was of most fundamental concern to us as central bankers.

What we learned as a result of this experience was, among other things, that years of historic data on fixed income market yields and spreads could not have anticipated the size of the movements in credit spreads that in fact occurred in August and September. We also learned that markets that did not previously move together can suddenly move very closely together, that trends that were underway for several years can abruptly come to an end, and that spreads that have been consistently narrow for years can suddenly widen.

In the wake of these events, we have become all too aware that liquidity can be illusory, that individual traders may be able to exit a position when they wish, but that not all traders can exit their positions at the same time. For many, these lessons have been humbling. For some, they've been impoverishing. Going forward, it is important to bear in mind that there most certainly will be further instances when the credit intermediation process is disrupted, when we will face other threats to the well-being of our market positions, our institutions, and the global economy. These risks are in the nature of the intermediation process itself.

As the global capital markets continue to grow and become evermore sophisticated, as I believe they will, what is most important for us as central bankers is to operate with a disciplined sense of priorities. It is clear that we, as central bankers, cannot be responsible for any single bond holder, any single bank, or any single financial institution. Nor can we control the functioning of the global debt markets or become the regulators of all financial market intermediaries.

What we as central bankers can do, however, is to understand the dynamics of the global debt markets, how they are evolving and whether they are sufficiently liquid and transparent. We can also ensure that banks perform their proper role in supporting the trading process through making sound, sound credit judgments. Furthermore, we can enhance the price discovery process by promoting transparency in our own actions. Finally, and most importantly, we can help create conditions in our own economies that will support sustainable non-inflationary growth. In these ways, we, as central banks, can encourage the efficient functioning of the credit intermediation process in our countries, and in so doing promote the welfare of the world economy of which we are all a part. Thank you. (Applause)

QUESTION AND ANSWER PERIOD

BARBARA HACKMAN FRANKLIN: Thank you very much Bill. Now, as is our custom, we have two questioners to begin that part of our program. On the left side of the dais, we have Robert D. Hormats who is Vice Chairman of Goldman Sachs International. On the right side of the dais, we have Robert H. Stovall who is President of Stovall/21st Advisers, Inc. We'll start the questioning with you, Bob Hormats.

ROBERT D. HORMATS: Thank you very much. First, let me say what a privilege it was to hear these two outstanding and very thoughtful presentations. It shows why both individuals are on the vanguard of the process of the globalization of financial markets. And that's the launching pad for the first discussion point that I'd like to raise. Barbara, in your introduction you made the point, and I think it's a fair one, that Bill and the New York Fed played a very constructive role in facilitating the private sector recapitalization of long-term capital management. What I'd like to do is follow up with a question to Bill on this point, particularly what conclusions we might draw from this. Chairman Greenspan, when you and he testified on October 1, noted that, and I quote, "Most hedge funds are only a short step from cyberspace. Any direct U.S. regulations restricting their flexibility will doubtless induce the more aggressive hedge funds to emigrate from under our jurisdiction. The best we can do is what we do today; regulate them indirectly through the regulation of their sources of funds." My question, Bill, is whether you see any need for any changes in the domestic regulation of these sources of funds and whether wearing your BIS hat, do you see any measures that can be taken internationally, both directly and indirectly to deal with this problem?

THE HONORABLE WILLIAM J. MCDONOUGH: I think we should always start that the function of the public sector of the government of the United States or governments around the world, or organizations like the Basel Committee on Banking Supervision, are put in place to serve the best interests of the people. It is, I think, clear from the long-term capital experience that if any hedge fund or what I prefer to call highly leveraged institution becomes large enough to have the possibility of creating systemic risk, that such an institution has to be subject to control in the public interest. That, to me, is clear. What is less clear is what is the best way to do it? And I think the best way to do it is the way that you can do it fastest. We do know how to control such institutions indirectly. They cannot become as large as that particular one did if their counterparties who are, by and large, supervised institutions – banks and securities firms in this and other countries – do not provide a great deal of credit to them. There are lessons that can be learned from that and other experiences of institutions not necessarily having better credit policies but perhaps most closely following, more closely following the policies that they have. I believe that, especially through the Basel Committee which is made up of the banking supervisors of the G-10 countries, the large industrial countries of the world, and with our fellow regulators on the securities side which have their own international grouping in which the SEC is a very important player, that we can, should, and will bring to bear on the financial intermediaries their responsibility to do their job somewhat better. A remaining question is whether that will be good enough. That is, whether it will be necessary to have direct supervisory or regulatory control over such institutions. It's easy to say that it will be very difficult. There's no doubt that it will. Many of them are incorporated in places like the Cayman Islands and they're a little hard to get at as a result, directly. Again, you can get at them indirectly. But I think if it is clear after a period of seeing what's the best we can do indirectly, that that isn't good enough, and that we have to do it directly, then at the international level a way will have to be found. I think, as in many things in life, it's important that the perfect not be the enemy of the good. And if one waited around to control them directly, considering the complexities including the legal complexities of doing so, one could not take advantage of the ability to protect the public interest in a more readily available way.

ROBERT H. STOVALL: A question for Dick Grasso. We all appreciate the visionary and yet practical presentation you gave us, Dick, and also the great job you've done in your tenure to date. Harking back a few years ago, the reason I thought we did not have more foreign listings here was the differences in accounting, differences perhaps in report disclosure, or frequency of reportage, but you said that you have a coming pilot program with some companies sticking with the ADR track and others going for full listing. Would you mind to explain? Maybe things have evolved past my faulty memory.

RICHARD A. GRASSO: Well, Bob, as always your memory is nothing short of perfect. The accounting challenges are still there. Clearly, for a non-U.S. company to be listed on the New York Stock Exchange it must be fully registered in the United States which means it's got to reconcile its accounts to U.S. generally accepted accounting principles. All 368 non-U.S. companies that we're privileged to trade today have done so. And every company that we bring to the exchange, whether in an ADR format or in an ordinary format, will do the same. I think the good news on the reconciliation of accounting principles front is the enlightened approach of both the SEC and the IASC. Through the organization of international securities regulators, there is a move towards harmonizing accounting principles to a global format. What simply I mean by that is that whether one is an issuer of U.S. origin, U.K. origin, or origins in the Pacific Rim, you will have the opportunity to register and report on a common format. I think the important point to make, though, is one that I touched on in my brief comments. America's investor community has been well served by the transparency and protections provided by the entire framework of our regulation, accounting included. So we can accept nothing less in terms of protecting consumer interests as investors see the opportunity to perhaps add a wide range of stocks from around the world. But those companies who will gain access to our market have got to do so on a basis consistent with investor protection. I did say in my comments, Bob, to his credit, to the leadership that he's provided at the agency, Chairman Levitt has been a true pillar of strength in bringing the international community closer to a U.S. format and in raising the issues of, if you will, not necessarily the traditional conventions of U.S. versus alternative formats but fundamentally restructuring accounting from the perspective of what best serves investors and markets. And I think we've made enormous progress that will result in great benefit over the years. I might take one, just footnote, to Bob Hormats' question to Bill McDonough because this is something that Bill can't say, but I can. I watched the process from the kitchen. The coffee was cold, the sandwiches were not good. But the job that was done by Bill McDonough in protecting this system of ours from massive systemic risk is one which all Americans should take great pride in. (Applause)

ROBERT D. HORMATS: I'd like, if I may, to follow up on Bob Stovall's question to you, with another question to you, Dick. And that relates to, again, the effort you're making to increase the number of foreign shares traded on the New York exchange. You mentioned the pilot program you're undertaking. I'd like you to look a little bit further out in the future. In light of the growing globalization of American portfolios and the growing number of shares traded on the exchange, do you foresee some time down the road a point in which foreign stocks will trade on the exchange in their own currencies as opposed to dollars?

RICHARD A. GRASSO: I have to tread very carefully, Bob, because I do enjoy those 275,000 frequent flyer miles that I run up every year. And part of the, part of clearing Customs is not suggesting that we're going to dilute home country markets. Our goal is very simply to be a world format market which means we will trade ordinary securities. We will trade in currencies other than the U.S. dollar. But importantly, our goal is to be the second most important equity market to a home country arena except where those markets are not providing what is necessary for investors or for issuers. So in sum, the answer is yes. It will be a multi-currency, multi-formatted environment. It will be an environment that will not have a time frame, if you will, definition to it. To be a global equities market, you must be literally 18 - 22 hours a day. We have that capacity technologically. We have the ability to create what I'll call the Cannon Mills model where every 6 ½ or so hours a new shift of brokers will walk in and trade places with those who are walking out. Most importantly, though, it's I think a requisite that currency be harmonized to the American arena. If one wants to trade a Taiwanese security in the euro, if there is demand for that here in the United States, then we either provide an arena to do that or we run the risk of defaulting that opportunity. And default is not one that I think is an acceptable option for us. (Applause)

ROBERT H. STOVALL: For Bill McDonough, talking about, thinking about memories, some generations ago I recall reading that the Chief Financial Officer of Great Britain took a creditor, his counterpart from The Netherlands, grouse hunting in Scotland and while mucking through the peat, the Brits devalued the pound and bagged the Dutchman. So now we've moved to a point of almost total communications and clarity amongst the central bankers. And I just wonder how effective that is and how you actually try to help some of these countries – I can think of three, we could think of more, link to commodities, specifically oil, with a bad year ahead of them perhaps –Venezuela, Indonesia, Russia. Are you observing only or do you give advice, you and other powerful central bankers? How does that function?

THE HONORABLE WILLIAM J. MCDONOUGH: Bob, we start, I think, with the best thing that we can possibly do for everybody in the world is to provide a monetary policy that is appropriate for the United States. If we can maintain into the ninth year an economic expansion in 1999, which I have every reason to believe that we can, and keep inflation at its very, very low level, or perhaps do even a little better, that is the best possible thing we can do for the rest of the world. I believe the same thing is true for the major central bankers of the European countries, that we need to keep the United States, Canada, and the European countries as an important source of strength for their exports, among other things, of the developing countries that you described. I think there is no question that the economic crises through which the countries that you mentioned and many of their neighbors are passing is something that will take them a number of years to get out of. The world's crisis which began in Thailand in July of 1997 and then spread to a number of its neighbors, then seemed to go into respite for a while, and then burst out in a new virulent way in Russia, is not necessarily fully behind us. We have to keep working very hard throughout the world to keep the countries that are growing, growing, and to try to get the countries that are having difficulties to return to the growth path. The indirect way in which we help those countries is to make sure we're managing our own well which is a combination of good fiscal policy which we have, good monetary policy – which leaving some modesty aside, I think we also have – and the remarkable performance of American business leadership in having our country's companies be the most ferociously competitive in the world in most major industries. It's a perfectly remarkable performance by the American private sector making us the envy of the world – a country in which there is a such a problem of chronic unemployment, even in Europe, a country that has been able to produce two to three million jobs a year, year after year, bringing into the labor force people who three or four years ago never thought they'd have a chance. A rather fascinating bit of economic data from the labor force is that the group within the labor force which has had the greatest job creation in the last year or so have been high school dropouts. Not an argument for dropping out of high school, but an indication that if we manage our economy well, we give everybody in our society greater opportunity than they would otherwise have. We work closely with our central bank confreres of the countries that you mentioned and many others as well. We try to provide them as good counsel as we can about monetary policy, about banking supervision. We've had a wonderful breakthrough recently. One of the great people of New York has agreed to become the first Chairman of the BIS Institute for Financial Stability, my good friend John Hyman, to my left. (Applause) John is taking over a very serious responsibility of helping to train bank supervisors around the world which is an important function in most countries, including this one fortunately, of central banks. So we are in there pitching. Again, running our own economy well is the single best thing we can do, but we give them every possible assistance. (Applause)

ROBERT D. HORMATS: Bill, another emerging market question. As you may know, particularly in the Treasury, concerns have been raised over the last several months about the official sector providing financing to emerging markets that are in crisis while the private sector at the same time is drawing money out which raises questions about what's come to be known as burden sharing. My question is what you believe the proper role of government authorities is in encouraging or arm-twisting the private sector to bail them in during this crisis so the public sector isn't left to shoulder the whole burden and bear the criticism in the Congress which results therefrom?

THE HONORABLE WILLIAM J. MCDONOUGH: Well, my basic view is that markets work best when you allow markets to work. Sometimes they need a little advice and assistance, and I think you can draw two very interesting comparisons, an interesting comparison between two examples. In the late fall, early winter of last year, of 1997, there was an increasing debt crisis in Korea. By the time Christmas week arrived, Korea was down to about $1 billion in reserves, having come down from about $40 billion. There had been a rather large amount of public sector support. And it was very clear that if the money continued to flow out of Korea, the country was going to default. In my view and that of Secretary Rubin and Chairman Greenspan and others concerned, it would have been unconscionable to allow the taxpayers' money, either directly or indirectly through the International Monetary Fund, to continue to go into Korea while the banks, mainly outside the United States but to some degree in the United States, were pulling their money out. So in a way we, well, we were able to present a fairly clear choice to the banks. That is, they could either reschedule their debt and in the process stop withdrawing support from Korea, or they could have Korea go into default, and they could take their choice. They freely chose to reschedule Korea's debt. And I think under the circumstance, that was the right thing to do. It was a tiny bit heavy-handed, but it worked. It was a very different situation and continues to be, in my view, in Brazil. Brazil is a country which is fundamentally extremely rich. It has a very gifted government. It has a very strong private sector. And it is sitting on about $41 billion of reserves. Now they ran up their reserves before their recent elections and then they run back down again. So at the peak they had about $73 billion in reserves, and so it's down to about $41 billion. In that situation, the public sector represented by the International Monetary Fund, the World Bank, the Inter-American Development Bank, and a group of bilateral supporters, that is, individual countries led by the United States, put together a substantial package for Brazil. The question is should the private sector be invited to come in and sign their names to something? Or should market mechanisms be permitted to work? The decision was made, in my view, very wisely, that market mechanisms should be allowed to work, that Brazil was not, in fact, Korea. And that the likelihood is that with effective action on the part of the Brazilians, with a very substantial amount of public sector support, that individual providers of funds, not just banks, it's a considerably more complicated source of suppliers of funds than was the Korean case which was in a way rather easy because it was almost all banks, this is much more complicated, and therefore lent itself more to allowing the private sector to work. That is the path that has been taken. It is a path that I believe in, and I think that it is highly likely to be productive. There is something that one can say a bit cynically about financial markets. They are driven by two emotions – fear and greed. And Brazil is a very attractive place to invest. It's a very attractive place for major firms to do business. And the hope, I would point out it's a hope, is that as the Brazilian situation begins to turn, that there will be a very strong interest in investing at what could look like some rather attractive prices to buy either equity or debt instruments in that country. That's how markets are supposed to work, and in the Brazil case they're being given the opportunity to work.

BARBARA HACKMAN FRANKLIN: Bob Stovall, last question.

ROBERT H. STOVALL: Thank you. For Dick Grasso, the New York Stock Exchange, as it's evolving under your leadership could also have a subhead – Global Stock Exchange. I think you allowed us to infer that. Yet creeping up from Washington is the NASDAQ which is going to build a big building with a huge display floor, I'm told, around 42nd Street. Their average daily volume is already larger than the New York exchange. Companies that we don't know much about, some of us, like Amazon.com, have a capital value greater than Delta Airlines. Is this going to be a competition? Is this going to be embraced? What is this relationship between the open outcry system you have, the old specialist system, and their electronic trading system?

RICHARD A. GRASSO: Well, Bob, first let me say that anything my competitors do to embed higher costs and less efficiencies (Laughter), I'm completely in support of. (Laughter) I'm very, you'll be very surprised, Bob, with my response. I'm a very strong believer that America has such a large universe of issuers, ranging from those with multiples of the hereafter to those who are trying to wonder why they can't get their multiples into double digits, that no one singular market structure can best accommodate the American landscape. NASDAQ has done a very good job in building its market and serving as a venue for, as you say, the Amazons and the emerging companies of the next millennium. They also have some great companies that we would love to have. If you look at their landscape, they're privileged to trade 7,000 issuers as of last count being the end of last month. Fewer than 700 of those companies meet the standards for listing on the New York Stock Exchange. So I would be the first to say that we need both market structures in the United States. To the extent there is competition, that is healthy for investors, that is healthy for issuers, and I am a great proponent of it. Having said all that, I will share with you my business plan. And that is, the deep hope that the NASDAQ market retain a 90% share of its current issuer community. (Laughter) Now I think General Reno might be interested in knowing that number. To hear someone who competes with the second market in the U.S. which is about today at $2.25 trillion, market cap, to hear me say that I hope they retain a 90% market share. You might not be all too surprised with the 10% I'd like to attract, but then again that's what makes competition in America great. (Applause)

BARBARA HACKMAN FRANKLIN: I think we could stay all night and engage in this dialogue, but we do have to close. And I want to thank our two questioners for aiding and abetting this discussion. And special thanks to Dick and Bill for such stimulating and thought-provoking and mind-stretching comments. Thank you very much. (Applause)