27

The IMF in Perspective

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Let me start with the mission of the IMF. In his excellent background essay, Edwin M. Truman (chapter 2) says that no single set or magic formula can be proposed to give new life to the IMF. I agree. At the same time, however, I think one thing can be, and should be, summarized in one key word, and this is what the mission of the Fund is. In my view, this key word is stability.

Let me explain this point by referring to the classic taxonomy of economic policy objectives, originally proposed by Richard Musgrave in his book on public finance. Musgrave identifies three economic policy functions: allocation; stabilization; and redistribution related to the three objectives of efficiency, stability, and equity. Such a triad provides a key paradigm for understanding the logic of the order conceived at the end of World War II for the postwar world. Somehow, the world leaders engaged in the fight against Nazi Germany thought that, in order to build a lasting peace, the three objectives and the three related policy functions needed to be pursued not only by and within countries individually, but also collectively at the international level.

Moreover, each function needed an institution. The institution for stability was the International Monetary Fund as planned during the International Monetary and Financial Conference at Bretton Woods in the summer of 1944. The institution for allocation was the trade organization foreseen by the Treaty of Havana, which never came into being. And the institution for redistribution was the World Bank and the system around

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it. This is the way I see the overall design of the international economic and financial architecture, and I think that this conceptual and institutional framework is still valid. Efficiency, stability, and equity are three needs arising in any space of economic and social interdependence, including the global space, and they require an appropriate apparatus for policymaking.

Adherence to the Musgravian paradigm leads me to share fully the idea that the Poverty Reduction and Growth Facility should be passed on to the World Bank. It also leads me to think that the opening of the capital account, that is, the design and implementation of policies concerning the international allocation of capital, should not be a function of the IMF. These policies, as those concerning trade in services, should be a task of the World Trade Organization. The IMF should, instead, deal with the stability problems that may arise as a consequence of a freer allocation of capital and financial services around the world, as part of the stability problems arising from global interdependence. In the world today, threats to stability arising from financial interdependence are dominant; however, in the aftermath of World War II such threats had been removed through the widespread recourse to financial segmentation and repression.

With this introduction, my remarks will deal with two types of topics. First, I will identify, and comment upon, four key factors that, in my view, are relevant to casting a discussion of the IMF's role in the appropriate framework. Second, I will briefly review three cases that provide illuminating examples of the issues at stake. These are cases in which I've been directly involved.

The four key factors are stability, scarcity, sovereignty, and leadership. If the IMF has an identity crisis, I think it is largely because these four factors have evolved in a way that makes the functioning of today's IMF—and the identification of its task—profoundly different from the original blueprint and very difficult to define.

Stability was a very simple notion in the early years of the Fund, when the stability—indeed, even the fixity—of the exchange rate was the pillar and the rule around which trade relations were organized among the few countries that were members at that time. Stability is a much more difficult and elusive notion today, in a world of 200 countries that pretend to be sovereign and yet are subject to a borderless trade of capital and financial services, while the IMF no longer derives authority from a simple recognized rule. And if the definition of the mission of the IMF is not clear, all the rest is not clear.

Of course, no one can say that all forms of instability should be relevant for the IMF. What should be relevant is instability that, first, arises from interdependence and, second, has some kind of systemic dimension. To deal with other forms of instability, there may be other mechanisms, including domestic policies and the market mechanism. Thus, the notion of stability today is elusive; it has certainly shifted very strongly from the

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real to the financial sector. If we are lacking a clear notion of stability, we also lack the compass with which to orient the activity of the Fund.

The second factor is scarcity. The IMF has operated for years at the nexus between instability and scarcity. There was a rule—the exchange rate rule—and when compliance with it was becoming problematic or even infringed, scarcity of finance would simultaneously arise for the country concerned. The nexus between instability and scarcity for many years determined the activity of the Fund.

Even after the exchange rate rule was written off, scarcity remained the lever of the activity of the Fund. Recourse to the Fund continued to be determined by scarcity of finance. After the scarcity caused by the need to defend the fixed exchange rate, another form of scarcity was caused by the massive increase in world savings associated with the first oil shock. Then came scarcity of finance associated with the debt crisis of the early 1980s. We could almost say that the Fund has been searching for areas where the scarcity factor would continue to be in play, to the point of concentrating a growing part of its activity on issues of poverty—the epitome of scarcity—which has nothing to do with stability. Indeed, although it belongs to another component of the Musgravian triad—equity and redistribution—poverty has been offering a raison d'être to a Fund in search of a mission in the sense that there has been scarcity there. However, we should not forget that stability is the end, and scarcity was the symptom. Today scarcity has largely disappeared because of the abundance of finance in a highly developed and global financial market, flooded with the liquidity generated by very accommodative monetary policies.

The third notion is sovereignty. Here we have two different trends. One trend is a significant erosion of the reality of sovereignty. And this is a sign of success of the post–World War II order, in the sense that interdependence has developed greatly owing to the increasing opening of trade and to an extraordinary expansion of the area of market economies. But another trend has been a hardening of the ideology of sovereignty, a growing nationalism, and a decline in the acceptance that sovereignty has to be shared.

So we have had divergent trends, whereby sovereignty was reduced on the field and enhanced in the minds. The ability of national governments to govern the economy and to ensure the basic goals for which they were elected has declined. But the defense of sovereignty has stiffened.

Now, in a world in which the Fund no longer derives authority from an accepted rule and the nexus between scarcity and instability has been loosened or even broken, the intellectual recognition of the implications of interdependence becomes a much more indispensable basis for policy cooperation. If this basis is weakened by the rise of new forms of nationalism, not much is left on which to build a meaningful activity for an international institution.

The fourth and final factor is leadership. We have a very clear description by C. Fred Bergsten (chapter 13) of how leadership has evolved over the

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years. As far as I am concerned, I don't think that the key problem today is a lack of legitimacy of the leadership. I tend to think that when leadership is good it earns its own legitimacy by the way it is exerted. Leadership is not the same thing as institutions. Leadership is something that has to function along with the institutions, not instead of them, for the institutions to be effective. When the leadership is good, everyone welcomes it.

Leadership requires being able to look ahead for a greater distance than those who are led, that is, to take a special responsibility for the future. It also requires giving rather than taking. I would almost say that the very essence of leadership consists in giving, not in taking. When there is a decline in leadership, it is precisely because there is a decline in the readiness to give by those who lead.

Today the decline in leadership is clearly a decline of US and European leadership. I think it is indeed here that we observe the lack of what is most needed. Let me concentrate on Europe, because it is where I have conducted most of my activity. It is clear that Europe would be contributing much more strongly to the successful functioning of international cooperation if it improved its own functioning and if it exerted leadership more effectively. Indeed, where Europe is united (I have experienced this in the field of monetary affairs, but we could say the same for trade or competition policy), its relationship with the United States is simple and fair. There is a clear recognition of the respective roles and agreement is not exceedingly difficult to reach. There are, of course, disagreements and even occasional tensions, but they are usually resolved. Europe is ineffective when it is divided, not when it is united. And Europe-US relationships are difficult where Europe is divided, not where Europe is united. So, in the decline of leadership, which is not a negligible part of the shortfalls of international cooperation today, I see a major responsibility on the European side of the Atlantic.

Let me now very briefly mention (without elaborating because I don't want to exceed my time) three areas in which, if more time were available, one could exemplify the above description of the change in the way the four factors play.

The first is the area of exchange rates, where one is struck by the almost complete absence of the IMF. My experience in the Group of Seven (G-7)—first as an Italian official, more recently as a European official—is that the basic stipulations in the field of exchange rates are taken without the IMF playing any significant role.

The story of the word "flexibility" in the most recent sequence of G-7 communiqués provides a striking example, but equally telling examples are all the relevant episodes of exchange rate cooperation (or lack thereof) among key currencies in the three decades that have followed the collapse of the Bretton Woods system.

The word "flexibility" was introduced in September 2003 in the communiqué drafted by the G-7 in Dubai on the eve of the IMF meetings. Dur-

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ing the spring before, the dollar had started to decline relative to the euro while Asian currencies had resisted appreciation by massively purchasing dollars in the market. Flexibility was used in a generic sense, not specifically referring to any currency or group of currencies. In a show of ineffectiveness, the Europeans signed on to the text, although they were quite dissatisfied with it. Indeed, they feared the communiqué would be read by the markets as inviting further depreciation of a dollar-euro exchange rate, the only exchange rate that was actually in regime of float.

European fears proved right, to the point that immediately after publication of the communiqué, the US Treasury declared that the communiqué had not been intended to push the dollar further down. Five months later, in Boca Raton, the new G-7 decided not to drop the word "flexibility" but to restrict the reference to it to the currencies that were not practicing flexibility, which to every reader meant, first, the renminbi and also possibly other Asian currencies.

Two comments on this little story: First, the story provides, to my mind, a telling example of the odd relationship between the IMF and its mission. The IMF was totally excluded from every step of this whole process—from analysis, to negotiation, to communication. The IMF can be actively involved in matters unrelated to its basic mission, and deliberations fully pertinent to its mission can occur without IMF involvement. Second, in spite of the Boca Raton correction, a lack of clarity between advocating a change in the level and advocating a change in the regime of the exchange rate of some Asian currencies remained. The story thus also provides a clear example of inefficient leadership by the G-7.

The second area is a success story, and it concerns the setting of standards and codes. As international instability has come to originate increasingly from the financial sector and from causes of a microeconomic rather than macroeconomic nature, the policy fields of regulation and supervision have grown in relevance on the agenda of international cooperation. In fact, cooperation in such fields started as early as the 1970s in, for example, banking supervision through the Basel Committee. However, for a long time cooperation on standards and codes remained confined to specialized bodies and to meetings in the secluded world of the Bank for International Settlements.

The turning point came after the 1994 Mexican crisis and its forceful management by the G-7 and the IMF. During the Halifax Summit that followed, financial stability made its triumphant entry in the area of interest of heads of states. As chair of the Basel Committee and Italian deputy to the G-7, I was directly involved in the definition of roles that followed the Halifax meeting. In particular, I insisted that the negotiation and drafting of standards and codes should remain the task of specialized bodies such as the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and so forth. In my view this was the only way to ensure both authority and ownership to them.

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Halifax was the start of new activity in fields including banking supervision, financial markets, and payment systems. Such activity involves three types of roles: political impulse, rule making, and implementation and enforcement. The G-7 and, later, the G-20 took charge of the leadership role, specialized bodies carried out the rule making, and the IMF undertook the task of promoting and monitoring implementation and enforcement. The Financial Stability Forum was later added to this constellation and rapidly rose to be the key coordinator of this area of activity.

The third area is European representation in the IMF. Interesting papers on this topic were presented here today. Some of them state what is obvious to any person using common sense and what a respectable European leadership should have done long ago: namely, there should be a single representation by Europe. After all, "monetary" is the key word in the very name of the IMF, and the euro is the second currency on the planet. It is simply grotesque that "the country of the euro," the political construct that invented and created the euro and its central bank (by this I mean the European Union, not the European Central Bank specifically), is not really present in the IMF.

True, the IMF was created at a time when the sole policymakers were countries, nation-states. Now, however, the one-to-one correspondence between countries and policies is gone. Failure to reflect this change in the governance of bodies such as the IMF (or, for that matter, the Bank for International Settlements or the Organization for Economic Cooperation and Development) is entirely due to the incapacity of the Europeans to live up to their responsibilities. It reflects the decline in Europe's sense of responsibility and in its ambition to play a meaningful role in the field of international relations. This is the same Europe that so often complains that leadership in world affairs has drifted away from its continent to the other shore of the Atlantic.

My final thought is the following. One could say, "All this is true, but why do we complain? After all, we are in one of the best years in terms of growth. We have a more resilient system than we had before." To the sirens singing the song of complacency, I would answer that we are in a situation in which the incubation of instability is extremely slow, but the instability that may eventually erupt is extremely large. And it is so because the basic elements of instability are profound: in the field of energy, in the field of finance, in the conservation of natural resources, in the preservation of life on the globe. These are of course not the classic fields where the IMF has a responsibility. However, it is hard to believe that the fields for which the IMF does hold responsibility (money, macroeconomics, and finance) would remain unaffected if a major instability erupted, from whatever source. It is precisely because of the contradiction between the length of the incubation and the size of what is incubating that leadership is most needed.

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