

CONFERENCE IN MEMORY OF TOMMASO PADOA-SCHIOPPA

THE REFORM OF THE INTERNATIONAL MONETARY SYSTEM

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Tommaso Padoa-Schioppa initially developed his views on economic and monetary relations among countries mainly in the context of his thinking on European integration, but he always drew important insights from the analogies and differences between the policy issues arising in the European and in the global context. He also felt that Europe, having an important stake in global stability, could and should contribute actively to more effective global governance. Particularly in the last years, with the global financial crisis, he was increasingly emphatic in advocating a profound reform of international monetary arrangements.

This note outlines the key themes running through his main writings on international monetary issues, presented in rough chronological order. As will emerge from this brief survey, there is considerable continuity of themes and ideas. One clear leitmotiv is the idea that growing economic and financial interdependence needs to be collectively managed, which usually requires a combination of rules and discretion that would be difficult to handle effectively without supranational institutions. The essays reviewed here are mostly concerned with defining the requirements for such rules and institutions. While there is substantial consistency in his analysis of these requirements, his judgements on how they are met by the existing international bodies (the IMF, the BIS, the G7, the G20) vary somewhat over time.

1. The “inconsistent quartet” at the global level

A good starting point is the well-known analysis by Padoa-Schioppa of what he called the “inconsistent quartet”, i.e. the impossibility of maintaining simultaneously i) free trade, ii) full capital mobility, iii) fixed (or managed) exchange rates, and iv) national autonomy in the conduct of monetary policy.¹ This insight was clearly drawn from the analysis of the demise of the Bretton Woods system, and can also be seen as a corollary of the Mundell-Fleming model. In the mid-1980s Padoa-Schioppa drew the conclusion that the eventual full liberalisation of capital movements in the European Community as part of the single market project would have dramatic implications for the viability of the European Monetary System’s adjustable peg regime, and ultimately required a move to monetary union.

Interestingly, while most authors refer to this as the “impossible triad” or “trilemma”, Padoa-Schioppa preferred to call it a “quartet”, with “free trade” as the fourth element. At first sight this may appear to be a puzzling choice, since from the strictly analytical standpoint the inconsistency between the other three elements holds regardless of the presence or absence of free trade. But in a deeper economic sense, taking trade into

¹ T. Padoa-Schioppa, (1988) “The European Monetary System: a long-term view”, in F. Giavazzi, S. Micossi and M. Miller (eds.), *The European Monetary System.*, Cambridge, Cambridge University Press.

consideration was essential, since the costs and benefits of different positions along that three-way trade-off depend crucially on the degree of trade integration. In fact, Padoa-Schioppa's argument for moving on to monetary union rested on the idea that, in a region as tightly integrated as the European Community, neither restrictions on capital mobility nor floating exchange rates would ultimately be compatible with a fully developed single market. Hence the need to forgo autonomous monetary policies.

Padoa-Schioppa used this same conceptual framework in a 1988 essay on the international monetary system.² "International monetary history in the post-war period can be interpreted in terms of the periodic manifestations of the 'inconsistent quartet' and the ensuing reactions and adaptations. ... By the early 1970s the system had come full circle. The two functions that Bretton Woods had reserved to the authorities, the control of exchange rates and management of international capital flows, had been handed over to the markets. The simple approach of the 1940s to the inconsistent quartet was replaced by a more complex one in which each of the four elements was restrained in some way to make room for the others."³

The hopes that floating exchange rates would ensure smooth external adjustment, reconcile conflicting national policies and free them from the external constraint were disappointed, however, as in practice exchange rates deviated widely and persistently from fundamentals. The costs of exchange rate misalignments in terms of resource misallocation and strained trade relations having become increasingly apparent, Padoa-Schioppa, writing soon after the Louvre and Plaza accords of 1985-1987, noted a gradual return toward a joint official management of exchange rates.

He suggested that the pragmatic, ad hoc approach taken by the G7 could evolve into a more structured and formalised system of adjustable "target zones" for the three key reserve currencies of the day, the dollar, the mark and the yen. That would imply accepting some degree of policy coordination, and the attendant discipline on economic policies, in exchange for greater exchange rate stability, given that, in his view, it was neither desirable nor feasible to curb capital mobility in order to reconcile the other components of the quartet.

As an "intermediate solution" between fixed and flexible rates, unlike the two extremes the system of managed "target zones" would not translate into a simple and unambiguous rule, but would require "a combination of rules and discretion, which is, however, difficult to attain". But who would have to exercise such discretion? Padoa-Schioppa's answer was that, since there was no prospect of a single leader country emerging, "it should be exercised by the international community in a cooperative way." And since "in our industrial democracies it would be unrealistic to expect cooperation to prevail spontaneously when needed ... the only option to be considered requires an international institution to play a stronger role".⁴ This institution – he argued at the time – would have to be the International Monetary Fund.

As compared to the European Monetary System, such an arrangement would have to involve less binding constraints on the monetary management of national authorities,

² T. Padoa-Schioppa (1988), "Towards a new adjustable peg?", in F. Bergsten, K. MacMahon and T. Padoa-Schioppa, *The international monetary system: the next twenty-five years*, Symposium at Basle University to commemorate twenty-five years of Per Jacobsson Lectures, June 12, 1988, Bank for International Settlements, Per Jacobsson Foundation.

³ *Ibid.*, pp. 17-18.

⁴ *Ibid.*, pp. 24-25.

since the three currency areas were not only much less integrated economically than EMS participants but also lacked a comparable institutional setup and underlying political commitment to support the enforcement of cooperation.

2. The market-led international monetary system and its “institutional gap”

If in the late 1980s Padoa-Schioppa was fairly optimistic about the prospects for the emergence of a new cooperative international monetary order, by 1994 his views on cooperation and the role of the IMF had become considerably less sanguine. In a joint essay together with Fabrizio Saccomanni for a conference marking the 50th anniversary of Bretton Woods that year,⁵ the two authors noted that, with the end of the Bretton Woods system the world had moved from a government-led international monetary system to a market-led system. The former had been characterised by “built-in asymmetry between an integrating world market for goods and commodities and domestically insulated, government-regulated financial markets”. That system’s very success “set the stage for the reawakening of financial markets, and the inability to adapt the management of its rules led to the eventual collapse of the fixed exchange rate regime”.⁶ The shift to floating rates was accompanied by a decision to allow the markets to recycle the large petrodollar balances and was followed by further exchange liberalization and market deregulation. “A true global financial market emerged. And like Aladdin’s genie, once out of the bottle it will not go back to rest.” The globalization of financial markets was bound to continue.

But the new market-led system also suffered from an asymmetry of its own, “between the globality of the financial market and the fragmentation of policy institutions, which are based on nation-states – an asymmetry that generates an institutional gap.”⁷ This gap would tend to grow over time: “as markets become the unifying factor of the world economy, despite the permanence of sovereign nations, the institutional requirements of the market-led international monetary system will tend to resemble more the framework applying within a single nation-state than the loose arrangements applying today among nation-states”.⁸

Padoa-Schioppa and Saccomanni examined the consequences of this gap and the policy responses in three areas within the domain of central banking: monetary management, international payments, and banking supervision. They noted that while the policy response had been “surprisingly strong and innovative” in the latter two fields – where common rules and strategies to ensure systemic stability had been defined through informal cooperation among central banks and supervisory institutions – it had been weak in the sphere of monetary and exchange rate policies, even though this was the area in which an institutional framework, centred on the IMF, already existed.

After the “coordination honeymoon” of the Plaza and Louvre, policy cooperation among the G7 on monetary matters was restricted to informal exchanges of views, with only sporadic coordinated actions by central banks. Meanwhile the IMF’s influence over the policies of the major industrial countries had gradually diminished, and the

⁵ T. Padoa-Schioppa and F. Saccomanni (1994), “Managing a market-led global financial system”, in P. Kenen (ed.), *Managing the world economy: fifty years after Bretton Woods*, Washington, Institute for International Economics.

⁶ *Ibid.*, pp. 264-265.

⁷ *Ibid.*, p. 265.

⁸ *Ibid.*, p. 262.

Fund had focused chiefly on the countries whose policies it could sway through its conditional lending. The Bretton Woods institutions, originally designed to manage relations among nation states operating in an environment of fragmented markets, had proved inadequate to deal with the market-led system.

This institutional gap produced widespread dissatisfaction with the operation of the system. Writing just after the EMS crisis of 1992-93 and the bond market turmoil of early 1994, Padoa-Schioppa and Saccomanni noted that large international capital movements and sharp portfolio shifts had shown their power to disrupt the conduct of national monetary policies and to distort global monetary conditions. At the same time, floating rates had proved “incapable not only of insulating countries that are economically and financially interdependent, but also of consistently exerting market discipline over economic policies.”⁹

How can the institutional void be filled? The two authors reasoned that the “institution” (or institutional arrangement) entrusted with the task of managing the market-led international monetary system should be in the nature of a central bank rather than a government, having global jurisdiction but also operating in the market and being able to cover the three areas of monetary management, payment systems and banking supervision. They argued that if the IMF could have evolved in that direction, in practice it had not done so. Therefore, somewhat provocatively, they pointed to the BIS as the institution most closely resembling their description, although the fact that unlike the IMF it is not based on an intergovernmental treaty severely limits its enforcement powers. They suggested that the IMF would still have an important role to play in surveillance, if not in rule-making and policy coordination.

3. The role of the IMF

Padoa-Schioppa discussed the role of the IMF again in 2005, shortly after leaving his position on the ECB Executive Board¹⁰ and would present some of those ideas two years later in his first address as chair of the IMFC.¹¹ Referring to the taxonomy of economic policy objectives proposed by Musgrave – allocation, stabilization and redistribution¹² – he suggested that the IMF should be in charge of ensuring stability, the other two objectives being the domain of the WTO and the World Bank, respectively. Clearly, in this scheme the Fund was to deal with the threats to stability arising from interdependence and having a systemic dimension, since there were other mechanisms and policies to handle more limited forms of instability. Padoa-Schioppa argued that in today’s world, unlike the early post-war period, the main threats to stability came from financial interdependence as a result of the freer allocation of capital and financial services.

In addressing the threats to stability, in practice the IMF had concentrated on financial assistance to countries that faced a temporary shortage of financial resources, originally to defend a fixed exchange rate and later on to deal with capital outflows or

⁹ Ibid., pp. 246-247.

¹⁰ T. Padoa-Schioppa (2006), “The IMF in perspective”, in E.M. Truman (ed.), *Reforming the IMF for the 21st century*, Institute for International Economics.

¹¹ T. Padoa-Schioppa (2007), *The role of the Fund and the IMFC*, remarks by the Chairman to the IMFC lunch, 20 October 2007.

¹² This taxonomy is also related to the so-called efficiency-equity-stability “triangle” (see the companion note *European integration*, by Balassone and Nicoletti-Altissimi).

meet debt obligations. Writing in the years preceding the global financial crisis, however, Padoa-Schioppa observed that with the development of global financial markets, and particularly in periods of abundant liquidity, scarcity of finance seemed to have become a thing of the past. In addition, the IMF suffered from declining legitimacy in the eyes of emerging countries, whose growing economic weight was inadequately reflected in the Fund's governance structure.¹³

However, Padoa-Schioppa also pointed to some deeper reasons for the IMF's identity crisis, which he saw as a symptom of a more general decline in the spirit of cooperation. One of them was that, while the *reality* of sovereignty had been eroded as a result of growing economic and financial interdependence, there had been "a hardening of the ideology of sovereignty, a growing nationalism, and a decline in the acceptance that sovereignty has to be shared".¹⁴

Another reason was lack of leadership, which, he argued, cannot be identified with an institution but must function along with it. "Leadership is the ability to look far ahead and to take special responsibility for the future, to make the common interest prevail over narrow self-interest".¹⁵ The decline in leadership, in his view, consisted in a decline in US and European leadership in particular. Concentrating on Europe, he suggested that the continent would contribute more to successful international cooperation if it improved its own internal functioning.

On Europe's representation in the IMF, he said it should be "obvious to any person using common sense" that there should be a single representation. "After all, 'monetary' is the key word in the very name of the IMF, and the euro is the second currency on the planet." The failure to reflect this reality in the governance of the IMF "reflects the decline in Europe's sense of responsibility and in its ambition to play a meaningful role in the field of international relations."¹⁶

That remark was in line with Padoa-Schioppa's long-standing view that Europe could and should contribute to better global governance. Also as member of the ECB Executive Board, he advocated an active involvement in international cooperation, convinced as he was that, "as the central bank of an economy roughly the same size as that of the United States, the Eurosystem had to gradually develop its international role and policy: it owed this to its 'domestic constituency' as well as to the global community, in which monetary unification in Europe could play an important role by enhancing global policy cooperation"¹⁷

4. The need for a global monetary anchor

As he reflected on the roots of the global financial crisis, Padoa-Schioppa emphasised the importance of monetary factors,¹⁸ noting that the protracted boom in US

¹³ As IMFC Chair, Padoa-Schioppa contributed to negotiate an important agreement in April 2008 for the rebalancing of IMF quotas and the reform of IMF governance (see F. Saccomanni, *Ricordo di Tommaso Padoa-Schioppa*, speech at Festival dell'Economia, Trento, 2 June 2011).

¹⁴ T. Padoa-Schioppa, "The IMF in perspective", op. cit., p. 515.

¹⁵ T. Padoa-Schioppa, "The role of the Fund and the IMFC", op. cit.

¹⁶ T. Padoa-Schioppa, "The IMF in perspective", op. cit., p. 518.

¹⁷ L. Bini Smaghi (2011), *Tommaso Padoa-Schioppa: Economist, policy-maker, citizen in search of European unity*, European University Institute, Fiesole, 28 January 2011

¹⁸ T. Padoa-Schioppa (2010), *The ghost of Bancor. The economic crisis and global economic disorder*, lecture held at the Triffin International Foundation, Louvain-la-Neuve, 25 February.

real estate prices had come in a context of overabundant liquidity supported by an easy monetary stance, encouraged by the fact that the globalisation of the economy had kept domestic inflation low. But he also argued that this process could not have been carried that far, with such an enormous accumulation of private and public debt, if the dollar had not been the main reserve currency and the United States therefore dispensed, *de facto*, from observing any external monetary discipline.

This pointed to the dollar-centred post-Bretton-Woods international monetary system as an important element in the constellation of factors that had led to the crisis. Its two key features – exchange rates left to the market and the global dollar standard – had not been created by design but had emerged largely by default, all the attempts to rebuild a more consistent system in the 1970s having failed. The fundamental flaw in this “order” lay in its failure to provide some degree of macro-economic discipline. That would have required correction mechanisms triggered by any breach of discipline. Two conditions were essential for such mechanisms to operate correctly – exchange rates in line with fundamentals and a stable anchor for the global monetary policy stance – and Padoa-Schioppa argued that neither was fulfilled by the present system.

On exchange rates, he maintained that neither a return to fixed rates nor universal free floating would be feasible or desirable. In particular, it would be an illusion to think that full exchange rate flexibility could guarantee the adjustment of imbalances and impose policy discipline: markets have proved unreliable in signalling unsustainable positions, and even when they do send the right signals the adjustment is not automatic, since policy changes are required. Equally illusory is the idea that flexible rates can insulate national economies from external shocks. Therefore, an intermediate solution would have to be found, with exchange rates determined jointly by markets and government policies through a mixture of rules and discretion.

On the role of a monetary policy anchor, Padoa-Schioppa suggested that the original Triffin dilemma – the need for the United States to provide dollar reserves to the world would inevitably undermine confidence in the dollar, as its dollar liabilities would eventually exceed its gold holdings – was just a special case of the more general flaw of any international monetary regime based on a national currency. That is, a US monetary policy conducted pursuing solely domestic objectives could not provide an adequate global anchor, and would ultimately prove inconsistent with the stability requirements of the system as a whole.

A conceivable SDR-centred system – the development of private SDR markets turning special drawing rights into a true reserve asset usable for official intervention and serving as a benchmark for countries’ exchange rate policies – might have the advantage of being more symmetrical and therefore subjecting issuers of reserve currencies to greater policy discipline. But it would not truly resolve the inconsistency as long as the SDR remained just a basket and the global monetary stance just the average policy stance of its component currencies. “In the absence of a global policy-maker pursuing ‘what is beneficial for the world’, a mere average of policies driven by national objectives cannot produce the global public good of a stable monetary anchor on a global scale.”¹⁹

What type of arrangement could play the role of “global policy-maker”? One conceptually viable solution would be a truly global currency – perhaps the SDR itself,

¹⁹ Ibid., p. 17.

if it should morph into a full-fledged currency – managed by a global policy-maker in order to meet the global demand for reserves, with the policy stance determined by the scarcity of its supply. However, such a solution, reminiscent of Keynes' Bancor, would probably be regarded as far-fetched by many observers. An alternative, at least in theory, would be policy coordination among the main monetary areas, but while some elements of a framework for coordination already exist (the IMF, the BIS, the G7, the G20), Padoa-Schioppa contended that this alternative may be no less far-fetched. "All past and recent experience suggests that, in practice, coordination fails precisely when it is most needed, i.e. when policy preferences are most divergent".²⁰ In the end, he did not offer a solution: "For the time being, I think we can conclusively prove that we need a flying object; inventing the airplane is a different matter altogether."

5. The governance of the international monetary system

Padoa-Schioppa was strongly critical of the thesis that interdependence could be self-regulating, with no need for supranational governance, and identified as one of that view's ideological underpinnings the doctrine of the "house in order". According to that doctrine, if every country pursued sound domestic policies, international order and stability would automatically follow. There would be no need for national authorities to decide anything in common; it would be enough for them to exchange information. Cooperative arrangements could even be dangerous, insofar as they might blur policy responsibilities and provide an excuse to deviate from sound national policies. Padoa-Schioppa found this notion dangerously misleading.²¹ First, while universal adherence to sound policies would obviously help, it cannot be seen as a precondition for cooperation, since a cooperative order is needed precisely to create the proper incentives for good behaviour and to manage the consequences of deviations from it. Second, even if all houses were in order, there would still be "common areas" (trade and financial relations, exchange rates, health, the environment, poverty) where externalities are too important to be ignored and need to be managed in common.

Padoa-Schioppa often deplored the *de facto* shift in international cooperation away from supranational institutions toward inter-governmental fora like the G7 and the G20, where decisions require unanimity. In his view, the unwillingness of individual nations to accept limitations to their sovereignty reflected the illusion that sovereignty could stay absolute despite economic interdependence.²²

Padoa-Schioppa saw a fatal shortcoming of the intergovernmental approach in the tendency for "peer pressure" – supposedly the mechanism for encouraging countries to put their own houses in order – to turn, in practice, into "peer protection." Citing the implementation of the EU Stability and Growth Pact and earlier attempts at global policy coordination, he pointed out that large players had often shown a tendency to stipulate "pacts of non-aggression" to the detriment of the global interest.

²⁰ Ibid., p. 17.

²¹ T. Padoa-Schioppa (2009), *La veduta corta*, il Mulino. Padoa-Schioppa also articulated this view in a series of lectures held at the European University Institute in 2005 (see T. Padoa-Schioppa (2005), *Four lectures on international economic policy cooperation*, Lectures to be delivered at the EUI Schuman Centre for Advanced Studies Pierre Werner Chair Programme, Florence 25-27 January, unpublished manuscript).

²² T. Padoa-Schioppa, *La veduta corta*, op. cit., chapter IV.

Having made the case for “the reconstruction of a fully-fledged international monetary order” in his Louvain lecture, in the fall of 2010 Padoa-Schioppa, together with Michel Camdessus and Alexandre Lamfalussy, assembled a group of former high-level policy-makers (the Palais-Royal Initiative) to draft a report on the reform of the international monetary system, to be delivered to the G20 Presidency in early 2011 as an input for the Group’s planned work in that area. In the event, the report was finalised a few weeks after Padoa-Schioppa’s untimely death.²³ Both its analysis and its proposals bear the unmistakable mark of his intellectual contribution.

After outlining the key weaknesses that have plagued the functioning of the international monetary system – ineffective global adjustment, excesses and sharp reversals in liquidity conditions and capital movements, exchange rate volatility and misalignments, excessive reserve accumulation – the Palais-Royal Initiative report describes their fundamental cause as the lack of an effective governance structure to manage economic and financial interdependence. It underscores that while those weaknesses are not new, in today’s increasingly integrated world economy the consequences of failure to address them are become more and more serious.

The report’s proposals recommend strengthening multilateral surveillance through: a) stronger obligations, backed by a set of “norms” for key variables (including exchange rates); b) well-defined assessment procedures triggered by deviations from those norms; c) the possibility of using incentives and sanctions to encourage compliance. To underpin stronger surveillance, a new governance architecture is proposed, integrating the G20 within the governance of the IMF (with a redefined and constituency-based grouping of G20 Ministers and Central Bank Governors taking over from the IMFC). The purpose is to give this governance structure legitimacy and make it effective, by combining the universal representation and treaty-based legal powers of the IMF with the high-level political commitment of the G20. The report also called for a “Global Advisory Council”, i.e. a panel of eminent independent experts to advise the key organs of the IMF. Its function would be to give a stronger voice to the global interest, making the peer review process more effective and avoiding deadlock on decisions.

²³ J.T. Boorman and A. Icard (eds.) (2011), *Reform of the international monetary system: the Palais-Royal Initiative*, SAGE Publications.