The IMF and the International Monetary System: Lessons from the Crisis

Axel A. Weber

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Per Jacobsson Foundation
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Foreword

The second Per Jacobsson Foundation Lecture of 2011, “The IMF and the International Monetary System: Lessons from the Crisis,” was presented by Axel A. Weber, Visiting Professor of Economics at the University of Chicago’s Booth School of Business and former President of the Deutsche Bundesbank. The lecture, part of the Annual Meetings of the World Bank Group and International Monetary Fund, was held on September 25 in the Gallery of the IMF’s HQ1 building in Washington, D.C. The event was moderated by Per Jacobsson Foundation Chair Guillermo Ortiz.

The Per Jacobsson Foundation was established in 1964 to commemorate the work of Per Jacobsson (1894–1963) as a statesman in international monetary affairs. Per Jacobsson was the third Managing Director of the IMF (1956–63) and had earlier served as the Economic Adviser of the BIS (1931–56). Per Jacobsson Foundation lectures and contributions to symposia are expressions of personal views and intended to be substantial contributions to the field in which Per Jacobsson worked. They are distributed free of charge by the Foundation. Further information about the Foundation may be obtained from the Secretary of the Foundation or may be found on the Foundation’s website (www.perjacobsson.org).
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Opening Remarks

GUILLERMO ORTIZ

Good morning, everyone. My name is Guillermo Ortiz. I’m the Chairman of the Per Jacobsson Foundation. After Andrew Crockett’s resignation last year, he passed me the baton. The Board did actually, but it was at the initiative of Andrew.

Before I introduce our speaker today and again welcome you to this edition of the Per Jacobsson Foundation, I would like to make a couple of announcements. Caroline Atkinson, who had been associated with the Foundation since 2009, left the IMF in early August to take a position at the White House, and thus she will not be able to serve as President of the Foundation. She did a wonderful job as President, and the good news is that I am delighted to announce that Minouche Shafik will succeed Caroline. As you all know, Minouche assumed the office of Deputy Managing Director of the Fund in April of 2011. Before that she was the youngest-ever Vice President of the World Bank, where she was responsible for private sector infrastructure portfolio investment and was part of the senior management team of the International Financial Corporation. And I have a couple of pages of résumé for her, so I’m going to skip those and just welcome her. It’s an honor for us to have you on board.

Let me now say that it’s a great pleasure for me to introduce Axel Weber. It’s obviously a cliche to say that he needs no introduction, but in this case it’s particularly true. But I’m going to do a brief introduction anyway. He is currently a Visiting Professor at the University of Chicago, the Booth School of Business. And as many of you know, this summer UBS announced that he will be nominated as a member of its board, and hopefully the board will propose him to be the chairman. This has to be approved by the assembly, which will happen sometime in May, I believe, of 2012.

Axel, as you all know, has very broad expertise in international finance and banking as well as strong leadership experience, something that we or anyone who has worked with him—and I have had the pleasure of sharing many meetings with Axel through the years—knows very well.
He was President of Deutsche Bundesbank and a member of the European Central Bank Governing Council from April 2004 to 2011. In his role at Bundesbank, he also served as a member of the Board of Directors of the Bank for International Settlements, Governor for Germany at the International Monetary Fund, and member of the steering committee of the European Systemic Risk Board and the Financial Stability Board. He’s a member of Group of Seven (G-7) and Group of Twenty (G-20) Ministers and Governors, respectively.

Prior to joining the Bundesbank, he was a member of the German Council of Economic Experts and served as a member of the Expert Advisory Panel to the Deutsche Bundesbank. Prior to joining the world of central banking, he had a distinguished academic career in Germany (which he has briefly taken up again now in Chicago) where in his previous incarnation he was an economics professor at various universities.

Axel’s subject for today’s lecture is “The IMF and the International Monetary System: Lessons from the Crisis.” So without any further ado, please, Axel.
The IMF and the International Monetary System: Lessons from the Crisis

AXEL A. WEBER

INTRODUCTION

Let me first of all start by thanking you very much for inviting me to give this speech. It's for me a pleasure to accept this invitation.

I also must say it's a great honor for me to be asked to give this Per Jacobsson lecture. It's a special honor, as I am the first German to deliver the lecture since Karl Otto Pöhl's appearance in 1992. He was also a former president of the Bundesbank at that time, and he talked about "a new monetary order for Europe"—a subject that has recently gained new relevance, as you all know. In my view, it would indeed be necessary to come up with a new foundation for the European Monetary Union—either by significantly strengthening the current system of fiscal controls or by making a big step towards a closer political and economic union.

This, however, is not the subject that I have chosen for today's lecture. Given the fact that this lecture is dedicated to Per Jacobsson, the long-standing Chairman of the Board and Managing Director of the IMF, I would like to focus on global issues. Among the pressing issues at this level are imbalances that are reflected by diverging current account positions. This problem is also high on the agenda of the Group of Twenty (G-20) framework to achieve strong, sustainable, and balanced growth. At a more analytical level, the central mechanisms to reduce the imbalances are provided by the international monetary system. Thus, I would like to present my view on some of the relevant issues such as the current state of the international monetary system, the IMF's role within it, and some proposals for reform that are currently being discussed.
THE FINANCIAL CRISIS AS A CATALYST FOR CHANGE

The international monetary system has always been the subject not only of intense discussions, but also of profound change. Prior to World War I, capital flowed freely, and the gold standard guaranteed stable exchange rates. Following the war, however, chaos emerged and led to a period of extensive capital controls that lasted until the beginning of World War II. Immediately after the war, a global system of fixed exchange rates was installed—the Bretton Woods system. It is here that the IMF makes its first appearance as a central institution of the international monetary system. Nevertheless, in 1973 the Bretton Woods system collapsed, and the international monetary system changed its structure once more. The new system was based on three floating currencies, namely, the U.S. dollar, the deutsche mark, and the yen. Together with a liberalization of capital flows, this arrangement guaranteed quasi-automatic adjustments of current account imbalances. As the IMF had been designed to assist countries with current account deficits, its role came under discussion. It subsequently regained some importance during the Latin American crises in the 1980s and the emerging market crises in the 1990s. Nevertheless, when the great moderation set in, the IMF, faced with demands to reduce its size, was in danger of losing its significance.

Then another crisis hit—a global financial crisis, followed by a sharp economic downturn. Given the severity of the crisis, we have to ask ourselves: Has it brought us to a new crossroads in the evolution of the international monetary system, and what are the implications for the IMF? What the crisis most certainly did do was to alter the external circumstances. First and foremost, it revealed a development that could be termed as a “globalization of crises.” This is relevant at two levels. First, it became apparent that an initially national crisis might very quickly assume a global character by spreading through closely linked financial systems. Second, the global financial system and the global real economy are so intertwined that a financial crisis can severely affect the real economy in both emerging and advanced economies. And regarding the relation between emerging and advanced economies, it is obvious that economic weights have shifted. Emerging economies acted as an important stabilizer at the height of the crisis, whereas major advanced economies are now facing a rather modest outlook for growth. At the same time, they no longer enjoy the status of doubt-free solvency.

What do these developments imply with regard to the role of the IMF? First of all, the crisis emphasized that the IMF is an indispensable global
institution. It played a crucial role in fighting the financial crisis at a global level, but also with regard to the sovereign debt crisis in Europe. Regarding the latter case, the decision to involve the IMF was correct, even though this step was preceded by intense discussions. Furthermore, the analytical input provided by the IMF is essential for increasing the resilience of the global economy to future crises. This is perhaps most obvious in the case of the Group of Twenty (G-20) Framework for Growth, where the Mutual Assessment Process benefits immensely from the IMF’s expertise in high-quality cross-country analysis. However, it has to be acknowledged that the current crisis has not been a random event but can be traced back to specific causes such as inadequate institutional arrangements or mistakes made by market participants and policymakers alike. Thus, the ultimate objective should be to tackle the roots of the crisis instead of just creating ever more instruments to fight the symptoms. Against this backdrop, any attempt to enhance the IMF’s capacity for crisis management has to be thoroughly assessed in terms of costs and benefits. I would like to elaborate on this point with regard to two key features of the international monetary system: the supply of international liquidity and the issue of exchange rate and capital flow regimes. Both features are part of the current debate: the first in the context of global financial safety nets and the second in the context of capital flow management. Let us begin with a few thoughts on global financial safety nets, a subject that is of direct relevance for the IMF.

GLOBAL FINANCIAL SAFETY NETS

A core problem during the financial crisis was that money markets literally dried up and were no longer able to provide international liquidity. This particularly affected banks with foreign-currency needs because banks usually do not have access to refinancing operations in foreign jurisdictions. Thus, they are dependent on the money market to obtain foreign-currency funding. To counter this liquidity squeeze, central banks introduced ad hoc swap lines with other central banks as an emergency measure. The objective was to provide each other with the capacity to deliver foreign-currency funding to the national banking systems. These measures proved to be successful in securing the supply of international liquidity.

At present, there are discussions as to whether the ad hoc swap lines should be replaced with a more permanent mechanism in which the IMF would play a central role. Leaving aside the details, such a mechanism
would, in essence, enable the IMF to provide almost unlimited liquidity support without adequate conditionality or pricing. Taking this as a starting point, I would like to raise some objections to such an institutionalized financial safety net. Enabling the IMF to offer quasi-unlimited amounts of short-term liquidity would implicitly require a precommitment from central banks to cover the potential financing needs of the IMF in times of stress. However, to me, such a commitment seems undesirable and unrealistic, not least considering the resulting unwarranted interference with members’ monetary policy as well as moral-hazard issues.

Central banks’ reaction to the systemic crisis has been swift, adequate, and well coordinated. This flexible “case-by-case” approach has substantial merits: due to the resulting constructive ambiguity, agents cannot expect to be bailed out in any case. This in turn reduces incentives for risky behavior. Also, the IMF is not a world central bank and not a lender of last resort. It cannot—and should not—be a “hub” for central bank swap lines. In those cases where central banks do not provide swap lines in a systemic crisis, the IMF is well placed with its existing instruments to cover liquidity needs while staying within its resource envelope.

More fundamentally, the main lesson of the financial crisis is that we need a better-regulated financial market environment. This would be a true safety net for our societies and the international system.

In the same vein, the argument can be transferred to the financing side of the IMF. The idea of granting the IMF the option to issue special drawing right (SDR) bonds to raise funds on capital markets is currently being discussed. This would replace the provision of foreign reserves via quota subscriptions. Such a step would, however, completely change the cooperative and monetary character of the IMF: the cooperative exchange of foreign reserves on a short-term basis—establishing the IMF’s unique character as a monetary institution—would be lost. In that case, it would only be logical for central banks to withdraw from the IMF’s financing mechanism altogether and leave the financial responsibility with the ministries of finance—just as is the case for the World Bank. Introducing SDR bonds would—under current proposals—also extend the IMF’s lending capacity further, since there would be virtually no funding limits anymore, but member countries would in fact guarantee the amounts raised by bond issuance. We could end up with an IMF that works like a hedge fund which leverages its quota resources with large amounts of additional debt. At the same time, adjustment efforts in countries borrowing from the IMF could be impaired given the quasi-unlimited availability of Fund resources.
From a practical perspective, generating a secondary market for SDR bonds of sufficient critical mass liquidity would require substantial new SDR allocations and the use of SDRs—not only in the official, but also in the private, sector. This would influence global liquidity conditions and even interfere with the monetary policy of those central banks that issue the major reserve currencies. The IMF could also distort the risk assessment in international financial markets: it would pay the risk-free interest rate to finance itself and, as has been suggested by some commentators, invest those resources in risky assets of crisis countries. This would lower the refinancing costs of the countries in question. Unless balanced by strict ex post conditionality, this would further undermine the principles of sound incentives necessary for a stable international system.

To sum up, the objective of making the international financial system more stable is welcome, and the IMF's contribution to this end is appreciated. However, to me it seems questionable whether a “structured,” that is, standardized approach to global financial safety nets makes sense compared with a more flexible case-by-case approach, which has proven very effective in the recent crisis. I am also not convinced of the need to again change facilities, which have only recently been introduced and already modified, or to invent ever more IMF facilities. In particular, I would not like quasi-unlimited and unconditional IMF “short-term liquidity lines” which would de facto rely on access to reserve currency central banks on demand to have any market credibility. For me, it is hard to imagine subsuming independent central banks under IMF crisis management coordination. Every crisis is different and needs different crisis managers.

MANAGEMENT OF CAPITAL FLOWS

Disruptions in the supply of international liquidity were undoubtedly a serious problem during the crisis. Recently, however, another aspect of the international monetary system has drawn some attention: capital flows. In the wake of the crisis, some emerging markets have experienced very high inflows of foreign capital. These inflows not only bear the threat of sudden reversals but might also contribute to the buildup of unsustainable bubbles.

Consequently, leaders of the G-20 called for national, regional, and multilateral responses to limit the risks associated with excessive volatility in international capital flows. The management of these flows plays a crucial role in the current G-20 work program on the international monetary system. To be sure, the main objective of capital flow management
is to enhance national and global financial stability. As long as stability is ensured, free movement of capital should remain the ultimate objective.

However, in circumstances of high and volatile capital flows, it is also clear that countries need room for maneuver to formulate their own policy mix against the background of country-specific circumstances in order to enhance financial stability. At the global level, it would be helpful in this regard to have a common understanding about the aims, benefits, and limitations of an active capital flow management. This understanding should recognize that capital flow management measures should never be used to buttress unsustainable or distortionary policies and thus delay necessary adjustments in the economy. Capital flow measures should therefore never substitute for sound monetary, fiscal, or other regulatory policies, but rather be used in extreme situations to add to their effectiveness in the pursuit of stability. In addition, whenever capital flow measures are applied, they should be predictable, temporary, reversible, targeted, and transparent.

What could the IMF's role be with regard to capital flow management? In close cooperation with the Bank for International Settlements, the IMF should play an enhanced role in the global monitoring of capital flows. In close cooperation with other relevant financial institutions, it should prioritize closing data gaps on global capital flows. While its members can benefit substantially from the technical expertise of the Fund in advising appropriate policy responses to volatile capital flows, the Fund's role can hardly go any further than that. It is hard to imagine that it is either feasible or desirable for the IMF to assume the role of an "umpire" over capital flows.

CONCLUSION

To wrap up my speech, let me summarize the main points. The current crisis has been devastating, and it is most certainly warranted to have the necessary instruments to manage such a crisis. In my view, recent experience shows that this is already the case. The liquidity squeeze has been effectively managed with the existing set of instruments. There is no demand and no need for the IMF to act as a world central bank or as a global lender of last resort. The IMF's principal strengths and role in the international division of labor is undoubtedly its analytical capacity, which is ever more important to serve as an input to international crisis prevention and crisis management.
Regarding the organization of the international monetary system in general, the first observation is that it has largely remained robust during the crisis. However, large internal and external imbalances exist and have to be addressed. This is a problem with global ramifications which requires a cooperative approach at the global level. Consequently, the G-20 has introduced a framework to achieve strong, sustainable, and balanced growth. In the current challenging phase, it is even more important that individual economies contribute to global stability. Some economies with large current account surpluses, such as China, have to remove structural deficiencies that limit internal demand. At the same time, they have to grant their currencies more flexibility and work towards full convertibility. Countries with large current account deficits should consolidate their public finances as quickly as possible. But even countries with balanced current accounts can contribute to global stability. A case in point is the European Monetary Union. Here, a swift and sustainable solution for the sovereign debt crisis would be beneficial not only at the national or regional, but also at the international, level. We are faced with global challenges that require a global response to which all of us have to contribute.
Questions and Answers

Following the formal presentation, Axel Weber took questions from the audience.

GUILLERMO ORTIZ: Well, thank you very much, Axel. You have given us as usual a very thorough, a very insightful, and a very rich presentation on very important aspects of the reforms of the international monetary system as well as the IMF. And you made it a point at the beginning of your lecture when you said you were not going to speak about the sovereign debt crisis in Europe, you predicted or touched on some aspects of this, including the fact that—and your view was correct to involve the IMF at the beginning—the IMF also has to play a very important role in sort of correcting global imbalances, of which, of course, the European Union is an important part. Although in aggregate, as you mentioned, the current account for the region is balanced.

Now as you know, the main subject perhaps in these meetings and one of the main preoccupations is precisely the sovereign debt crisis in Europe. And there have been important steps that have been taken. There have been the July 21 accords and so on and so forth, which will take a few months to go through. So one of the important questions is whether something else is missing, whether we perhaps need a lender of last resort in terms of the solvent countries in Europe and the only institution that can provide that perhaps is the European Central Bank (ECB), as a bridge to when the European Financial Stability Facility (EFSF) is fully implemented.

So, Axel, I don’t know if you would like to expand at least partially on some of these problems that we are seeing before opening to the floor.

AXEL WEBER: It’s one of the trademarks of your job that once you’ve been a central banker, you can never walk away from it. So let me maybe say a few things on the European situation.

I think I’d like to start with the point I tried to make in the end. The measures to be taken are not disputed. What is needed is firm implementation of these measures. So I think for the European situation, it’s pretty clear what is needed. And let me go back to what I tried to say before about how to deal with global problems. The first action must always be
at the underlying root causes of the problem. Then you can talk about financial mechanisms at the international or at the European level to deal with the fallout if some of these problems emerge.

So what does that suggest for Europe? It suggests first and foremost that those countries where there is excessive debt and where fiscal balances are out of whack need a very fast-track program to rebalance their economies. So fiscal consolidation in those countries where the debt sustainability discussion is prevalent is a key input into any solution in Europe. It's just a conditio sine qua non for moving ahead, so European countries that have a debt problem need to work at reducing their debt. And when you're a minister of finance, you usually have two ways to do that. One is the expenditure side of your budget; the other is the revenue side of the budget. I have zero understanding for European debates, whether it is a sacrosanct discussion about parts of the expenditure or parts of the revenue. Everything needs to be on the table. And when everything has been on the table and analyzed and action has been taken, there is a residual if expenditure and revenues don't match. Well, in that case, you can talk about some short-term aid programs and support programs as they are in place. But let me repeat again: that is dealing with the symptoms. It is not getting at the core of the problems. We need to deal with the root cause of the problems in Europe, and that is excessive debt and the buildup of excessive debt in some of these member countries.

I'm not one of those that believe that if you only reduce the funding cost of dealing with legacy debt, you will solve the debt problem. My prediction is a different one. If, for those countries that have excessive debt built up over years and years, you reduce the funding costs for that, they will add more debt. They will not achieve the fiscal turnaround. They will continue in a similar vein as they have before. So, therefore, you really have to attach conditionality to some of these international programs.

And I'm quite worried about the current debate about throwing any conditionality out of the window, about just focusing on the cost of funding and continuing from there. The whole debate, for example, about a euro bond is just totally misled. It takes away the attention from what is really the action that needs to be taken, because as long as you have irrelevant alternatives on the table, you spend a lot of time kidding yourself that some of these instruments are a solution to your problem. The euro bond is an instrument where everybody takes their own decisions about expenditure and revenues, and they let the European level, the community, pick up the bill for the residual of that decision. No taxpayer in Europe would be advisable to go there.
So before we can talk about something like that, there needs to be a joint process for decision making on expenditure. There needs to be a joint process for decision making on revenues. There needs to be then a discussion on what defines “unavoidable” or “surprise shortfalls of revenues” or “excessive expenditure.” And then you can talk after all these decisions about a joint funding of that, which moves the entire euro bond into such a European instrument that, if you have a European economy that is more like a United States or Europe with joint fiscal policymaking, could be an option. Unless you get there, it just prolongs the pain in those countries that basically by such an instrument achieve lower funding costs for their legacy debt and take that as a signal to carry on as in the past. It would be futile for the future of Europe, and it’s just the wrong debate. And as always in politics, as long as you can afford to have the wrong debates about irrelevant alternatives, they delay policy action. And we should simply take those wrong discussions off the table and focus on the core of what needs to be done.

GUILLERMO ORTIZ: Thank you very much, Axel. So let me open this to the floor, please, first question there.

QUESTIONER: Mr. Weber, I'd like to ask a question with a background that my first meeting, my first Jacobson lecture, was in the year 1968 and most of the IMF I attended. And I only have a very short question. Isn't the less polite message that you present and with your personal decision, isn't that after the first—after the banking crisis broke out in 2007 and we have now the big European crisis or mess since last year—that as journalists we can summarize that in the first crisis with the U.S. leading and in the second disaster that is happening in Europe governments being totally pressed have in part been destroying, politicizing, instrumentizing, muscling the central banks of this world?

AXEL WEBER: I'm not a journalist, and I wouldn't want to describe how you do your job, so you can summarize my lecture in any which way you want. But I wouldn't associate myself with your summary.

QUESTIONER: I've got a question which goes to the heart of what you were saying about the funding of the IMF, because there are some people who say that the IMF has overextended itself in the direction of Europe, that there was a large amount of lending going on there as you know. And there are alternative mechanisms being talked about. The rather innocuous-sounding AMRO,
the ASEAN Plus Three monetary research office set up in Singapore recently, which could, if developed, turn itself into a kind of Asian monetary fund. There could be a diversion of funds from central banks and monetary authorities in Asia to such mechanisms under the Chiang Mai Initiative. One hears very interesting debates about how the Chiang Mai Initiative might itself be leveraged, could raise money on markets, and so on. This could set itself up as a kind of alternative mechanism to the International Monetary Fund with the Asian countries, which have the lion's share of the reserves these days, actually putting money into different channels, into areas which they think might be more propitious for the development of the world economy. And it could actually, I think, be quite an interesting salutatory in competition to the way the still largely Western-dominated IMF runs its affairs.

So let me get it from a raw, academic, historical point of view. Do you think you could give some thoughts to that series of reflections?

AXEL WEBER: Well, you just mentioned the right word, sort of almost at the end of what you said—it's competition. Clearly the IMF has a history of competing with local institutions, with regional institutions, that have similar remits. And to be honest, the IMF always managed to emerge from these debates as the prime institution that has the key expertise internationally. So, whilst it is an endeavor that countries should embark on, if they have a regional development bank and if they put research and expertise into these institutions, it is a long haul and uphill battle to come to the same standard of research and analytical capacity as the IMF has. So, I mean, take the IMF as a role model. Try and build regional funds with the same remit or similar remit and with the same capacity of international expertise—great thing to happen. And I don't think the IMF would fear the competition coming from there.

Let me also say the IMF—and that's a second dimension—is the only real global institution that we have. Regional institutions may supplement IMF action, but when we come to the next crisis, given where we are now—the world is now so globalized in financial markets, is so globalized in trade. It is so globalized in the provision of knowledge and technology. You just need to be in a university like Chicago where I am now. You rarely have 10 percent of your students coming from the United States itself. So we are in a global, knowledge-based society with global financial markets and global trade. Regional institutions cannot cope with the next crisis that will come because if one thing is clear, it is that the next crisis will not be less global than the past crisis has been. I don't really see that we will go back in international integration to any level that would allow a
regional crisis of reasonable size to be contained simply by regional action alone. And there I think we shouldn’t kid ourselves. That’s not going to happen again. So the IMF’s role is key.

I wasn’t asking about any reduction from where we are now in terms of the IMF. I was simply cautioning in two directions: one is that throwing ever larger funds at the problem is not usually a good solution if you don’t deal with the root cause. And I think some of the discussions about funding extension may lead us astray at focusing at the real issues that underlie.

And the second issue that I think really is very important: the IMF has a huge capacity for analyzing problems and being blunt to member states about telling them how they view the situation. And to go back to the European situation, without the IMF’s involvement, do you really think that leaders around the table—peers—would have come up with tough measures on some of the programs that have been embarked on? I rely very strongly on the IMF as an independent source of conditionality because on the IMF Board, you don’t just have Europe, you have emerging markets, and you have all of those countries in Asia and South America that have been subject to conditionality in previous crises. And I think it is a very good idea to not waver on the standards of conditionality that were imposed on those crises on those countries and to continue imposing the same standards even now that the crisis is more an industrialized economies’ crisis. And I think emerging markets sitting on the Board of the IMF can ensure a high level of required conditionality. And that is why I think it is important to have the IMF involved in the regional problem in Europe.

GUILLERMO ORTIZ: I think we have time for one or two questions, please.

QUESTIONER: You highlight the good academic resources of the IMF, and you had some really nice words. Last week the IMF asked the European Central Bank to continue or maybe enhance the securities market program. Would you say that is also a result of good academic work, and do you accept that?

AXEL WEBER: I was talking about the average suggestion, not each individual suggestion. But I don’t think I have to embark in a very long and extended way on what I view as sort of the borderline between fiscal policy and monetary policy.

Let me just repeat my position, and I’ve held that throughout, and I’m still of the same position. If we want to deal with the root causes of prob-
lems, we need to make a clear analysis whether those problems are in the central bank remit or in the fiscal remit. Dealing with liquidity crises is a key central bank remit, be it international liquidity, then it’s swap lines, be it national liquidity, it’s extensive lending, all the special facilities that the European Central Bank and all of the central banks embarked on. And I highly endorse these. I voted for them. And I was one of the drivers for embarking on them early on in the crisis, so don’t get me wrong.

There is another set of problems that doesn’t emerge in liquidity space because deep down it is a solvency issue. And when we talk about some countries in the European periphery, there is a debate, a warranted debate, about sustainability of fiscal positions. When I teach my graduate students in Chicago, I give them a very simple formula for debt sustainability. And that debt sustainability formula basically tells you three things: your growth rate in the long run, your current interest rate funding cost, and basically your level of legacy debt give you an answer on what your primary surplus needs to be to fund that. If a country is bordering on recession and recession becomes deeper and deeper, if interest rates are very high so there is no growth model for the future, and funding costs are huge, a large amount of legacy debt—and there we really talk about anything that is three digits—becomes a problem, and that’s when debt sustainability is an issue. And to solve debt-sustainability problems should not involve the central bank. There is a borderline between fiscal space and monetary space, and unless we want to go back to a world that existed before central banks became independent of governments and we’re freed of the obligation to contribute to the funding of government debt, we don’t want to cross that line. So I hold a very firm, principle-based view on that. I have never had problems with building a bridge to basically bridge a dire situation. That’s not the case. But in order to build a bridge, you need two pillars. That bridge cannot lead into nowhere. You need the fiscal authorities to build the other pillar of the bridge, and what I see in Europe is that fiscal pillar of the bridge has, for one-and-a-half years, a sign hanging out there: “Under Construction.” And that just won’t work.

GUILLERMO ORTIZ: Okay, let’s have the last question here, please.

QUESTIONER: Thank you very much. Let’s continue to talk about a euro zone crisis which you want to avoid a little bit. Before the fundamental problems have been addressed, which as you prefer, we have to do something to rescue. That’s the reason why the finance ministers and also the central governors gathered together here mainly from BRIC [Brazil, Russia, India, China]
countries to talk about what they can do to help to rescue. And they declared
that they will do something if needed and if necessary. Then the question is
what and how. At least four options came to mind. The first is that you can or
they can—BRIC countries can give money to the EFSE. And number two, you
can inject more money into IMF through a new agreement of the instruments.
And third, you can inject capital directly into the banks in the euro zone
just as the IMF has stressed for awhile. And finally, maybe you can purchase
sovereign debt of the euro zone. It’s very dangerous in my mind. So what do
you think about all these options? All of them are misleading, or maybe one of
them is a little bit of help. Thank you very much.

AXEL WEBER: Well, just to put that right, I didn’t say that I wanted to
avoid speaking about the euro zone crisis. Whenever I’m summoned that’s
the only thing I ever get asked. So I was under no illusion to be able to
walk away from questions on that. What I wanted to say more is that I’m
not a policymaker on the inside of the policy circle anymore, and I do
think actually that having made that transition from the policy world to
a more private role it warrants actually not to be seen sitting on the fence
and giving your former colleagues good advice from the outside all the
time. And having a cooling-off period, I try and stick with that advice.

So if you ask me about the question of what should be done—and you
mentioned four or five dimensions in which the European fund could be
improved—yes, I think we all understand that there needs to be further
action, because the action embarked on so far hasn’t really convinced the
market that we are in a sustainable solution. And all of the elements you
mentioned could be either jointly or separately part of the solution.

But again, let me just maybe allude to what my understanding of the
role of central banks and maybe ex-central bankers is. We can advise gov-
ernments on the technicality of choosing those tools, but the European
rescue mechanism is a deeply fiscal mechanism. When we advise gov-
ernments, we basically can warn about incentive policies, moral-hazard
problems that emerge from wrong constructions, and the idea of leverage
that you mentioned as one of them was an idea that was around the table
all the time. The idea about leverage—and that is putting capital into this
fund—means that if governments agree, that the money that is in the
fund is not just junior only to the IMF and senior to the market. If it’s no
longer with the market and junior only to the IMF, it becomes a capital
element, a first loss tranche, in reinsuring European capital markets. If
that’s a decision governments take, then I think that is something that is
firmly in the set of their responsibilities. But you cannot expect central
banks that have a different remit to go to the point where they suggest to governments, on what is the risk profile of common funding in a rescue program, that they should expose national taxpayers' money to in an international rescue mechanism. Clearly, most bang for the buck you get with a first loss tranche. With a capital thing, you can leverage that fund. And there is a real debate about the need to increase the funding ability, and basically leverage is one of the instruments.

But if you talk about leverage, it should ring a bell. When we discuss leverage in financial institutions, you can make the point that if leverage was part of the problem, leveraging public finances can be part of the solution. Fighting fire with fire—it's well known, but it's a risky thing because what it means is that you expose taxpayers to a much higher probability of losing their entire money on the table if you move them into an adverse risk position relative to the market. And my understanding is once this is theoretically possible and we have all the financial expertise on how to construct such vehicles, the real debate is, will the taxpayers, after having rescued the banking system with billions of euros, accept being put at risk with their funding again to such a degree? So it's a political decision. It firmly belongs in political space. I hold a clear view on what should be done and what should not be done, but I don't really think that governments can circumvent the hard decision to put that in front of their taxpayers and their parliaments, and let parliaments decide whether they want to take this position or not. Ultimately I believe that if market circumstances become much worse than they are now, we will see much more drastic action. We've seen that in the United States. It needed drastic circumstances. It almost needed an institution in failure to warrant drastic action. It's not a first-best solution. It clearly is second-best, bordering onto third-best. But very often in political circumstances, the choice is not between first-best solutions. The choice is very often between second- and third-best. And I feel very much that the situation is going to deteriorate further before it improves.

GUILLERMO ORTIZ: Well, let me again thank Axel for his excellent presentation and his frankness in answering these difficult questions. So please join me and I'll say goodbye to him.

AXEL WEBER: Thank you.
GUILLERMO ORTIZ: Before we adjourn, Kate Langdon, who is the Vice President and Secretary of the Foundation—who really runs everything here—will tell you some logistical things.

KATE LANGDON: Axel’s lecture will be available on the Foundation’s website shortly if you want to read it in much more detail. There is also coffee at the back of the room. We’d like to thank you for coming out on a Sunday morning to join us here. So thank you very much for coming,
Axel A. Weber (b. 1957) is the Chairman of UBS. He was president of the Deutsche Bundesbank between 2004 and 2011, during which time he served as a member of the Governing Council of the European Central Bank, a member of the Board of Directors of the Bank for International Settlements, German governor of the International Monetary Fund, a member of the Steering Committees of the European Systemic Risk Board and Financial Stability Board, and a member of the Group of Seven (G-7) and Group of Twenty (G-20) Ministers and Governors. Currently on leave from the University of Cologne, he is a visiting professor at the University of Chicago Booth School of Business. From 2002 to 2004, Mr. Weber served as a member of the German Council of Economic Experts. He was a professor for international economics and Director of the Centre for Financial Research at the University of Cologne from 2001 to 2004, and a professor for monetary economics and Director of the Center for Financial Studies at the University of Frankfurt am Main from 1998 to 2001. Prior to this he taught economic theory at the University of Bonn.

He is a member of the Group of Thirty in Washington, D.C., and a research fellow at the Centre for Economic Policy Research in London and at the Centre for Financial Research in Cologne. Mr. Weber is also a senior research fellow at the Centre for Financial Studies in Frankfurt am Main and a member of the European Money and Finance Forum. In addition, he is a member of the Monetary Economics and International
Economics Councils of the leading association of German-speaking economists, the Verein für Socialpolitik, a member of the advisory board of the German Market Economy Foundation, and a member of the Hochschulrat of the Goethe University in Frankfurt am Main.

Mr. Weber graduated from the University of Siegen with a PhD in economics after receiving a bachelor’s degree in economics from the University of Konstanz. He holds honorary doctorate degrees from the University of Duisburg-Essen and Konstanz. Mr. Weber is a German citizen.
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