Markets and Government Before, During, and After the 2007–20XX Crisis

Tommaso Padoa-Schioppa

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Foreword

The first Per Jacobsson Foundation Lecture of 2010, "Markets and Government Before, During, and After the 2007–20XX Crisis," was delivered by Tommaso Padoa-Schioppa, President of Notre Europe and Chairman for Europe of Promontory Financial Group. The lecture was held on Sunday, June 27, in the auditorium at the headquarters of the Bank for International Settlements in Basel, Switzerland, in conjunction with the 2010 BIS Annual General Meetings. Sir Andrew Crockett, Chairman of the Foundation's Board of Directors, served as moderator for the event.

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).

Opening Remarks

ANDREW CROCKETT: Good morning, ladies and gentlemen. It's a great pleasure for me to be back here in this environment and to be able to welcome all of you to this Per Jacobsson Lecture.

As most of you know, but some may not, Per Jacobsson was the Chief Economic Advisor of the Bank for International Settlements for almost 25 years before becoming Managing Director of the IMF, so he's an individual who played a great role in the development of this institution as well as being a key actor in the period during which the IMF rose to prominence in international affairs.

It's a great pleasure, also, to be able to introduce Tommaso Padoa-Schioppa, somebody that we all know and have worked with for many years. Many of you know this, but just to recall, Tommaso has been Chairman of the International Monetary and Financial Committee, Minister of Economy and Finance in Italy, a member of the board of the European Central Bank, Chairman of the Basel Committee, Chairman of the Committee on Payments and Settlement Systems, and one or two other major international roles. In fact, I calculated that if he was entitled on the basis of past positions to occupy current seats, he would occupy eight of the seats on the Financial Stability Board.

But more than the positions that Tommaso has occupied, those of us who have known him for many years have, I think, always profited from his friendship, from his wisdom, and from his insights. I know that I never fail to come away from a talk or a meeting with Tommaso without thinking of at least something in a rather new light than when I went into the meeting.

Tommaso's subject for today is "Markets and Government Before, During, and After the Crisis." And without further ado, let me ask him to come to the podium and give us his lecture.

Markets and Government Before, During, and After the 2007–20XX Crisis

TOMMASO PADOA-SCHIOPPA

Thank you, Andrew, for your words and thank you particularly for the privilege you offer me to deliver the Per Jacobsson Lecture today. For me, Per Jacobsson is a mythical name, a mythical person. I never met him, but the distance between his exit and my joining this community was not so great. And it is a real honor and a pleasure to speak before you, before so many persons I have interacted with over many, many years.

The title of my lecture was given by you, Andrew, and so I will just begin.

When the long rise in U.S. housing prices came to an end in December 2006, the newspapers did not announce with six-column headlines that a hurricane was coming. Nor did the crisis units of national or international policy bodies call any emergency meeting to open the sealed envelopes with plans for managing the long-predicted "disorderly reversal." Perhaps the most lucid understanding of the facts could be found among market participants, if anecdotal accounts of some confidential utterances, like "now every man for himself," are accurate.

Three and a half years later, the crisis is still with us, and like HIV, it shows a pertinacious capacity to renew its destructive potential through continuous mutation. Unsurprisingly, it still lacks an agreed interpretation; after all, it took decades to understand the crisis of the 1930s. It also lacks a name—"subprime" appearing too dismissive—and it lacks precise dates, because we do not see its end. I would call it the "2007–20XX crisis."

The theme I have chosen for this lecture reflects the conviction that the market-government nexus lies at the heart of the crisis. It is the place where something went wrong.

In summary, I shall argue that while the crisis seems to come from the market side of the nexus, what really went wrong is on the side of the government. Firstly, government was captured by the myth that finance can regulate and correct itself spontaneously and hence retreated too much from the regulatory and supervisory role that is necessary to ensure stability. Secondly, fiscal and monetary policies fueled imbalances and inflated bubbles. Thirdly, policymaking remained almost exclusively concentrated at the level of the nation-state, hence leaving unmanaged the rapid emerging reality of global finance. The crisis has only partially corrected such errors. The exit from the configuration that led to it should be a government which, of course, respects economic freedom, but at the same time exerts its role forcefully and is not prostrate before the twin idols of the market and the nation-state.

Let me now move from the abstract to the lecture. The 2007 fracture has come as the culmination of an era in which economic policy had been guided by a strong belief in the virtues—even the "magic"—of the market. The era had started at the end of the 1970s with another fracture, when Margaret Thatcher and Ronald Reagan were brought to power by voters frustrated with a weak economy, plagued with inflation and high unemployment and with a government discredited for being both intrusive and ineffective.

In the *political arena*, the 1979 U.K. and 1980 U.S. elections were the tipping point, but the change had been prepared for years in *academia*, by a generation of economists who challenged the ideas and policies of what Paul Samuelson called the *neoclassical synthesis*.

My education—first at university, then as a practitioner—took place in the pre-Thatcher climate. When I began my central banking service at the Bank of Italy at the end of the 1960s, the view was that monetary policy could enforce virtually *any* real rate of interest merely by persistently conducting open market operations. Similarly, it was widely believed that policy could obtain high levels of employment by accepting a little more inflation. Later, as inflation began to bite, administrative controls became the principal instrument for influencing the amount and the composition of total credit. In most countries (Germany was the notable exception) firms and individuals lived in a cage of tight foreign exchange controls. In European countries virtually all public utilities and a large portion of the productive capacity and of the banking industry were state owned. In the basket forming the consumer price index, most goods were priced not by the market, but by decree.

Undoubtedly, the change in direction was long overdue. In spite of its success with the voters, however, the promarket mindset inspiring the change was by no means dominant. It met with strong resistance on the part of academics, public commentators, and influential press. Reagan was clearly defeated in the midterm vote following his election, while Thatcher's reelection in 1982 was due more to the war in the Falklands than to her domestic policies.

The Thatcher-Reagan reforms shifted the line dividing markets from government. Rules, bureaucratic red tape, and other impediments were removed. Perverse incentives discouraging work and efficiency were suppressed. Administrative controls were lifted. Exchange rate restrictions were dismantled. A vast program of privatization expanded private ownership, spread people's participation in entrepreneurial risk, and injected new dynamism into the productive sector.

In Thatcher's case, the promarket philosophy was initially stronger than her anti-EU prejudice, to the point that she gave her approval to the single market program; only later, when she realized that such a program implied a limitation of national sovereignty, did she regret approving it.

The "premarket" revolution must be credited for correcting earlier excesses, for liberating animal spirits, for accelerating growth, and for imparting renewed dynamism to Great Britain and to the United States.

It takes time for new ideas to be accepted. Then, at some point, they go from merely being accepted to becoming conventional wisdom, and the burden of proof shifts from their proponents to their opponents. This happened at the turn of the 1990s. The Thatcher-Reagan "revolution" conquered minds and set a new policy paradigm only late in the 1980s, and worse came after both left power, sometimes from leaders of opposition parties who had been converted to promarket ideas (like Clinton or Blair).

The winning ideology gradually remained without adversaries and lost the moderation, sophistication, and sense of proportion that would have been necessary to avoid incidents and, eventually, disaster. When it came to dominate the intellectual and policy arena, it turned into a form of radicalism. Radicalism had a strong root in the field of economic ideas, but it also became a pattern of social behavior.

Let me dwell first on the role played by economic ideas mechanically transferred from the laboratory to the world of practitioners. Choosing among many possible examples, consider the wide acceptance of the hypothesis that financial markets are efficient, that is, that they always reflect all the available information. The adoption of this hypothesis, and the companion one that market forces always move to arbitrage, was strongly influenced by the more general contention—belonging more to the realm of political philosophy than to economic analysis—whereby the market economy is superior to a centrally planned economy. A powerful boost to this contention came from the 1989–91 collapse of the communist system. In the view of some, this event was linked to the Thatcher-Reagan policies and, for sure, it was fully consistent with their ideas.

In its radical version that came to dominate, the received wisdom was that if it is efficient, "the market is always right"; we can say, in a loose sense, that it always moves toward equilibrium. Then, the policymaker has nothing to tell the market; he has only to listen and learn. If prices—be they the stock market index, or an exchange rate, or the price of oil and other primary commodities—move far away from the range that any reasonable observer (including the policymaker) deems to be appropriate, the observer must humbly admit that there must be something somewhere he has missed which causes the market, in its infinite wisdom, to behave the way it does. When we grant an entity "infinite" wisdom, we enter the realm of faith. "Infinite wisdom" was indeed the expression used by clerics when I was an adolescent to persuade the believer to accept a nondemonstrable, non-self-evident proposition.

If financial markets are "always right," they also possess "natural stability." This is so because financial institutions and market participants are best placed to manage risks and unforeseen external shocks. Thanks to financial innovation and improved risk management techniques, all assets have become marketable and, hence, liquid. Large financial and diversified institutions, because of their very size and of the magnitude of the risk they face, have the information, the means, and the incentives to manage risk efficiently. From this, the unwarranted conclusion was drawn that there is little need to subject the financial system to special regulation concerning products, institutions, and market structures. Markets are self-correcting. Regulation is not only unnecessary, it is also harmful because it imposes extra costs and makes market participants deviate from the path of efficiency.

The dominance of the efficient market hypothesis removed other strands of economic theory from the visual angle of policymakers and market practitioners alike. This was the fate of the opposite—and analytically no less respectable—theories according to which finance is naturally *unstable*. The two essential propositions that lost influence were first, that unregulated banks tend to be undercapitalized, and second, that financial markets are prone to alternating phases of euphoria with others of panic. Let me briefly review each of them.

According to the first proposition, banks left to the spontaneous play of profit maximization tend to be overleveraged because of the inability of fragmented depositors to impose discipline on bank managers and shareholders and restrict excessive risk taking. The result is that in a free banking world, risk is likely to grow over time, and a systemic crisis is bound to occur sooner or later. In the William Taylor Memorial Lecture I had the honor to deliver in 1999, I argued extensively against the resurrection of a "free banking approach" and suggested that the only remedy against the inherent instability of such a regime was a strict policy of licensing combined with capital requirements. Self-regulation would not be a solution. Narrow banking would not be a solution.

The second proposition states that markets tend to overshoot and undershoot. This holds particularly true when they trade storable goods, because these offer more scope for speculation-driven transactions, that is, for transactions whose ultimate motive is not a commercial need, but profit from trading. The speculator neither is nor should be interested in "the right price" of an asset, but in "where the market will go."

Surely, commerce-driven and speculation-driven transactions are hard to separate because an element of speculation (choosing the best moment to buy or sell) is present in both. Moreover, without a component of speculation-driven transactions, financial markets would probably not be sufficiently deep or liquid to perform their allocation function efficiently. However, if this component grows too large, markets become more unstable. Those who bet are not independent observers. The market is a horse race in which the winner is not the strongest horse or the best jockey, but the one on whose victory most watchers have placed their bets. This is not ordinary gambling, it is a special gamble in which the pellet spins at the command of the players.

As temporary departures from equilibrium, bubbles are part of the ordinary nature of the market. However, the bubbles we are concerned with are not of an ordinary nature. They are those which, instead of being promptly burst by traders, are inflated by them through the process of self-fulfilling expectations.

Let me now turn from the role of economic theories to what could be called the human factor, or social behavior, in the market-government relationship. The market has subjected government not only in the mindset, but also as a value in life and as a guide for social behavior. An increasing share of the best and the brightest were attracted to profit-making activities rather than to public service or research. In the "learn-earn-serve" triptych—which, according to an old saying, describes the life path of an accomplished gentleman—the middle term, "earn," acquired prominence in the aspirations of the educated youth entering the labor market. The social status of the public servant and even of the scholar resisting the blandishments of business correspondingly declined.

Public servants absorbed promarket radicalism in classrooms before graduation, then in the discourse of political leaders to whom they owed appointments and promotions, then in patterns of social life where the "industry" outshone the "bureaucracy." The capture of the regulator, adequately described in forgotten academic papers, belongs to the realm of sociology and psychology before becoming an intellectual credo and a guide for action. Officials imbued (admittedly, often excessively imbued) with the sacrality of government were succeeded by clerks highly trained, but too chary not to spoil the party of the private sector.

I have myself observed the impervious reluctance of a generation of economists to use basic economic concepts such as equilibrium exchange rate, core inflation, neutral interest rate, output gap, or structural deficit. They were putting forward difficulties in the measurement and definitional controversy, but the root of their reluctance was the self-cancellation of the policymaker's judgment: only the market knows, only credibility counts, and if you speak against the market, your credibility is destroyed.

A significant aspect of this environment is the strong bias toward rules in the "rules versus discretion" debate. The promarket revolution preaches that policy must be guided by rules, paradigms, frameworks, and strategies; it tells us that to be credible, the policymaker must be predictable, that he should never surprise the market. These imperatives, I must confess, have always struck me as oversimplistic. Of course, the policymaker must be credible; for sure, the policymaker needs a method; undoubtedly, discretion must not degenerate into capriciousness. But this does not mean plugging in the automatic pilot and letting it fly the aircraft, nor does it allow us to confuse iron firmness over the mission and the objective with fetishism over instruments and operating procedures. Of course the market does not like to be surprised, but why should it be seconded? Why on earth should the conduct of a business be allowed greater discretion than the conduct of a policy? Equating credibility to rules and rules to predictability looks to me like yet another aspect of the subjugation of policy by the market.

When radicalism becomes the ordinary social behavior of the moderates, there are reasons to be concerned.

Was the crisis a market failure or a government failure? The essential goods that were lost in this crisis are systemic stability, high employment, and—in some cases and certain countries—social justice. It is known, it was known, although increasingly denied in public discourse, that such goods are *not* provided by the market itself and can *only* be reached with the help of government, through active public policies. In a narrow technical sense, we can speak of a market failure. However, when the market failure is known and patently described in the manual—like a disease for which the standard of treatment is fixed by medical protocols—government, not the market, is to be blamed for failing to act.

So let me turn attention to government. What we have seen in 2008 and 2009 has been a spectacular comeback of government, often cried for by the same quarters that had for so long pushed for deregulation and laissez-faire. However, we should look more deeply into the matter and, instead of speaking loosely of government, dwell on its *action* and its *jurisdiction*.

Consider *action* first. Most, perhaps all, economic policy actions rely on one or another of four instruments: first, fiscal policy, that is, taxing and spending; second, monetary policy, that is, ensuring the proper exercise of the three functions of money; third, command and control, that is, regulating and supervising economic activities; fourth, public ownership, that is, directly managing enterprises.

Now, if we use this taxonomy to look at the three decades that ended with the crisis, we see that—in spite of the proclaimed imperative that it should "stay out"—government shrank in the third and fourth function (regulation and ownership) while in the first and second (money and budget) it expanded significantly. Deregulation and privatizations were the warhorses of the Thatcher-Reagan program, but public debt and money over time swelled up. The combination of very expansionary macroeconomic policies with very "liberal" microeconomic ones is, in fact, the policy mix which led to the crisis.

The response to the crisis was a stepping up of all four instruments: more public deficit, more liquidity, more regulation, more public ownership. This response has to be considered for what it is: crisis *management*, not crisis *prevention*, not the construction of the more resilient, more stable, less crisis-prone economic and financial system for the future. Although they cannot and should not be kept completely separate, crisis management and crisis prevention are quite different modes of the government machine. What is appropriate in crisis management mode may be detrimental in the more structural and lasting perspective of prevention.

For example, the huge expansion of *liquidity* and *public debts* may be justified as temporary measures, but should be rolled back as soon as the situation permits. The delicacy of designing a successful exit strategy lies precisely in the fact that the short-term and the longer-term requirements of macro policy have opposite signs.

Equally temporary ought to be the *nationalization* of financial institutions. If truly acting as buyer of last resort, government should step in only when private shareholders have lost the entire value of their shares and exit as soon as profitability has been restored.

As to *financial regulation*, gauging the response is a more complex matter. Firstly, I am one of those that think that supervision, not regulation, was the main problem. Stronger enforcement of the existing rules would have sufficed to avoid the disaster. Understandably, most supervisors have motives to argue differently. Secondly, finance and supervision have already been restructured by the crisis itself, albeit sometimes in the wrong direction. To give two examples: compared to the precrisis situation, the financial industry is now concentrated in even fewer, presumably too-big-to-fail, institutions, and financial supervision is more nationally segmented. Thirdly, the results of the exercise in re-regulation have yet to come, and they are not easy to predict. No doubt rules will be tightened, but with what degree of consistency across the world? The urge for reform comes more from local infections than from pandemic disease, and reformers are more responsive to national constituencies than to the call for global governance. Finally, the influence of market sentiments on the reform remains considerable. For example, the market has moved from obliviousness to alarmism over the capital adequacy of financial institutions, thus pushing bank, market, and insurance regulators to propose what appears excessively severe tightening. The outcome of the current calibration exercise remains to be seen.

Obviously, economic policy should subject its four instruments to a unitary and consistent design. This is easy for crisis *management*, where the objective is the single, simple, and uncontroversial one of stopping the meltdown of the financial and productive system. It is difficult for crisis *prevention*, where the objective is a composite of goals, which strongly depends on political compromises and varies across the world.

The crisis has caused so much damage because the correction of the unsustainable course has been protracted for too long, and a key facilitator of that protraction has been globalization; indeed, the crisis is global in its origin, not only in its consequences. Coherent prevention therefore requires a truly global policy, decided and implemented as effectively as national policies. I fully realize, of course, how difficult it is to move, say, from a Hobbesian to a Kantian world. I have not forgotten the days when I was myself in office. However, nothing excuses us—as responsible individuals—from the intellectual duty of adopting a truly cosmopolitan perspective and from engaging in the thought experiment of devising the first-best response. This first best is nothing less than a global policy revolving around the notion of globally sustainable growth.

The hard constraints imposed by the requirement of sustainability, in my view, are three: an economic and financial one, a social one, and an environmental one. All of them, sooner or later, bite. All have become ultimately global, not merely local. This holds true for financial stability, peace, security, migrations, multiculturalism, scarcity of national resources, and climate change. A sudden halt to the growth process may equally be caused by a terrorist attack or by a series of hurricanes, by millions of people dying because of the rising price of rice, or by financial panic spreading around the clock.

This leads to *jurisdiction* of government, an issue that has been, so far, neglected in the "markets and government" debate. To my mind, it is not exaggerated to say that the policy failure was due as much to a faulty jurisdiction of governments as to errors *in action*.

In a market economy, the jurisdiction of government has a straightforward definition: it consists in providing "public goods," the locution economists use for the goods the market cannot produce spontaneously. In this locution, the pitfalls lie mainly in the adjective—"public"—more than in the noun—"goods." The jurisdiction of government is defined as the answer to the question, what does "public" mean? The answer I suggest is this: "public" identifies the human group sharing consumption of the public goods in point, and from this it follows that government must be multilevel. Let me explain why I regard this proposition as critically important to understanding the crisis and designing a good exit from it.

Humans sharing common interests constitute groups of different sizes on a scale that goes from the condominium to the population of the world. Goods like a garden, the judiciary system, navigation on the Rhine, or the biosphere are "public" for different jurisdictions such as a town, a country, a continent, or the planet.

It follows that also the government—as the provider of public goods—needs to be structured at different levels in order to operate in different jurisdictions and to refer to different constituencies. Government must be, therefore, plural and multilevel. The Jacobin aspiration to concentrate public power in the hands of a single ruler produces both oppression and ineffectiveness.

The present crisis stems largely from the inconsistency between the increasingly cross-national span of markets—be it regional or global—and the persistently national span of government: lack of an international monetary order providing a degree of macroeconomic discipline, regulatory competition among financial centers to attract bits of the global financial industry, and other similar phenomena. This most important flaw in the market-government nexus cannot be simplistically described as a "lack" or an "excess" of government. The defect lies in the *level* rather than in the *quantum* of government and has deep roots in the field of practices and in that of ideas.

In the field of *practices*, the dominance of the nation-state model is supported by the powerful vested interests associated with the preservation of its monopoly on economic policy: national bureaucracies, public policy agencies, political processes, and tax-and-spend activities are all predominantly geared to the nation-state irrespective of the fact that its power is insufficient to manage an increasing part of the objectives it declares. In the field of *ideas*, the model of state subconsciously adopted by most is the one issued in the Treaty of Westphalia in 1648: the state should be uniform inside its border and exempt from any right of interference from outside of its borders. In the concluding chapter of his *General Theory*, Keynes wrote a much-quoted passage on "practical men [being] the slaves of a defunct economist." Unfortunately, sophisticated economists, public officials, authors of editorials, and market traders are the slaves of a defunct *political* thinker or historian, hence their unshakable faith in the Westphalian model.

A priori, a combination of too much national and too little international policy power was not the only conceivable liberal response to the market repression of the preceding era. Unfortunately, however, the brand of economic liberalism that returned to power thirty years ago was not that of internationalist liberal thinkers like Lionel Robbins, Friedrich Hayek, or Luigi Einaudi, who had combined strong promarket economic convictions with a profound critique of the nation-state derived from the lessons of World War I. It was of the, to my mind, far cruder, less solid, and essentially nationalistic brand uncritically attached to the nation-state model, naively preaching that everyone "keeping the house in order" was the necessary and sufficient condition for ensuring international order, living and thinking as if a century of world history had not demonstrated its fatal flaws.

The nationalist bias of the promarket revolution can of course be explained. Both the Thatcher and Reagan governments were bent on reviving the flagging self-confidence of countries suffering from economic decline and loss of international influence. Both attracted votes with a combination of strong government and strong market: hands-off vis-à-vis the economy, hands-on in the reaffirmation of national power. A nondemocratic version of the same combination had been practiced years earlier in Chile by the Pinochet regime.

The fact of the matter is that the thirty years of growing laissez-faire and globalization were also years of declining international cooperation. This was epitomized by the shift from international institutions to "forums," from the strong, treaty-based, binding form invented in the mid-1940s to the soft, voluntary, and narcissistic form of periodic meetings of self-appointed groups, without the support of staff commitment to the "interest of the world," and without any power to take binding decisions. I have myself participated in countless communiqué sessions of various Gs in which the declaration that the course was "unsustainable" was accompanied by no action.

The weight carried by the Westphalian bias has popped up dramatically in these weeks and months in which the crisis has moved to Euroland. Seen as "the land of the euro" (and the early adoption, in 1998–99, of the word "land" by the media was deliberately and characteristically opposed by the EU institutions), Europe has none of the flaws comprising the unsustainable mix that led to the crisis: no significant fiscal or external deficits, no high indebtedness of the housing sector, no collapse of its banking sector. Yet it is under heavy attack by the market because the market does not believe in the robustness of the post-Westphalian project that Europe has been pursuing for sixty years now, and the skepticism of the market is shared and reinforced by a global array of economists and commentators who predict the end of the euro because they do not believe that "a currency without a state" can survive. The European politicians facing those economists and commentators maintain the opposite and equally mistaken view that it can last forever without further steps toward political union. What they share is the primitive belief that the Westphalian model is eternal and indestructible.

Let me conclude. It took centuries to define and set up the appropriate constitutional relationship between the state and the church. The process was so long because politics and religion are linked and separate at the same time and both aspire to capture the totality of the person. They must be kept apart because they have to do with fundamentally different aspects of human experience—power and faith—and when the two contaminate each other, both deprave. Yet they are bound to interact and mutually interfere because social bonds, authority, freedom, rules are implicated in both.

In our time, economic activity occupies the center stage of society in a way similar to what religion did a thousand or more years ago. The present search for a constitutional order in the relationship between the economic dimension of society and government bears analogies with the ancient struggle between the king and the religious sects and clerics or between the emperor and the Pope.

The Industrial Revolution, the rise of mass production, the creation of large and impersonal markets, in the *economic* sphere, and concurrently, in the sphere of government, the advent of mass participation in political life, have disrupted market-government relationships that had lasted for centuries. More recently, the self-same technological revolution—in the field of information and communication—has produced a mutation in the mechanism whereby opinions are formed and expressed, a mechanism which is at the heart of the proper functioning of *both* markets and governments.

Political and economic activity too are linked and separate at the same time. They too are corrupted by contamination, but need to relate to each other. Power and wealth are two fundamentally different categories, and yet each may determine the fate of the other. The present crisis is not only a powerful reminder that the relationship between markets and government is still largely unsettled, it is also an event that may disrupt economic prosperity and democratic freedoms.

The combat between the emperor and Croesus is marked by alternating phases of supremacy of one or the other. A peaceful and mutually respected constitution is still to be found. In the past century, we have seen the high social costs incurred when policy subjugates the market, not only through the totally repressive experiment of communism, but also through the excessive interference of the pre-Thatcher-Reagan years. At the beginning of this century, the crisis that started in 2007 shows what disasters can occur when the market subjugates the government. A successful exit from the present troubles can be found only by fundamentally rethinking the relationship between markets and government in a global world.

Thank you.

Questions and Answers

Following the formal presentation, Mr. Padoa-Schioppa took questions from the audience.

ANDREW CROCKETT: Thank you very much, Tommaso. That was really, I think we'll all agree, a tour de force with many, many layers of reflection for us to take away and think about.

We have a little bit of time for questions or observations from the floor. There are microphones that will be brought to you, so I will ask you, if you would, to raise your hand and wait until the microphone is brought to you to speak. I'm going to suggest that we take a number of observations or comments or questions and ask Tommaso perhaps to respond at the end. And at the end, after his response, please remain in your seats and we will bring the next panel to the podium.

QUESTIONER: *Can I ask the obvious question, which is that—at least from a distance—it looks to us that the euro zone crisis is penalizing those southern countries that would seem to be more redistributive and less market-focused and less efficiency-focused, and rewarding the northern countries that are more efficiency-focused and have brought more into those market reforms? And this presumably is not just a market mood sort of reaction because it looks like the real economic data will support that difference as well. Interested in your comments on that.*

QUESTIONER: *Thank you. I'll just pick up on your Westphalian point. You know, there is a doctrine that has developed in international relations, in the last five years or last decade, of responsibility to protect through the UN, which pierces the unitary state. And I guess the question is, do you see an analogy in our world in financial stability so that national sovereignty in this domain would be pierced, would be influence-determined by treaty-based organizations as opposed to left entirely to their own determination?*

ANDREW CROCKETT: Thank you. Anybody else? Maybe I'll put a question myself and then ask Tommaso to reflect on all the points that have been made.

You talked in the earlier part of your remarks about markets versus governments. And in the face of the crises that have resulted from perhaps excess reliance on markets, I think one can draw two opposite conclusions: one is that you have to interfere with the outcomes produced by markets because they are unacceptable, and the other is you have to make markets more effective by perhaps relying more on markets, but making them more perfect through dealing with market failures. Where would you come out on that spectrum of either counteracting market effects or trying to improve market processes?

I think those are three fairly wide-ranging questions, and you have about five or six minutes, Tommaso.

TOMMASO PADOA-SCHIOPPA: On the first question, yes, indeed, what we have seen so far is that the—what you call the southern countries of the euro zone, more generally I don't think it's a question of latitude, but it's more a question of economic and financial data—they are those that the markets are targeting. It does not mean to me that the attack, so to speak, is on those countries. It is on the euro in reality. Of course, it attacks the weak parts of the organism, which are the more highly indebted countries. But my view is that the deep disbelief that moves the market is about the capacity of the euro area to act in the way, say, the United States would act if the attack was on a state. And this is where the Westphalian thing comes in, so to speak.

With many people with whom I have discussed this issue, very often analogies are drawn with sovereign debt crises of countries—as I say, loose countries rather than regions or states or land or provinces of a federal state. The EU is in between. Greece is something in between, between being a province of Canada and a loose country such as Argentina was or others. But the Westphalian model, which has programmed in the brains of almost everybody the defunct political thinker, is not even brought to the level of something that can be subject to discussion and to reconsideration. And this is why I think the market is going to lose its bet. It simply does not understand that the force of keeping the EU together, possibly at the cost of tightening the union, the force pushing in that direction is stronger than what, say, the analysis of data of individual countries would lead one to think and to predict.

Of course, catastrophes can always come. There is nothing that has really a zero probability. But the view I have is that there is a misunderstanding which leads to—which misguides the prevalent opinion of not only market participants, but also of commentators, of reputed economists, and of officials. So it is what I call a very wide array.

As for the question of national sovereignty, the question is not to suppress national sovereignty. The problem is to admit that it is not absolute. When, in the seventeenth century, the idea arose that the separation of power was a desirable fundamental constitutional principle for most, the idea of dividing power was the end of the state, and for many people today, the idea that sovereignty could be limited is seen almost as a threat to the very existence and survival of the nation-state. The advent of democracy was seen with equal preoccupation. The division of power was seen with equal preoccupation. Today, there is the return of the myth of indivisible sovereignty. But to an economist, it seems to me that it is almost a platitude to say that if common goods or public goods are belonging to different circles of human beings, it would be inefficient, let us say, not to articulate the structure of government in a multilayer fashion.

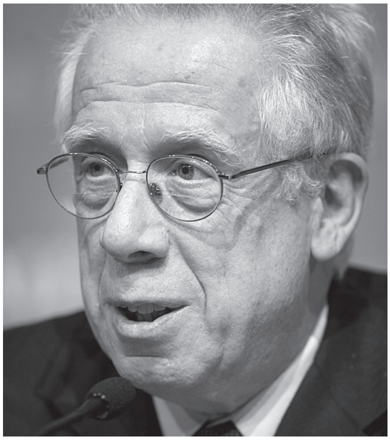
Now, of course, I know how difficult this is, but we can easily recognize a number of examples which show that we are already in a post-Westphalian world. The first example was, I think, the treaty in the mid-nineteenth century precisely about the navigation of the Rhine. It was a completely plurinational, supranational arrangement to ensure that this river could be navigated through the countries that it crosses. Of course, for air navigation we need common rules. It would be quite funny to have indicated that national sovereignty implies that every country sets its hour and has its navigational rule. Nobody would be daring flying any longer if this was the case. And so there are, in fact, many more examples of post-Westphalian arrangements than we are ready to admit.

The Bretton Woods institutions, or the institutions invented in the 1940s, were a clear step in that direction. And to my mind, the movement to G-5, G-7, G-8, and G-20 is a regression. It is a regression, there is no doubt. It is a regression to the extent to which it undermines the role of institutions. It may not be a regression if it is a form of leadership that serves the institution because I think good governance requires as much institution as it requires leadership. But to have had for years G-7 meetings that the IMF could visually not attend and at which the IMF was literally not invited to the meeting except for negligible fractions, it was a ridiculous attack on the more solid form of international cooperation that in the middle of World War II was created.

Andrew, I think my answer is that as long as all work can be done by making market functioning better, this should be preferred over intervening in the outcome because a market mechanism first exploits animal spirits. And animal spirits exist, so it is better to exploit them than to repress them. And secondly, because even if it is regulated, the market is an expression of freedom superior to, say, authoritative production of the outcome.

And in my view, it is not even easy to establish a priori whether one or the other is necessary. I think it is historical, it is social, like public goods. There are many public goods which are produced by spontaneous social behavior: not by the market, but by spontaneous social behavior. When I was a child and came to Switzerland for my vacation, I was surprised by the fact that one could leave something of value unguarded and find it the next day. I hope it is still the case. There are not many countries like this, where it is social behavior. I do not say that it makes police unnecessary, but certainly it significantly reduces the cost of producing security through governmental action. So I think that the guide is that whatever can rely on spontaneous behavior should be preferred and the, say, direct production should be a last resort.

ANDREW CROCKETT: Tommaso, thank you very much for what I think is a wonderful combination of philosophy, economics, politics, and history, and I know it has left us all with much food for thought; certainly it has for me. Thank you again for giving the lecture. May I also ask people to stay in their seats and express with me their appreciation of what we've heard.



IMF/Stephen Jaffe

Tommaso Padoa-Schioppa

Tommaso Padoa-Schioppa, who passed away in December 2010 at the age of 70, was Italy's Minister of Economy and Finance in 2006–08 and was, at the time of his death, the Chairman for Europe of Promontory Financial Group, a consulting firm for global financial services companies, and the President of Notre Europe, a prominent Paris-based think tank, as well as an unpaid adviser to the government of Greece. He was also a former Chairman of the Trustees of the IASC Foundation (International Accounting Standard Committee, 2005–06) and a member of the Executive Board of the European Central Bank (1998–2006), as well as the Chairman of the International Monetary and Financial Committee (IMFC, 2007–08). Additionally, he served as Chairman of Commissione Nazionale per le Società e la Borsa (CONSOB, 1997–98), Deputy General Director of the Banca d'Italia (1984–97), and General Director for Economic and Financial Affairs at the Commission of the European Communities (1979–83). He was Joint Secretary to the Delors Committee (1988–89), Chairman of the Banking Advisory Committee of the European Commission (1988–91), Chairman of the Basel Committee on Banking Supervision (1993–97), and Chairman of the Committee on Payment and Settlement Systems (2000–05).

Mr. Padoa-Schioppa was the author of more than 100 publications, many of them in English and in French. His recent books include *The Short View* (2009), *Italy: A Timid Ambition* (2007), *Europe: An Active Patience* (2006), *The Euro and Its Central Bank, Regulating Finance,* and *Europe: A Civil Power* (all 2004), and *Twelfth of September: The World Is Not at Square One* (2002). He graduated from the Luigi Bocconi University in Milan and held a master's degree from the Massachusetts Institute of Technology.

The Per Jacobsson Lectures

2010 *Navigating the New Normal in Industrial Countries*. Lecture by Mohamed A. El-Erian.

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2008 *The Role and Governance of the IMF: Further Reflections on Reform*. Symposium panelists: Stanley Fischer, Trevor Manuel, Jean Pisani-Ferry, and Raghuram Rajan.

The Approach to Macroeconomic Management: How It Has Evolved. Lecture by Lord George.

2007 *Balance of Payments Imbalances.* Lecture by Alan Greenspan.

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2001 No lecture took place due to the cancellation of the Annual Meetings of the IMF and the World Bank.

2000 *Ten Years On—Some Lessons from the Transition.* Lecture by Josef Tošovský (Prague).

Strengthening the Resilience of Financial Systems. Symposium panelists: Peter B. Kenen, Arminio Fraga, and Jacques de Larosière (Lucerne).

1999 *The Past and Future of European Integration—A Central Banker's View.* Lecture by Willem F. Duisenberg.

1998 *Managing the International Economy in the Age of Globalization.* Lecture by Peter D. Sutherland.

1997 *Asian Monetary Cooperation.* Lecture by Joseph C.K. Yam, CBE, JP (Hong Kong SAR).

1996 *Financing Development in a World of Private Capital Flows: The Challenge for International Financial Institutions in Working with the Private Sector.* Lecture by Jacques de Larosière.

1995 *Economic Transformation: The Tasks Still Ahead.* Symposium panelists: Jan Svejnar, Oleh Havrylyshyn, and Sergei K. Dubinin.

1994 *Central Banking in Transition.* Lecture by Baron Alexandre Lamfalussy (London).

Capital Flows to Emerging Countries: Are They Sustainable? Lecture by Guillermo de la Dehesa (Madrid).

1993 *Latin America: Economic and Social Transition to the Twenty-First Century.* Lecture by Enrique V. Iglesias.

1992 *A New Monetary Order for Europe.* Lecture by Karl Otto Pöhl.

1991 *The Road to European Monetary Union: Lessons from the Bretton Woods Regime.* Lecture by Alexander K. Swoboda (Basel).

Privatization: Financial Choices and Opportunities. Lecture by Amnuay Viravan (Bangkok).

1990 *The Triumph of Central Banking?* Lecture by Paul A. Volcker.

1989 *Promoting Successful Adjustment: The Experience of Ghana.* Lecture by J.L.S. Abbey.

Economic Restructuring in New Zealand Since 1984. Lecture by David Caygill.

1988 *The International Monetary System: The Next Twenty-Five Years.* Symposium panelists: Sir Kit McMahon, Tommaso Padoa-Schioppa, and C. Fred Bergsten (Basel).

1987 *Interdependence: Vulnerability and Opportunity.* Lecture by Sylvia Ostry.

1986 *The Emergence of Global Finance.* Lecture by Yusuke Kashiwagi.

1985 *Do We Know Where We're Going?* Lecture by Sir Jeremy Morse (Seoul).

1984 *Economic Nationalism and International Interdependence: The Global Costs of National Choices.* Lecture by Peter G. Peterson.

1983 *Developing a New International Monetary System: A Long-Term View.* Lecture by H. Johannes Witteveen.

1982 *Monetary Policy: Finding a Place to Stand.* Lecture by Gerald K. Bouey (Toronto).

1981 *Central Banking with the Benefit of Hindsight.* Lecture by Jelle Zijlstra; commentary by Albert Adomakoh.

1980 *Reflections on the International Monetary System.* Lecture by Guillaume Guindey; commentary by Charles A. Coombs (Basel).

1979 *The Anguish of Central Banking.* Lecture by Arthur F. Burns; commentaries by Milutin Ćirović and Jacques J. Polak (Belgrade).

1978 *The International Capital Market and the International Monetary System.* Lecture by Gabriel Hauge and Erik Hoffmeyer; commentary by Lord Roll of Ipsden.

1977 *The International Monetary System in Operation.* Lectures by Wilfried Guth and Sir Arthur Lewis.

1976 *Why Banks Are Unpopular*. Lecture by Guido Carli; commentary by Milton Gilbert (Basel).

1975 *Emerging Arrangements in International Payments: Public and Private.* Lecture by Alfred Hayes; commentaries by Khodadad Farmanfarmaian, Carlos Massad, and Claudio Segré.

1974 *Steps to International Monetary Order.* Lectures by Conrad J. Oort and Puey Ungphakorn; commentaries by Saburo Okita and William McChesney Martin (Tokyo).

1973 *Inflation and the International Monetary System.* Lecture by Otmar Emminger; commentaries by Adolfo Diz and János Fekete (Basel).

1972 *The Monetary Crisis of 1971: The Lessons to Be Learned.* Lecture by Henry C. Wallich; commentaries by C.J. Morse and I.G. Patel.

1971 *International Capital Movements: Past, Present, Future.* Lecture by Sir Eric Roll; commentaries by Henry H. Fowler and Wilfried Guth.

1970 *Toward a World Central Bank?* Lecture by William McChesney Martin; commentaries by Karl Blessing, Alfredo Machado Gómez, and Harry G. Johnson (Basel).

1969 *The Role of Monetary Gold over the Next Ten Years.* Lecture by Alexandre Lamfalussy; commentaries by Wilfrid Baumgartner, Guido Carli, and L.K. Jha.

1968 *Central Banking and Economic Integration.* Lecture by M.W. Holtrop; commentary by Lord Cromer (Stockholm).

1967 *Economic Development: The Banking Aspects*. Lecture by David Rockefeller; commentaries by Felipe Herrera and Shigeo Horie (Rio de Janeiro).

1966 *The Role of the Central Banker Today*. Lecture by Louis Rasminsky; commentaries by Donato Menichella, Stefano Siglienti, Marcus Wallenberg, and Franz Aschinger (Rome).

1965 *The Balance Between Monetary Policy and Other Instruments of Economic Policy in a Modern Society.* Lectures by C.D. Deshmukh and Robert V. Roosa.

1964 *Economic Growth and Monetary Stability*. Lectures by Maurice Frère and Rodrigo Gómez (Basel).

The Per Jacobsson Lectures are available on the Internet at www.perjacobsson.org, which also contains further information on the Foundation. Copies of the Per Jacobsson Lectures may be acquired without charge from the Secretary. Unless otherwise indicated, the lectures were delivered in Washington, D.C.

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