Foreword

In presenting this book I have to acknowledge a personal involvement with the genesis of the underlying research project. In 1994, Fred Bergsten invited me to take part in a seminar organized by his Institute for International Economics to celebrate the 50th anniversary of the Bretton Woods Conference. I accepted on condition that I could associate in the endeavour Fabrizio Saccomanni, friend and colleague of many decades. At the time, Fabrizio was head of the Bank of Italy’s Foreign Department and Chairman of the Exchange Rate Policy Committee of the European Monetary Institute, the precursor of the European Central Bank; he combined a solid background in international economics – based on his earlier experience at the IMF – with a rare insight into the operation of foreign exchange and capital markets. We had been discussing international monetary problems for many years and had become convinced, particularly after the EMS crisis of 1992–93, that all was not well with the working of what used to be called the international monetary system. We thought that the IIE seminar provided a good opportunity for us to express our misgivings about current international monetary arrangements. We quickly agreed that in our paper we should avoid following the path of those who regarded the combination of freely floating exchange rates and full capital mobility as a ‘non system’; we also agreed to refrain from advocating a ‘new Bretton Woods’. In the paper we prepared, which is quoted in this book, we asked ourselves what kind of institutional underpinnings were needed to ensure the smooth functioning of the ‘market-led international monetary system’ that had emerged from the demise of the old ‘government-led international monetary system’ created in 1944 at Bretton Woods. We argued that under the new system, global financial markets would determine the creation and the distribution of international liquidity and the level of exchange rates. We urged monetary authorities to improve their understanding of the unwritten rules and conventions of the market-led system and of their implications for the world economy. Indeed, we feared that, in the likely context of further expansion and increased globalization of financial markets, there was a risk of ‘disturbances that may have an impact on the stability of the financial system’. As our paper was delivered in the summer of 1994, the Mexican crisis was just months away and it would usher in one of the most difficult periods in the recent history of the world’s monetary system.
Although plenty has been written on the financial turbulence of the late 1990s, particularly on the debt crises of emerging countries, the hint we gave about the need to investigate the systemic causes of financial instability and the role that global financial markets could play in the process did not find many followers. Fabrizio’s book, when it was first published in Italy in 2002, provided an important contribution to filling that gap. I found then the book to be very rich in analytical, technical and historical insights and only regretted that it had been written in Italian, a language not widely read internationally on matters other than religion, art, gastronomy, and fashion. I think it is very good that the book appears now in English, in an updated and expanded version covering the new episodes of financial instability that have marked the early years of the third millennium.

The main theme of the book is the relationship between policy-makers and global financial markets. It makes for fascinating reading to follow the author’s detailed yet concise description of the actions and reactions that have generated, amplified and propagated situations of financial instability. Although the book strives to project an objective analysis of the underlying economic and political determinants of instability, the conclusion the reader is led to draw is that the blame for the many crises of the era of financial globalization rests more with the policy-makers than with the market. Monetary and financial authorities are constrained by political and institutional considerations to formulate and implement policies in a national context; but in the case of systemically important countries, policies have significant international repercussions via global financial markets. Of course, policy-makers are fully aware of the existence of the markets, but they tend to believe that these will reconcile the inconsistency of their national approaches, correct the inadequacy of their measures, or can be convinced through appropriate communication strategies that there are no inconsistencies or inadequacies to worry about. The book provides ample evidence that none of these assumptions is correct. Markets are willing to listen to policy-makers and to analyse carefully their strategies and statements but when, sooner or later, they detect any inconsistency or inadequacy they react with speed and severity. The book also clearly describes the situations in which markets may overreact, leading to unsustainable trends in financial flows and asset prices. The correction of any such overshooting is generally abrupt and painful.

The author does not believe that dealing with international financial instability would require a major institutional reform or innovative policy strategies, a belief I am not sure I share in full. He is convinced that the international community already possesses the analytical tools and the policy instruments to deal with the problem; but he is adamant in suggesting that policy-makers have the duty to guide the markets towards
achieving monetary and financial stability. He fears, correctly in my view, that recurrent episodes of turbulence in asset markets – if left unchecked – may eventually lead to protectionist pressures that could be detrimental to the growth of output, trade and employment worldwide. In suggesting a more pre-emptive and active policy approach he departs from conventional wisdom. At times, he seems openly ‘interventionist’ and goes so far as to advocate ‘interference’ by the IMF in the operation of the international monetary system. It is clear, however, that in the pragmatic framework of multilateral cooperation that he advocates, he would easily settle for any realistic, ‘golden mean’, policy strategy provided it delivered the required results.

All in all, this is a book well worth reading by any person interested in understanding how the global financial system works and in having a critical appraisal of its performance. It also contains a number of suggestions that could be part of the ‘research agenda’ of monetary and financial authorities, both national and international, as well as of academic and business economists. The book flows smoothly and the narration is pleasantly supported by personal recollections of events that the author witnessed. There are also many clever economic and literary quotations, evidence of the author’s broad cultural interests and sharp wit. I found particularly appropriate, in the turbulent liquidity conditions currently prevailing in global financial markets, the quote in Chapter 14 from Shakespeare’s Julius Caesar, where the Bard reminds us that ‘on such a full sea are we now afloat;/and we must take the current when it serves,/or lose our ventures’.

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Rome, September 2007