

Transcript 3: International Monetary Fund

Conversation with Maurice Obstfeld. Recorded 27 February 2024, online.

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Hello and welcome to Global Shocks. Maurice Obstfeld, could you just briefly introduce yourself in your own words?

00:00:06 MO

I'm currently a senior fellow at the Peterson Institute for International Economics. I have formerly been a, for many years, a professor of economics at the University of California in Berkeley. And prior to retiring from Berkeley, I served on the Council of Economic Advisors in the US Obama administration, and as chief economist at the International Monetary Fund.

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Right, so in your own words, from your point of view as an economist, why does thinking about global shocks matter?

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Well, all economies are to a greater or less extent attached to the rest of the world through trade linkages, but also other linkages, communications linkages, movements of people, communications, diseases, the climate. So, to pretend that any economy can be removed from shocks or disturbances that occur abroad is somewhat delusional. And so, particularly in the economic realm, these interactions between domestic economies and foreign economies are key conduits for the transmission of shocks and for the mechanisms that intermediate how domestic policies affect the domestic economy, even those are affected by global linkages. So, it seems to me that the global perspective is one that is absolutely essential for understanding a range of phenomena, but especially economic policies and the evolution of the economy.

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So, in your own words, what's it like to work at the International Monetary Fund? What does the IMF do exactly?

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The IMF was established in the 1940s with the purpose of avoiding some of the worst economic policies that countries carried out during the Great Depression, often to their mutual detriment, with political ramifications that arguably helped pave the way to the Second World War. Initially, I would say that the goals of the fund were modest relative to what it does today, although at the time they were incredibly far-reaching, but basically to govern the exchange rate relationships among economies, to promote the liberalization of international payments connected with international trade, and to provide a source of credit for economies that might find themselves in difficulty in meeting their commitments to manage exchange rates in the way that the fund system required, or that might need credit for other reasons to simply avoid a huge economic downturn.

This exchange rate system that was built into the original IMF articles of agreement, which was a system of exchange rates fixed to the United States dollar, but occasionally adjustable, went by the board a little over 50 years ago in the early 1970s. And since then, the fund has evolved to still exercise surveillance over exchange rate arrangements, but to allow countries to pursue the exchange rate systems that they feel are most compatible with their abilities to use domestic policies to preserve domestic prosperity. The fund has also expanded in the realms of providing capacity development for countries and moreover, overseeing issues connected with financial stability.

In the period just after World War II, the financial interconnections among countries were minimal, basically very little private finance, some official finance, tightly regulated financial markets around the world. Since the 70s, we've moved to a landscape with less regulated financial markets, which have exploded in breadth and scope, and have raised serious concerns about financial stability, as we saw in the 2008-2009 crisis. So, the fund now undertakes considerable activity evaluating the health of countries' financial systems and worrying about the interconnections among those financial systems, and that those might lead to outcomes that are unfortunate in the sense that the 2008-2009 crisis was also unfortunate.

So, a large expansion in the realm of the economic transactions that the fund is concerned with, but also expansion in terms of concerns on other public goods that are relevant to macroeconomic outcomes, such as climate and global public health.

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So, we've just talked a little bit about global shocks in general. And then you gave the example of the financial crisis, of course, of 2008, 2009. And now my question to you is, during your time working at the IMF, what stood out to you as the most notable shock that the organization had to deal with and that you were confronted with in particular? And how did you or your colleagues or the IMF as an organization deal with that shock? What was the sort of initial response? What was the go-to response by the International Monetary Fund?

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When I came in, the world economy was still digesting the aftereffects of some events in August 2015 that really set the global economy back. For several years, China had been suffering from a sharply declining stock market and from capital outflows. It actually used up about 1/4 of its \$4 trillion in foreign exchange reserves trying to prevent those capital outflows from bringing about a sharp depreciation of its currency, which it feared would have negative ramifications.

And in August of 2015, China carried out a fairly puzzling and non-transparent and unexpected shift in its exchange rate regime, which involved the devaluation, a small devaluation of the yuan, but also in a very, very sort of murky guidance about what to expect going forward. And this did set off something of a panic in financial markets. And the concern was that if China were to simply let its exchange rate go, this would have ripple impacts across the Asian region, which could be destabilizing.

So, in point of fact, the markets remained fairly volatile for roughly nine months after this, with a lot of concerns about what direction China was taking, what would be the impact on Chinese growth, which of course is a major component of global growth and particularly important in the dynamic Asian region. So, this was a problem that, it wasn't up to the fund to manage, it was mainly up to the Chinese authorities to manage, but one where we, consulted with them and gave advice and where I think the worst outcomes were avoided.

Fast-forward to June of 2016, another shock we were concerned about was the Brexit referendum. We in the fund, I think like everyone else, observing the ongoing events in the UK, I did not think it's likely that the referendum on Brexit would go in the negative direction that it did. We way underestimated the power of social media and the power of online targeting using granular data about voters to modify electoral outcomes. I think we also underestimated the depth of negative healing toward the EU and the British ruling establishment generally in regions that had been, regions of the UK that had been de-industrialized, where staple industries such as mining have disappeared over the years, which were severely depressed, where formerly solid labor voting blocks were in transition in many ways politically.

So, at the fund, we sort of gamed out what would be the economic consequences of Brexit, although that was very speculative because you didn't know what type of relationship the UK would negotiate with the EU post-Brexit. That took years, something else we could anticipate. But we also worried about the impact on financial markets. Given what we had just seen in relationship to China, would the financial markets become more volatile? And could that have a similarly suppressing effect on the world economy as the Chinese events seem to have had for nine months?

Now, as it happens, in June of 2016, the world economy was just starting to recover from the turbulence of the previous nine months. In fact, a number of indicators were turning up just at the time of the Brexit vote, which is unfortunate because it turned out not to have the sort of systemic financial market consequences that we feared. That being said, it did set off considerable uncertainty regarding the UK economy, regarding its ultimate relationship with the EU, and that played out over a stretch of years. I think it's fair to say that Brexit did not do any favors for the UK economy, but the extent to which you can directly blame Brexit remains contested. Certainly, it's hard to discern the positive effects that were advertised by the proponents of Brexit in the campaign leading up to the referendum vote.

The next major shock, I think, was the Trump election in 2016, for which the Brexit vote had, in some sense, been a bellwether in terms of unveiling the scope for social media to play a big role in elections, the scope for voters whose political leanings you think you understand, rapidly shift position in the face of their own frustration cultural and economic. And the challenge of Trump was to really upend the U.S. economy's sense of global leadership, to withdraw from key international bodies like the WHO, like the Paris Agreement, to turn toward protection to undertake a trade war with China, but also protectionist measures against allies, not just against China.

So, this, I think, was another shock to the world economy. The [inaudible] effects were offset by other factors. For example, the big US tax cut in 2018 was a positive, at least in terms of macro stimulus. By the time COVID emerged, I think we were seeing the negative effects, Trump's trade war on global activity. But of course, by that time, I had left the fund. I left in December of 2018.

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Right. I'm curious to hear a bit more about the inner workings of the International Monetary Fund. So, let's picture a shock hitting the global economy. What exactly happens within the IMF? How does the fund respond? How does it decide whether this is a threat to international or global stability? Which aspect of it is a threat, which aspect might be an opportunity? What's going on exactly at those moments?

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Well, the institution is a complex one with some functional departments. So, the department I headed, research, is a functional department. So is fiscal affairs. So is money and capital markets, which oversees the financial stability work. So is strategy policy review, which basically is the repository of fund doctrine and policy, as it were, and oversees all of the country work for consistency with fund philosophy, fund practices, fund understanding of macroeconomics and financial economics.

But having much of the country work, there are also the regional departments which encompass the various country teams. So the European Department, the African Department, the Asian Department, Middle East, Central Asia. And each of these departments is a collection of country teams which engage intensively with the authorities of the countries they are in charge of. And this engagement is ongoing.

It's not just about crises, it's about regular review of policy and economic outlook and regular missions to the country to discuss the policy direction and make recommendations, which recommendations are, of course, non-binding unless a country is negotiating a fund program, in which case the conditions of the fund program, the policy conditionality does become binding as a condition for obtaining resources from the fund.

You know, when a shock hits, generally, some countries may be more affected than others. I was not really present for a truly, truly global shock, such as the financial crisis of 2008, 2009, like the Lehman shock. But more often the shock is centered on a particular country, but it may have spillover effects abroad. And then the focus is twofold. First on the country where the shock originates, and secondly on its neighbors who may feel repercussions. There's not much we can do about the neighbors except to heighten scrutiny and engagement with the authorities. In the country where the shock originates, there would be intensified discussions and intensified scrutiny.

So, in the case of China, I would say the authorities were quite open to discussions with the Fund and to the Fund's recommendations. They, of course, did what they wanted. The Fund's recommendations were not binding. But I think the fund's advice was quite consistent with the approach the authorities took. And whether the fund

deserves credit or not is open to debate. But I think at the end of the day, that particular crisis was well managed.

With respect to Brexit, I would say the back and forth with the UK over the years following the referendum vote, while agreements, well, attempts were made to negotiate a withdrawal agreement, with the EU was more contentious. The IMF would do its forecasts of different arrangements and how they would affect the UK and Europe. To the extent these were negative for the UK, the UK authorities would generally reject them. You know, I think the chaotic nature of the UK process spoke for itself, really. And the fund's view is that the UK should try to preserve as much of the structure of European supply chains that had been established over the previous decades as possible and to be as little disruptive as possible. But that's not the way the politics went.

At the same time, the private sector sort of did what it could to protect itself from the ongoing uncertainty. But the period was, clearly negative to the ... in terms of, very depressed investment, which continues, and rather tepid growth. There's not much we could do about it at the fund except to, sort of preach to the unconverted and, just sort of take the opprobrium in the British political space and in segments of the British press.

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Right. So, let's stay with Brexit for another moment. If I picture economists working at the IMF trying to figure out a policy, a response to something like Brexit, do historical precedents play a role in IMF deliberations? Or is it rather a kind of background matter that isn't really talked about all that much?

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You know, fortunately, there are relatively few examples of such a self-inflicted wound in history. I mean, we do have great arrangements breaking up, but it's usually in the context of a wider geopolitical conflict, kind of makes it impossible to tease out the, specific effects of what one country is doing. So, this was a, this was in some, I wouldn't say it's unique, but there aren't a lot of precedents. So, you know, the main analytical tools would be more econometric, just trying to say, well, suppose we increase trade costs between the EU and the continental EU and the UK, you know, what effect do we think that would have on GDP? Or suppose we increase uncertainty, what effect would that have?

So, it's all rather, you know, you have to make assumptions. So, it's all debatable, but, you know, a large number of studies that we did that were done by private sector, academic economists in the UK all pretty much pointed to the same conclusion. And you can argue about the precise numbers, but they were negative and they were not negligible.

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So, if we just think a little bit more about global shocks and what they mean for an organization like the International Monetary Fund, I mean, there's lots of talk at the moment about "polycrisis," referring to the fact that multiple crises happen at the

same time and they intersect and overlap and mutually compound each other. So, does that term mean anything to you, and does the IMF actually treat crises case by case as individual occurrences or rather as connected parts of longer-term historical patterns of turbulence?

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It depends on the country and it depends really on the shock. I mean, when, again, the China episode I described to you, it was clear that the problems were originating inside China, but there were potential spillovers to other countries that we needed to be aware of in our policy advice. You know, when a small country runs into debt problems, that will possibly affect its immediate neighbors if it has close trading relationships with them, but it's typically a country-by-country exercise.

That being said, there are situations in which a lot of small countries run into trouble because they are responding to some common macroeconomic development. So, we have a number of countries now with debt problems or debt distress. Some of them, many of them have fund programs or renegotiating their liabilities to foreign creditors. They're not enough at the moment in serious trouble to pose a global systemic problem, but we have seen such problems in the past. For example, the Asian crisis of 1998 had a major regional impact.

Going back further, the debt crisis of developing countries in the early 1980s, which was largely a Latin American crisis, but not exclusively a Latin American crisis. It reflected the very high interest rates in the United States and the global slowdown. That was a sort of a crisis within a country group that was widespread and that had much more systemic effects. And these systemic effects can be rather subtle. In the case of the debt crisis of the 1980s, that followed a period in which large banks in rich countries, particularly in the US, had lent a lot of money to Latin America.

And with so many Latin American countries unable to pay their debts, it raised the prospects that the banks that had lent to them could get into trouble, which would have severe financial stability implications in the US and in other rich countries, with ties to the US, which is all rich countries. And this became a major crisis for the fund, together with the Federal Reserve, to manage over a period of nearly a decade, throughout almost the entire 1980s, this crisis was being managed in various ways.

So, this is just to say that whether a crisis can truly be treated as an individual matter or is more systemic is a matter of degree. It depends on how deep is the crisis, how widespread is the crisis, what are the linkages financial and trade-wise between the crisis countries and other countries, which may on the surface appear to be in good health, but which linkages determine the networks through which a crisis can spread through other countries?

Similarly with the 2008, 2009 crisis, you could have said, well, this is the US housing market. The ramifications will be contained, but the financial superstructure built on that housing market and the interconnection of that superstructure with the financial systems of countries the world over turned it into a completely global crisis. It's basically a matter of degree. And sometimes it comes as a surprise when the crisis

spread. The Asian crisis was viewed as a localized crisis in Thailand in 1997 when it broke out, and then it just exploded. There can be contagion as financial market participants look for similarities and weaknesses in countries that are not immediately affected. But then when they act on those received weaknesses, a crisis can spread.

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Right. So, you're explaining in very interesting detail how economic changes affect political dynamics and vice versa. How there's a kind of interconnection between political and economic change. So, what role does the IMF play in those dynamics, especially since the IMF often asks governments to implement pretty tough and drastic changes, right? Say, to decrease public spending, that's politically costly for individual governments and they might lose popularity as a result. But lots of people also see that as a kind of undemocratic intrusion by an unelected elite of economists sitting at this international organization.

That kind of pushback can really lead to a loss of authority or even membership for institutions such as the IMF in the long run. So, how has the IMF dealt with this challenge in particular in the past? And what would you say is your perspective on that, [from] your experience?

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I mean, the link between domestic politics and policy is always a treacherous one for the fund. I think that the sort of textbook example of the hazards would be the Asian crisis in the late 1990s, where, as I said, a crisis in Thailand spread across the region to Indonesia, to Malaysia, to Korea. And the IMF came in with programs which, you know, to some extent went beyond its typical remit. And one of the reasons for that, I think it was a learning experience, was that, you know, if you looked at countries like Indonesia and Malaysia, before the crisis. The fund would have said that their macroeconomic fundamentals are good. They had sound public finances, low public debts, not big current account deficits, not big fiscal deficits. And yet, when markets turned against them, this turned up weaknesses in their banking system of a sort that the fund hadn't really been used to focusing on at that point. And the fund reacted with policies that were viewed in these countries as quite intrusive.

Following these crises, the countries built up large war chests of international reserves precisely so they would not have to go back to the fund again, so they would not have to surrender their policy autonomy to the fund in the event of a crisis. And so that hopefully with those levels of international reserves, a crisis would not even occur. It wasn't really until, so the Asian crisis was in 1998. In 2018, 20 years later, the fund held its annual meetings in Bali, Indonesia. And the fact that the fund had been able to negotiate to actually come to Indonesia was the end result of a lot of fence mending between the fund and these East Asian economies, which were very skeptical of the fund, and where finally, after 20 years, a reconciliation did occur. So, it can be a very broad relationship.

Another example would be the Euro crisis. This was a very complex situation in that the IMF was engaged together with the European Central Bank and the Commission in trying to address the crisis to the extent that the crisis was fueled by high public debt

levels in some countries. The fund thought that a response focusing on fiscal austerity would be appropriate. The problem with fiscal austerity is it also reduces economic output and may actually make the fiscal situation worse. And arguably, in some cases, the austerity was excessive. So here too, in some countries, the result was a lot of resentment against the fund. Think about Greece as an example.

I think the fund learned as a result of this that fiscal austerity has to be coupled with policy packages that protect the most vulnerable. For example, you go to an emerging market and you say, you have to balance the budget in part by removing your extensive food subsidies, okay? Suddenly people can't get enough to eat. You can't, you know, you have to be much more targeted in how you go about things to prevent distress among people who are really going to be hit hardest by even small fiscal cuts. So, the fund has just gotten much more sensitive about these issues in terms of how it designs stabilization programs.

But nonetheless, politics still intrudes. You can't realistically always be blind to the likely political consequences of policies because they may undermine good policies much more than would be the case if you shade your policies a bit in a way that avoids the worst political outcomes. And that's just a matter of judgment. That's a matter of judgment.

An example is Argentina, Argentina 2018, the fund probably was more indulgent to the government than should have been, given that the consequence of the government losing the election would have been the election of a Peronist regime, whose economic policies would have been far worse. At the end of the day, it didn't work. The Peronist came in. Their policies were as bad as expected. And now Argentina is again in a – it's been sort of yo-yoing between market-oriented and Peronist policies. So, it's in a market-oriented phase with Milei, and the fund will have to make some tough decisions about support for Argentina under this new regime. And frankly, it's hard to avoid the political implications of what your program conditions are. This is just reality.

But that in turn raises a different matter for the fund, which is that, you know, countries look around at the programs other countries are getting and call for even-handedness. You know, even-handedness is in the eye of the beholder. So, you know, how can you sort of adhere to an even-handed approach when each country raises its own political challenges. So it's a tough problem. I don't think it's a problem that will go away, but it's a problem that the fund is just going to have to navigate going forward.

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Lots of commentators have stressed geopolitical divides hardening in the world today and mutually compounding crises. These make it really hard for international organizations today to navigate a world of instability, of crisis. My final question to you is, how can the International Monetary Fund learn from its own past as an organization, from past shocks as well, in order to be better prepared for a turbulent future and to improve its resilience in the face of future shocks?

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I think there is a process of self-examination within the fund. I mean, a great example is the work that was done on fiscal austerity under my predecessor, Olivier Blanchard, just sort of evaluating the kind of multiplier effects of fiscal contraction in European economies. And this was very controversial work within the fund. There was a lot of debate within the fund, but at the end of the day, the research indicated that the fund had way underestimated the contractionary effects of austerity within the context of the European crisis. And that is pretty much now accepted and informs the caution with which the IMF views fiscal austerity.

I think there was a huge process of learning as a result of the global financial crisis in '08, '09, just the risks of financial stability, and that's helped propel the very important financial assessment work that the fund does across countries. Aside from this, the fund also has had for some time an independent evaluation office, which is an internal, a freestanding office that regularly assesses fund programs and fund policies and is often quite critical of fund decisions. And management is never happy when the IEO comes out with a critical report and there's some process of negotiation over that.

But it really does reflect, I think, a very healthy mechanism for self-reflection, honest self-reflection that the fund management takes very seriously. There were a number of reports on the Euro crisis. There have been a number of reports on the fund's views on capital account liberalization, which have changed dramatically over the years. There's ongoing work, I'm not sure if it's been completed yet, on Argentina in the 2018, 2019 events. So that's one strength that the fund has as an organization that actually not many organizations have, and where the fund, I think, deserves a lot of credit.

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Right. Well, on that positive note, Maurice Obstfeld, thank you so much for your time, for joining me today on Global Shocks, and for sharing your fascinating insights as a former economist of the International Monetary Fund.

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Absolutely.

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Thank you, Maurice.

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Great talking to you. Thank you.