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The inside story on the surprise resignation of the IMF's top man. A lesson on the dangers of collateral damage.

The Köhler Episode

BY KLAUS C. ENGELEN

The sudden resignation of Horst Köhler from the top post of the International Monetary Fund a year before serving out his first term raises some nasty questions that have been almost totally ignored so far in the German media. Do the Germans—in this case the country's opposition parties and their supporters plus large parts of the financial, economic, and academic elite, the media, and a large segment of the broader public—understand what giving up the most important international post means in the age of globalization?

As the result of a political power game among three opposition leaders in Germany—Angela Merkel, Edmund Stoiber, and Guido Westerwelle, the bosses respectively of the Christian Democrats, Bavaria's Christian Social Union, and the Free Democrats—Köhler, age 61, was chosen as opposition candidate to fill the post of German president. For months, conservatives and liberals had been quarreling over who should succeed Federal President Johannes Rau, a member of Chancellor Gerhard Schröder's Social Democrats who is stepping down in May after a single five-year-term.

On March 4, Köhler confirmed in Washington that he was quitting his IMF post to accept the nomination as the conservative candidate for president. Since the center-right opposition parties have a twenty-one–seat edge in the Federal Convention, Köhler stands a good chance of becoming Germany's ninth post-war president. In a brave gesture, the governing Social Democrats and Greens nominated their candidate, Gesine Schwan, dean of Europa-Universität Viadrina. But her chance of winning is slim when the Federal Convention votes on the new German president on May 23, 2004.

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Out of His Depth?

"What people outside Germany find hard to understand is why anyone in one of the key jobs managing the world economy—arguably the single most important coordinating role—would want to give it all up for an honorary position opening buildings and handing out colored ribbons to brave fire-fighters. It merely raises the suspicion that **Horst Köhler** *(right) felt himself to be out of his depth." This is how* **Chris Huhne**, *the economic spokesman of the Liberal Group in the European Parliament, reacted to the news that Köhler was quitting. Another theory: his devotion to his political party.*

—K. Engelen

As expected, since Köhler stepped down, the race to lead the IMF is on. Since European member countries collectively hold the largest shareholding block, they insist on nominating the Fund's managing director while leaving the World Bank presidency to the United States. Spain's outgoing economy minister Rodrigo Rato remains the frontrunner for the job. Frenchman Jean Lemierre was viewed as his main rival, but withdrew to accept a second term as head of the European Bank for Reconstruction and Development. That Rato was able to get the support of most of the Latin American member countries at the recent annual meeting of the Inter-American Development Bank in Lima, Peru, might give him a slight edge.

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Why did Horst Köhler leave the most powerful international position? All along, Köhler remained close to his party.

A similar puzzlement and lack of understanding is expressed by others such as Tim Cullen, former press aide to several World Bank presidents: "Given the vigor with which Germany pressed to ensure the installation of its nationals as head of the IMF four years ago, it is indeed surprising that the political leadership in Berlin has allowed this key position to slip from its grasp. However, it must be said that the appointment process of the head of any of these international bodies always seems to show governments in their worst light. The unseemly lobbying and horse-trading that has increasingly characterized these appointments in recent years does no service to the global community the international organizations are meant to serve. Too often in recent years, UN agencies and other international bodies have been headed by compromise candidates or weak leaders whose main qualification is that it was their country's turn or they were the least objectionable of the candidates on offer. It's time governments put national pride aside and simply looked for the best person qualified to do the job."

Alluding to Köhler's farewell statement at the Fund that he accepted the nomination "with a laughing and a crying eye," Martin Wolf, *Financial Times* columnist, observed sarcastically that many share such feelings: "The manner of Mr. Köhler's departure was as absurd and outrageous as that of his arrival. That matters because the institution remains of great importance." Wolf is right when he characterizes Köhler's arrival and departure as "absurd and outrageous." And the veteran columnist was right on the mark when he noted: "The chancellor's political opponents have turned that victory into a defeat by nominating Mr. Köhler for the ceremonial position of president. Germany was as insensitive in its government's insistence that a German must head the IMF as it is now parochial in its decision to remove him."

But let's clarify one thing. It was not the German government that allowed its most important international position slip away just like that—a position it waited to fill with one of its nationals for almost half of a century. For Chancellor Schröder, the unexpected quitting of the man whom he had sent to head the IMF four years ago after a ferocious international fight was a heavy blow. After all, a German heading the most powerful international institution had been the centerpiece of Schröder's strategy to strengthen the presence of German nationals at the higher echelons of major international organizations. There was a bipartisan consensus that Germany, with a population of more than 80 million and representing the largest economy in Europe, should be much better represented at the key levers of the international system.

Köhler's quitting also was a bitter disappointment on a personal level to Chancellor Schröder and his finance minister Hans Eichel. Both had been busy for months in a discreet diplomatic campaign to secure support for a second term for Köhler well ahead of the end of April 2005, when his first five-year term would expire. When Eichel visited Brazil and Argentina earlier this year, the first thing he did after talking to Presidents Lula and Kirchner was to telephone Köhler with the news that these countries supported his second term. Since the presidents of Poland and other EU accession countries had been asked by French President Jacques Chirac to support a French candidate instead of a second term for Köhler, that was a new challenge for Berlin's financial diplomacy. As it turned out, Köhler was to meet with Schröder and Eichel in Berlin on March 11 to discuss how this diplomatic effort had progressed. That appointment—scheduled a long time ahead—was, of course, cancelled. One week after his resignation, Köhler, accompanied by his wife, was making the rounds of the talk shows as Germany's newest media star—campaigning for the opposition.

The manner in which Germany both waged a ferocious campaign to place a German national at the head of the IMF and then recalled Köhler one year before his first term expired may have damaged Germany's chances for adequate representation and influence in major international institutions for years to come. Those who picked Köhler as the presidential candidate—over several politicians who have been elected many times and held major cabinet posts such as Wolfgang Scheuble—showed a callous disregard for the international implications of their move and for the most important international financial institution and its global membership.

Those conservative and liberal opposition leaders who are "elevating" the former aide to Chancellor Helmut Kohl from IMF headquarters in Washington to the Belvedere Castle in Berlin have a common partisan goal: by using the office of the Presidency as a bully pulpit for economic reform, they hope to improve their election chances against the Schröder government that has been trying to implement economic and social reforms and is facing punishing defeats by the voters in state and local elections.

A Heavy Blow

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Köhler's sudden "recall" without serving out his first term has caused bewilderment in all parts of the world. A finance minister of a major Latin American country, who dealt intensively with Köhler as IMF managing director, sarcastically asked at the IADB meeting in Lima whether "those who are managing Europe's largest economy might not be suffering from mad cow disease for recalling their most important German ambassador in the world at this critical stage of globalization." At this same Latin American banking summit, Uschi Eid, Germany's deputy development minister, expressed her surprise at "how much Horst Köhler's work at the Fund was appreciated by the region's financial officials and how much he was considered as a most important friend of Latin America."

Some international observers are puzzled that the negative implications of Köhler's recall and candidacy are meeting a "wall of silence" inside Germany. But there are some exceptions. Only the German business and financial daily *Handelsblatt* talked of the Köhler matter in terms of a "setback to the Berlin government's strategy to put German nationals in key positions in international institutions." And in a rare statement from the academic side, Michael Frenkel of Koblenz University WHU, an authority on IMF matters, noted, "Regrettably, by nominating Horst Köhler for the office of Federal President, Germany has lost such an important position as that of a managing director of the IMF. It may take a very long time in which Germany will not be able to put a German national in this influential position."

Why were these possible negative consequences of Köhler's sudden exit from the Fund not discussed? One explanation might be that the broad bipartisan support for promoting German economic and financial interests in the European Union and in the global arena is eroding as fast as the common ground on what used to be the "Deutschland AG."

So let's put things in perspective. Since the Federal Republic of Germany joined the Bretton Woods institutions on August 14, 1952, almost half a century passed until a united Germany could put one of its own at the helm of the most important institution in the multilateral system—the International Monetary Fund. It may take another generation until another German national might have a chance.

Köhler came to the Fund as Germany's second choice. He arrived in Washington after what looked like a modern-day Waterloo in the field of German financial diplomacy. After replacing the conservative-liberal government of Helmut Kohl, which governed the country for sixteen years, the new socialist Chancellor Schröder saw the historic opportunity to place a German at the helm of the IMF. This move was the centerpiece of a strategy to increase the presence of Germans in top positions of international institutions after decades of leaving the top jobs to other countries—in particular to France. Schröder put forward Caio Koch-Weser, who had spent twenty-five years at the World Bank before becoming Germany's deputy finance minister.

The United States—with U.S. Treasury Secretary Larry Summers pulling the strings—blocked Koch-Weser as successor to Frenchman Michel Camdessus. When Koch-Weser was rejected by the Americans—although he had the backing of all EU countries—most Germans felt at the time that their candidate had gotten a bum rap from the Clinton administration. Some saw the Anglo-Saxon press as practicing the art of professional destruction against a German candidate who may have lacked experience in central banking, but could make up for that with experience as a top manager and as a global development banker (see "Koch-Weser Gang Bang," *The International Economy,* March/April 2000).

Those who picked Köhler as the presidential candidate showed a callous disregard for the international implications of their move.

Schröder was forced to send another German candidate into the race. He turned to Horst Köhler, who had been deputy finance minister during the hectic years of German unification and who at the time was president of the European Bank for Reconstruction and Development. Köhler, a member of today's conservative Christian Democratic Union, was able to mobilize broad international support for his new, much larger mission as managing director of the Fund.

So there remains the obvious question, in particular outside Germany—why did Köhler leave to become what the news magazine *Der Spiegel* called "Merkel's Bundespräsident"? I think we gave the answer some time ago when we reported exclusively on the "strange new personal war" that erupted between Köhler and German Finance Minister Eichel ("German vs. German," *The International Economy,* Summer 2003). An active member of the conservative CDU since 1981, Köhler gave the appearance of being first and foremost an economist who never let party politics influence his decisions. "But in reality," argues one of his former colleagues at the savings banks federation DSGV, "he has furthered his stunning career as a willing servant and sometimes even overzealous party soldier for his conservative higher-ups in the CDU." All along—from his early bosses, Gerhard Stoltenberg and long-term chancellor Helmut Kohl, up to his present conservative party leaders, Angela Merkel and Edmund Stoiber—Köhler remained close to his party.

His party allegiances showed up last year during elections when he aided the conservative and liberal opposition to Chancellor Schröder, who sent him to the IMF four years ago. That Köhler didn't even pay courtesy visits to the chancellor and the finance minister when giving helpful speeches for his own side was seen as a signal that the IMF chief was sure that his CDU/CSU friends would get back into government. Some of Köhler's interviews blasting the economic policy failures of the Schröder government were seen as highly partisan and—considering Köhler's past role as defender of the status quo and as a master of political expediency—lacking a good measure of credibility.

After all, it was Köhler who, as economic policy aide to Chancellor Kohl in devising the programs to finance German unification, played a key role in the ruinous build-up of national debt in the 1990s that put federal, state, and local budgets into ever-larger deficits. There was also a disastrous failure to finance the extension of social protection to the East

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Germans by raising taxes. Instead, the Kohl government—with economic advisers like Köhler lending a helping hand—used the contributions of West German workers and employers for social security, unemployment, and health insurance to extend social protection toward East Germans. In this way, the Kohl government, where Köhler served as "sherpa" and deputy finance minister, instituted ever-higher supplemental charges on labor costs which increased unemployment and put a brake on economic growth.

But there is another credibility problem for Köhler when he wants to use the office of the German president as a pulpit for reform and austerity. After leaving the Kohl government, Köhler became president of the Association of German Savings Banks, thus looking after the interests of a large segment of the country's public-sector banks. In this position, Köhler played a critical role in defending Germany's system of public guarantees at the same time as the IMF and the EU Commission were objecting to not giving private-sector banks a level playing field. While Köhler, a chief negotiator of the Maastricht treaty, tried hard to get the status quo protection of public bank guarantees into the treaty, it was Koch-Weser who, as Eichel's deputy, was forced by EU Commissioner Mario Monti into a multi-year agreement under which Germany's Landesbanken must phase out their state guaranty structures.

All this may limit Köhler's credibility as the "reform president" he wants to be. Since Köhler had an active part in most of the major economic blunders of the Kohl era, his political opponents—and there are many—will question his credibility and limit his authority. Already Köhler has shown that, having never stood for any elected office and having spent many of his recent years abroad in London and Washington, he may have a hard time avoiding being seen merely as someone put in the highest German ceremonial office as a willing hand to win the next national election for the conservative and liberal opposition parties.

That leaves us with the last question: What impact did Köhler have in his shortened four-year tenure at the Fund? Having covered the IMF since the annual meeting of 1968, I gave him high marks after his first six month in office ("A Good Start," *The International Economy,* September/October 2000). Right after Köhler announced that he was stepping down, U.S. Treasury Secretary John Snow presented a list of Köhler's achievements: "Horst Köhler brought great energy and focus to his tenure as managing director of the IMF. He transformed the institution in terms of its transparency, established the International Capital Markets Department as recognition of the changes in the world of international finance, refocused the IMF's lending conditions on core macroeconomic areas within the IMF's competencies, and worked to develop better crisis prevention tools and more effective crisis management. This is a long list of achievements in relatively brief tenure." And Snow continued: "On a personal level I will miss our regular discussions and meetings on the U.S. and world economies and on the challenges facing the IMF. Horst was steadfast in his genuine, fundamental objectives of attaining sustainable economic growth and improving the standards of living of people everywhere."

The last time the international financial community looked at Köhler's successes and failures at the Fund was last September, when the IMF and the World Bank had their annual meetings in Dubai. For the Dubai meetings, the magazine *The Banker* came up with a thoroughly researched cover story under the headline "Horst Köhler—Pass Or Fail?" The London magazine concluded that "with only one major failure in the past three years (Argentina), Köhler's track record is better than his predecessor Michel Camdessus." In the view of *The Banker,* Köhler's score card showed pluses in that he slashed loan conditions, improved the capital market focus, introduced better evaluation controls, and saved Brazil. Köhler's minuses were that under his tenure the IMF failed in Argentina, had not yet developed a clear strategy in its role to fight poverty, and didn't make much progress in streamlining its bureaucracy. *The Banker's* score of "4/7" comes down to a fair bottom-line assessment of what Köhler achieved or didn't achieve in his reign at the Fund. He didn't pass with flying colors but his IMF leadership wasn't a dismal failure. As *The Banker* concludes, Köhler has been "tireless, focused, and has a vision he follows through" and "he's happy to bang heads."

From close range it was clear that Köhler had a terrible time with power-hungry deputy Anne Krueger, who took her mission as the U.S.-deputized operational manager of the Fund very seriously. Since Köhler, contrary to most of his predecessors, got very involved on technical issues, his micro-management met resistance in the organization, especially from his deputy. Köhler also faced, as Columbia University Professor Jeffrey Sachs pointed out, "a particularly conservative, uninterested, and inexperienced U.S. administration in international economics." That Argentina gained infamy as the single biggest sovereign debt default in history cast a shadow over his shortened term. It is almost impossible to untangle Köhler's culpability in the Argentine default because the IMF was under so much pressure by the United States and other G7 governments to disburse money up until the end.

But in his other major failure—the break-up of the IMF's bankruptcy plan, the sovereign debt restructuring mechanism (SDRM) that Krueger had developed and proposed—Köhler changed sides under pressure from the private sector and the United States in a manner that damaged his credibility. To Köhler's credit, none of his predecessors have done more to develop formal relations between the IMF and the private sector, in particular the major financial institutions dominating issuance and trading activities on global capital markets. Establishing the Fund's new capital markets division, which issues the Global Financial Stability Report, and putting higher on the international agenda the issue that rich countries must open their markets to agricultural products from poor countries, are things Köhler's IMF term might be remembered by. Although Köhler's lasting impact at the IMF might be modest, as a former managing director of the Fund he will command a unique international standing. Therefore, to the German public and the Federal Convention that will elect him according to party membership, Köhler can impress his audiences as a world-renowned economic and financial leader. Even introducing himself in his new role in the media-blitz following his nomination, he didn't shrink from criticizing Germany's failure to carry out social and economic reforms.

When it comes to the bottom line, the Köhler episode—his controversial arrival at the Fund, his achievements and failures there, and his nomination as candidate for the German president and his sudden recall—occurs at a time when we are again reminded of the primacy of domestic politics. Pointing to EU enlargement and the historic events of NATO formally welcoming seven new members—"an accomplishment which is breathtaking in the context of post-World War II history"—Jackson Janes, executive director of the American Institute for Contemporary German Studies, points out that these events will be overshadowed in Germany and the United States by domestic political battles. He points to the huge demonstrations all over Germany against raising health care prices, cuts in pensions, an extended workweek, and the threat of "McJobs" encroaching on the labor market.

A greater part of the German public and political elite seems to be so much absorbed in lamenting the "German disease" and blaming the government and the ruling parties for stagnating growth, mass unemployment, and high welfare outlays that they turn a blind eye to whether Germany's standing and credibility in the international system is weakened. While one side argues that the "Model Germany" is threatened by those who want to reform it, the other side argues that the Model itself—because the costs of the welfare state are too high—can no longer work in the age of globalization.

Even before being elected, Köhler has gotten in big trouble by preaching more reform, more work, and more austerity to millions of Germans who think that they are the losers in Europe's biggest economy. For them, a former Kohl aide who preferred to plunder the contribution-financed social funds of West German working people to avoid raising taxes for West German richer classes and who helped to de-industrialize the former East Germany—a major reason for today's mass unemployment—might not have that much credibility and moral authority. Therefore, Horst Köhler's new challenge may not prove to be a lot easier than managing the Fund with the U.S. Treasury, Anne Krueger, and the G7 all breathing down his neck. ◆

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