FINANCIAL TIMES

October 20, 2014 4:49 pm

A healthy challenge to the old guard of global finance

Eswar Prasad

The IMF's is able to assess countries' financial and macroeconomic policies, writes Eswar Prasad

Change is coming to the international monetary system. Weary of broken promises to give them a say in the running of the International Monetary Fund that matches their economic heft, the so-called Brics countries have set up their own development bank. Brazil, Russia, India and China also plan to pool foreign exchange reserves and avoid having to rely on the IMF during crises.

The eurozone crisis in some ways demonstrated the worth of the old multilateral order. True, the IMF at first went along with a rescue programme premised on fanciful assumptions at the behest of the EU and the European Central Bank. But the Fund subsequently stiffened its spine. It insisted on recognising the full extent of the debt and banking problems in Greece and Cyprus, and demanded a realistic assessment of reforms needed in other troubled economies. Left to themselves, Europeans might have stuck to their delusions.

Such actions demonstrate the IMF's worth. But its legitimacy remains in doubt. Emerging markets harbour a strong suspicion that if they found themselves in trouble, they would receive smaller loans under more stringent conditions. When it comes to mediating currency wars they see an institution that is impatient when developing countries seek competitive advantage in a weak currency – but which readily acquiesces when big western economies embark on massive programmes of monetary easing that might also be seen as a form of competitive devaluation.

The IMF's real strength is its ability to assess countries' macroeconomic and financial policies and evaluate what they mean for the world economy. The Fund should make these assessments its main job. It could do them better if it was no longer doing the frontline work of rescuing troubled economies. Combining the two functions makes it needlessly vulnerable to accusations of favouritism.

Lending with conditions could be managed by regional insurance pools and backed up by IMF money if needed. At a time of crisis, the IMF would be called upon to develop a realistic plan for a country to rectify its policies. The country would simultaneously negotiate with the relevant regional monetary fund for a loan programme. Any watering down of the IMF's recommendations would make it obvious how much the country in trouble was being subsidised by others in its regional group. Such decisions would be political, as they always are. But other countries in the group would be fully informed about the costs of bailing out one of their own.

> The IMF's strength is its ability to assess countries' macroeconomic and financial policies
>
> Tweet this quote

Could a dominant country in a regional pool sabotage a smaller country's borrowing for petty political reasons? Yes, but the option of an IMF loan takes the edge off large countries' threats to run the regional insurance pools however the fancy takes them.

Some western policy makers have argued that allowing regional funds to compete with the IMF could trigger a race to the bottom, in which countries play different would-be rescuers off against each other in an attempt to negotiate less onerous conditions. This is a red herring. The IMF and the regional funds would have the same incentives to maintain their credibility and protect their investment. They have strong reasons to aim for good economic outcomes.

Rather than whinge about China's plans to set up competing institutions, the US and other advanced economies ought to take quicker action to reform the governance of the ones they dominate. Co-operation is not all it is cracked up to be. The IMF has long advocated the benefits of greater competition and market discipline in place of the cosy status quo. Perhaps the IMF itself, and the governance system for global finance, would be better served by being subject to some of both.

The writer is professor of trade at Cornell University

RELATED TOPICS International Monetary Fund, Central Banks, China, European banks, European Union