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Global Lenders Rebuild Identities After the Crisis

By ESWAR S. PRASAD

Just five short years ago, the International Monetary Fund and the World Bank were struggling for an identity. Practically the entire global economy, from poor to rich countries, was enjoying a golden period of growth and stability — and seemed unlikely to need a hand, or a handout, from either of these two institutions.

Those existential questions were erased by the global financial crisis that began in September 2008. And in dealing with the aftermath of that crisis, it has become clear that the world needs both institutions more than ever.

The I.M.F. is now helping the euro zone cope with its sovereign debt crisis, going back to the fund's roots at the Bretton Woods conference in New Hampshire in 1944, when it was set up to manage the fixed exchange-rate system among the major industrial economies.

The World Bank, also a Bretton Woods creation, is helping low-income economies deal with the collateral damage from the financial crisis, as well as declines in world trade and the surge in commodity prices.

Yet even as their angst over their usefulness to the world has dissipated, both institutions now face a different challenge: adapting to the rapidly shifting structure of the world economy.

Emerging market economies now account for an increasing share of global gross domestic product and the major share of global growth. With the advanced economies strapped for cash and facing rising levels of public debt, the emerging markets will determine not only the relevance but also the funding base of the Bretton Woods institutions.

These institutions cannot afford to ignore this growing middle. And, in fact, recent changes to governance structures will help in strengthening legitimacy among emerging markets. These economies are getting bigger voting shares, and the compositions of the governing boards are being altered to reflect the declining economic importance of advanced economies.

But both the I.M.F. and the World Bank still have much to do to build trust among emerging markets and make a convincing case that they are not merely instruments of the rich economies.

Many emerging-market countries had to go hat in hand to the I.M.F. during the currency and banking crises that hit them in the 1980s and 1990s. The fund's assistance typically came with many conditions attached, requiring necessary but painful policy changes. This evolved into a deep distrust of the I.M.F., which came to be seen as a handmaiden of the advanced economies, parroting those countries' views about free and unfettered financial markets.

Given their rising income levels, many emerging economies have also come to see the World Bank as less relevant to the challenges they face.

The role the I.M.F. plays in dealing with the next phases of the euro zone debt crisis will influence the credibility it has with emerging markets.

The euro zone does not lack the financial wherewithal to stem the crisis. What it lacks is the political will. The European Central Bank has committed to buying sovereign bonds of euro zone countries that agree to undertake policy overhauls. The Spanish government has agreed to do its part by implementing fiscal austerity measures and other changes.

Disaster has been averted, but this comfort will not last for long. Markets may trust the E.C.B. to keep its word, but they do not fully trust politicians to keep their end of the bargain. Recent riots on the streets of Greece and Spain show how difficult it will be for European governments to enact the necessary changes.

Europe, therefore, needs a credible and tough disciplinarian. The E.C.B. remains the only institution that fills the bill. But for all the talk of conditions attached to E.C.B. money, the pushback from countries like Spain that hope to benefit from the E.C.B.'s largess will only intensify as their domestic political circumstances deteriorate.

And the pushback will continue even after commitments are made. The E.C.B. cannot credibly threaten to retreat from its defense of any euro zone country that accepts its conditions, even if the commitments to undertake overhauls subsequently remain unfulfilled.

In short, Europe needs the I.M.F. The question is whether the fund will now use its extraordinary leverage to set a course correction for Europe and for itself.

To serve as an effective and honest broker, the I.M.F. needs to restore its own credibility along with its broader legitimacy.

Early on in the crisis, the I.M.F. pumped large sums of money into the European periphery. This money came with conditions but also twisted the fund into the position of looking through rose-tinted glasses at harsh realities, in order to rationalize its lending decisions.

Moreover, it cost the I.M.F. some credibility to lend large amounts to a small economy like Greece's. Many emerging-market policy makers viewed this as a double standard at work, noting that they would probably not have been able to count on such largess.

Without putting more of its own money at stake, the I.M.F. is now in a position to speak the truth. To rebuild credibility, it will have to be blunt. In the case of countries like Greece, the understandable desire to play up the positives has to end. What is needed is a direct and open assessment of the prospects of each distressed economy and what it will take for each of those economies to regain its footing, either within or outside the euro zone.

The I.M.F. should also take a broader view of what Europe as a whole needs. For far too long, the core euro zone economies have apparently held the view that different rules should apply to them compared with their less virtuous neighbors.

All of Europe needs to hear some harsh truths about what it will take for the euro zone to hold together and prosper. Using the power of its megaphone rather than its purse strings, the I.M.F. can not only redeem its own credibility but also do a lot of good for Europe and the world economy.

As for the World Bank, in an era of rising incomes it is clear that the emerging markets do not need the institution's money as much as they need its technical expertise. To stay relevant to this group, the institution must do a more skillful job of tying together policy advice on major macroeconomic issues, including fiscal and monetary policies, with more "micro" development issues, like health care and education.

Jim Yong Kim, the new president of the World Bank, has a distinguished record on innovative and nonideological approaches to development issues and policies to implement them at micro levels. This is exactly along the lines of what emerging market economies need.

The I.M.F. and the World Bank have proved their worth in tough times and have become important instruments of change in rich and poor economies, respectively. The challenge they face in order to remain relevant in a fast-changing world economy is to retool themselves so that the countries in the middle, the fast-growing emerging markets, also see them as useful institutions that are not beholden to the club of rich countries and that adapt well to changing circumstances.

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