FINANCIAL TIMES TUESDAY OCTOBER 21 2008

The Fund must be a global asset manager

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The chaotic, costly and ineffective international response to the current financial disorder has prompted French president Nicolas Sarkozy, British prime minister Gordon Brown and German president Horst Köhler, a former head of the International Monetary Fund, to call for a new Bretton Woods conference to design a new global financial system.

This is the first big crisis since the Bretton Woods conference in 1944, when the IMF was created, when the Fund has stood on the sidelines. Yet the origins of the crisis lie in some of the areas where it has a direct mandate – in particular, the large current account imbalances – as well as in the areas where it has recently been extending its mandate to cover financial stability.

The core IMF function should be multilateral surveillance. But at present this often means just talking. This is quite different from past visions. The IMF originally supervised the rules of the system of the par value of currencies under the Bretton Woods order, which disintegrated in 1971. The effectiveness of multilateral surveillance as it developed in the 1960s was linked to the IMF's presence as a significant financial intermediary. It is this role that needs to be rethought.

In the past, the ability to give powerful advice to the systemically important countries, such as the UK, was enhanced by the dependence of those countries on IMF resources. It was the financial power of the IMF that gave it its bite, and that power was enhanced by its borrowing – at first from the Group of 10 nations that constituted the General Arrangements to Borrow.

In the years after the collapse of Bretton Woods, the IMF reinvented itself as a vehicle for the management of the surpluses of the time. It borrowed from the new surplus countries, which as a consequence in part managed their new assets through the intermediation of the IMF. It was then able to lend to those countries that suffered shocks as a result of the increase in petroleum prices.

A very large financial actor can have a stabilising role. In the more distant past, market expectations were stabilised during panics by the counter-cyclical behaviour of very large private institutions. The multinational house of Rothschild made the first half of the 19th century stable. In the great panics of 1895-96 and 1907, the US economy was calmed by JPMorgan. At the time of the Great Depression in the 1930s, there was no house of equivalent power.

The IMF could be a powerful stabiliser in global markets if it managed a significant part of the reserve assets of the new surplus countries. It would be in a strong position to take bets against speculators, potentially in regard to speculative attacks on both countries and on financial institutions.

The IMF could be a powerful stabiliser in markets if it managed some reserve assets of the surplus countries

The stabilising action would benefit both the world economy and the interests of the owners of the reserve assets, which have (simply by the fact of the accumulation of the surpluses) a similar interest in world economic and financial stability. At the same time, the management of reserve assets by an internationally controlled asset manager would remove suspicions and doubts about the use of assets for strategic political purposes.

In order to carry out this new task, the IMF would need to regain the trust of its members. The rise in reserves in many Asian countries was a deliberate response to the 1997 Asia crisis, in which there was substantial disillusionment with the IMF. A precondition for acting as a global reserve manager would be governance reform in which the new surplus countries were able to exercise substantive influence through the IMF and feel secure that they were not being politically manipulated.

In particular, if the IMF were to be in a position of an asset manager that could shift assets from one market to another, it would need to be at greater distance from US influence and attempts at control: otherwise, it might be seen as a device for propping up the dollar or particular financial institutions for political economic reasons.

In a revised approach, votes in the IMF would be allocated or "bought" to a large extent through the assets held at the IMF. The proportion of votes determined in this way might be as high as 50 per cent, while the rest would be allocated in the traditional way. There is an analogy to this double determination of voting power in the US constitution, according to which all states have an equal share of Senate votes but very different numbers of seats in the House of Representatives, reflecting population differences.

Making a substantial part of Fund voting a reflection of the reserve positions held in the IMF would allow quick adjustments to new international realities. It would make the IMF more of a market institution, much like the ownership of joint-stock companies can change quickly and noiselessly.

A new version of the Fund could be a substantial contributor to stabilising market expectations. The IMF was conceived in 1944 in a world without major private capital flows, in which states would undertake all international transactions. Extending its mission to include some private sector rescues would be a recognition of the preponderant role markets now play. At the same time, the involvement of a rule-bound international agency would minimise the political poison associated with bank recapitalisations as well as currency interventions.

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