Reforming the International Monetary Fund – Some Reflections

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This paper reviews the most recent issues in the ongoing debate on the reform of the International Monetary Fund (IMF).

The Fund has recognized that IMF surveillance should put greater weight on analyzing and discussing global economic issues. By taking account of international spillovers, surveillance should in future be multilateral rather than purely country-specific. Exchange rates and policies should also be the focus of renewed interest.

Moreover, there is no doubt that IMF quotas will have to be adjusted to take account of the changing economic weight of many IMF member countries in the world economy. Negotiations on a new quota formula started after the Annual Meeting in Singapore in September 2006. The influence of low income countries should be strengthened by increasing the number of basic votes in order to prevent the Fund from loosing legitimacy. However, with the IMF's intention to put more weight on GDP in the new quota formula, the stage is set for complex, difficult and time-consuming negotiations.

Finally, the IMF will need to reform its financing system and budgeting procedures to ensure that expenditures will be adequately curtailed to enable it to work efficiently despite income shortfalls, which might well be not transitory but of a permanent nature.

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1 Introduction

The International Monetary Fund (IMF) was officially established when its Articles of Agreement entered into force on December 27, 1945. In accordance with Article I the purposes of the IMF are to promote international monetary cooperation through a permanent institution, facilitate the expansion and balanced growth of international trade and promote exchange stability. Moreover, the IMF has been mandated to assist in the establishment of a multilateral system of payments in respect of current transactions and to make the general resources of the Fund temporarily available in order to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of its members.

Before looking into the ways and means by which the IMF has intended to fulfill this role, it might be useful to see whether its mandate is still appropriate for our times. Reforming the IMF has been on the agenda of international policymakers at least since the early 1970s, when the Bretton Woods System collapsed; doubts have been raised whether the IMF still has the tools appropriate for its mission.

In many respects the Fund plays an important role in international monetary cooperation, proving just how far-sighted its founding fathers were. In some cases, however, its purposes have become outdated and need to be revised.

Specifically, the following arguments have been brought forward:

– Facilitating international trade falls within the competence of the World Trade Organization. As such it need not be listed among the primary purposes of the IMF any longer, even though it will remain of considerable, albeit secondary, interest for the IMF.

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– The emergence of a variety of regional cooperative initiatives, such as the introduction of the euro or the Chiang Mai Initiative, have reduced but not eliminated the need for balance of payments support by the IMF and provide an additional platform on exchange rates and monetary cooperation.
– The role of the IMF as a clearing house for payments for current transactions is more theoretical than practical. The Fund promotes the idea of the liberalization of payments for current transactions in its Article VIII, augments foreign exchange reserves by allocating Special Drawing Rights (SDRs) and can – in extremis – "designate" countries to accept another country's SDRs. In practice, however, the international monetary system runs smoothly without constant recourse to the IMF.
– The purposes of the Fund, as listed in its Articles of Agreement, cover only indirectly one of the main sources of crisis: the capital account. Citing the capital account explicitly as an area for temporary financing might be appropriate.
– Furthermore, it might be deemed appropriate to augment the Fund's instruments that are listed in the Articles of Agreement by explicitly including macroeconomic surveillance and technical assistance.
– Finally, in view of the fact that regional cooperations and/or currency unions are becoming more and more widespread it might be opportune to allow such bodies to become IMF members in lieu of (or perhaps in addition to) their composite members.

From the Fund's purposes we now move on to the instruments which the IMF used in the past to fulfill its tasks and to the question of how to improve and adapt them to master future challenges. Section 2 deals with surveillance issues, section 3 with IMF financing and section 4 briefly outlines the main principles of technical assistance. Section 5 refers to IMF finances and budget, section 6 to issues of representation and governance and section 7 concludes our reflections on reforming the Fund.

2 Surveillance

IMF surveillance is one of the mainstays of cooperation between the Fund and its member countries. It is the conduit through which the IMF tenders advice when no program is in place and the antenna through which the first tremors of upcoming difficulties are transmitted. It is thus imperative that surveillance works well.

However, over the years, surveillance has somewhat lost its focus. In addition to exchange rate, fiscal and financial system surveillance a plethora of irrelevant – or at the very least less relevant – items have entered the surveillance agenda: structural reform, social and anti-money laundering issues. Many of these items fall outside the traditional area of IMF competence and thus necessitated costly recruiting efforts without ultimately achieving the outstanding expertise the Fund needs to rely on in its areas of core competence and which makes its advice so universally respected. A refocus on what the Fund does well is thus urgently needed. This would also help to stop the frequently cited dwindling of its reputation.

At the same time, resources saved could be spent on areas of neglect and on new interests. Increasing and rapid globalization mandates a move away from the traditional system of only single country-based surveillance toward multilateral and regional consultations.

Since the Fund's 2006 Spring Meeting, the Executive Board of the IMF has put its main emphasis in the fields of implementing its Medium-Term Strategy on surveillance (IMF, 2006a). In order to deal with the challenges of deepening financial market integration and large-scale private capital flows, the IMF started to overhaul its surveillance framework by attaching more importance to the relation between the financial sector and the macroeconomic situation.

Until recently, single-country Article IV consultations were the main basis of surveillance. Complementary to these bilateral consultations, the IMF has now launched the first multilateral surveillance consultation process (IMF, 2006b). Multilateral consultations are intended to provide a forum for discussion on common economic issues and vulnerabilities that affect both individual IMF members and the global financial system. The first multilateral consultation addressed global imbalances and had five participants (China, the euro area, Japan, Saudi Arabia and the U.S.A.) experiencing large current account surpluses/deficits and representing large shares of global output. These recent efforts to conduct multilateral surveillance are a step in the right direction. However, they need to be complemented by more discussion among the countries participating in the exercise as, so far, the IMF has in effect served as a go-between for the participants.

Considering that for the last ten years, the capital account has been the most likely as well as the most grievous source of crisis, the Fund should concentrate more of its efforts on advising on capital movement liberalization and on exchange rate surveillance. The latter is not only a topical issue these days in light of the economic relationship between China and the U.S.A., but can potentially affect the relationship between all major currencies. The IMF has therefore started to review its surveillance activities on exchange rates, which have their foundations – inter alia – in the 1977 Decision on Surveillance over Exchange Rate Policies agreed upon after the breakdown of the Bretton Woods System of fixed exchange rates (IMF, 2005a). Although it is currently not clear yet to what extent the 1977 Decision will be amended, i.e. whether closer links to the Article IV consultations will be established or not, indications are that exchange rate surveillance will be strengthened on operational and analytical grounds. The ECB and national central banks of the euro area thus need to consider carefully what the Fund's role ought to be in this respect, since publications on equilibrium exchange rate levels could lead to undesired market movements. However, deeper involvement of the IMF in exchange rate surveillance and analysis, in particular with regard to emerging market economies, definitely seems to be warranted.

The IMF will also attach greater importance to financial sector surveillance. Financial sector developments have become increasingly important for individual economies as well as for the world economy as a whole. It is high time that the IMF becomes more closely involved in financial sector surveillance and starts to recommend improvements on a regular basis. One route that could be followed in a promising way is to thoroughly incorporate financial sector analysis into Article IV surveillance. A close cooperation of the Fund's country departments and its Financial Markets Department seems warranted in this context.

3 Financing

Box 1

IMF Financing

Normally, member countries are granted access to IMF resources to the amount of up to 100% of their quota on an annual basis and up to 300% cumulatively. Under exceptional circumstances or when using some special facilities – such as the Supplementary Reserve Facility (SRF) – this limit can be exceeded: for some special facilities the IMF charges a surcharge on the rate of charge with the aim to encourage early repayment in order to free up funds for future emergencies.

The IMF – other than the World Bank – does not use international capital markets for its financing but relies solely on contributions by its members. In principle, each member country provides 25% of its quota to the Fund in gold or hard currencies. The other 75% of its quota (payable in domestic currency) are available on call. The IMF uses quarterly Financial Transaction Plans (FTPs) to determine the amounts available for "Purchases" (IMF terminology for lending) and "Repurchases" (repayment of loans).

However, only those currencies which are tradable in world financial markets are of immediate practical use to the Fund for lending purposes. If the IMF wants to call upon the part of the quota that is paid in domestic currency, it at first evaluates the reserve position of the country in question (to see whether it is "strong enough" to participate in the FTP) and in a second step asks the respective country to convert the domestic currency amount into freely convertible currencies. By doing so, the IMF makes sure that another country that is in need of financial help does not receive a domestic currency with limited use, but a freely convertible currency that can be used both for domestic purposes and in international capital markets.

The IMF's traditional role is to provide emergency financing for countries with balance of payments problems that stem from e.g. trade imbalances and/or an exploding public external debt situation due to fiscal overspending. In recent years capital account issues have become the primary source of crisis in many countries. The traditional instrument for providing Fund financing, the Stand-By Arrangement in its basic concept, has proven insufficient for resolving a capital account crisis. Although the Fund has introduced an "exceptional" access window (providing financing beyond 300% of quota with an extra surcharge to the rate of charge) and even established a completely new facility (the Supplementary Reserve Facility – SRF) there is still the question of whether enough has been done. Therefore, some countries have argued in favor of establishing a new insurance-type contingent facility.

At the same time, the Fund is no longer the only source of emergency help/financing. Lately, it has been drawn at an ever increasing pace into providing developing aid and has thus come into conflict with its traditional mandate and other international organizations, such as the World Bank, which have traditionally been active in this field.

The number of capital account-driven crises has risen sharply in the past decades. The IMF is not entirely without fault in this development: While striving to make the advantages of capital movement liberalization available to as many economies as possible, it has perhaps not taken enough care to take account of all country-specific idiosyncrasies. Also, in some cases speed was given more importance than a carefully designed step-by-step program which avoids the risk of a maturity mismatch of foreign loans and their domestic utilization (i.e. short-term flows being intermediated by the domestic banking system into long-term investments) or accepts an undue amount of currency risk. In fact, there was very little advice on proper sequencing and the risks when of disregarding it. Since the Asian crisis, IMF economists have improved their track record in this respect, and countries interested in pursuing capital movement liberalization have become more circumspect.

In any case, the number of capital account crises can, on the one hand, be considered almost a good sign: It shows that countries are pushing forward with their capital movement liberalization agenda and are thereby removing inequalities and inefficiencies from the global monetary system. At the same time, this trend inevitably poses difficulties when a liberalization process has gone wrong or market sentiment has changed, thus generating a crisis. Such crises are challenging in particular for two reasons: the size and speed of a crisis and the confidence issue. A capital account crisis can happen through contagion and affect perfectly sound countries, but it more frequently affects economies with some underlying economic problems. Sound economic policies and an exchange rate close to equilibrium do not serve well as breeding grounds for crises and allow a country hit by contagion to recuperate more swiftly. However, once a crisis strikes, the amount of financing needed to restore credibility is – usually – far in excess of the maximum amount of 300% of a country's quota. This problem has led to the establishment of the SRF and of the option of exceptional access.

A concomitant problem is the need for rapid access to financing. The traditional process for program implementation is frequently considered too slow and cumbersome in situations which call for rapid restoration of market confidence. This, in turn, has led to the notion of "contingent financing" which is, in essence, an assurance by the Fund to provide financing for countries with solid economic policies at exceptional access levels more or less automatically when a capital account crisis strikes.

Of course, that approach generates a number of problems: It reduces conditionality (in fact, a peculiar situation would arise in that for a "nonborrowing program" full conditionality would be applied whereas no conditionality would be necessary for a contingent financing-related case of exceptional access); it provides Fund financing with little to no involvement of the Executive Board; and it undermines access limits. Such resources given to the Fund by donor countries for lending-on might no longer be deemed risk-free and therefore could logically not be fully recorded on the asset side of participating central banks. In addition, the signaling effect of such an insurance-type facility might well be negative, premeditating the very crisis it purports to avoid. This latter argument in fact led to the final demise of the IMF's Contingent Financing Facility for lack of interest. However, the related discussion has shed light on some pertinent facts and areas of possible improvement. It has become obvious that the speed of design and the implementation of programs need to be improved. This can be done by establishing a closer relationship between countries that are possibly confronted with capital account crises and the Fund, by improving administrative processes within the IMF and by concentrating program measures on those areas that are of most immediate effect on the capital account. Publicity and transparency vis-à-vis the financial markets need to be improved in order to turn around sentiment rapidly. The initiative for such efforts should rest with the country concerned, but the Fund should be ready to support them. Finally, the mobilization of exceptionable access financing must be at an acceptable level and not delayed by cumbersome procedures. At the same time, involvement of the Executive Board and strict conditionality must be maintained.

Another issue concerns the fact that regional initiatives have come into existence which provide for an additional level of help before countries turn to the Fund. Examples reach from fairly informal efforts such as the Chiang Mai-Initiative to such full formal integration the European Union and the euro area provide. The challenge for the IMF is how to adjust to these permanent changes, which have a noticeable impact on its own financial structure as members of regional initiatives will presumably turn to their regional partners as a first line of defense in case of crisis. At the same time the coincidence of crises will be reduced with the help of closer regional integration.

It is interesting to note that development aid is not listed among the purposes of the IMF. The reason is straightforward: An organization which depends on a reasonably quick turn-around of its means in order to have funds available for the next crisis cannot afford to have much of its financing more or less permanently sunk into a significant number of long-term problem cases. Nevertheless, IMF members and management have been drawn into granting development aid at an ever increasing pace. This is partly attributable to pressure from the civil society, partly to the desire to look good in the press and partly to competition with the World Bank for the job of an advisor to developing countries. Over time the Fund has established various facilities based on donor country contributions which are used to subsidize lending operations to developing countries (Enhanced Structural Adjustment Facility I, Enhanced Structural Adjustment Facility II, Poverty Reduction and Growth Facility.)[1] These efforts recently culminated in the Multilateral Debt Relief Initiative (MDRI) – an out-right debt forgiveness. Pessimists can be excused for believing that particularly in the latter case, the emphasis lies on debt relief and not on achieving a sustainable external debt position based on sound economic policies guaranteed and fostered by an IMF program based on

[1] *As part of its contribution to an enhanced global poverty-reduction effort, the IMF transformed the Enhanced Structural Adjustment Facility into the Poverty Reduction and Growth Facility in 1999.*

sound conditionality. Debt Sustainability Analyses and other efforts by the IMF and the World Bank to bring about a sustainable debt environment notwithstanding, in some cases the situation will be back to what it was prior to the Multilateral Debt Relief Initiative in a short while. This dilemma is exemplified by the case of Sudan, which takes up nonconcessional debt[2] at a speed far outpacing its debt sustainability level. In other cases (e.g. Ghana), however, the MDRI has been more successful in achieving longer-term sustainability. It is perhaps illuminating that – despite (1) having the IMF's mandate to improve world trade, and (2) the universal acknowledgement that product market liberalization by industrial countries would have a far more positive impact on the developing world than almost any amount of direct aid or debt forgiveness – the Fund has shown little commitment when it comes to convincing the industrial countries to open their markets to third world products. In any case, the IMF should ask itself whether it would not be preferable to concentrate on its core competences and refrain from costly development aid projects in order to earn praise from the press and civil society or to score points at the expense of the World Bank or other development institutions.

4 Technical Assistance

By providing technical assistance (TA) to member countries, the IMF helps countries to build up their human and institutional capacity to design and implement effective macroeconomic and structural policies aimed at putting in place reforms that strengthen their financial sectors and reduce vulnerability to crises (IMF, 2005b). In doing so, the Fund doubtlessly provides a very helpful service. Up to now technical assistance has been provided for free, but in future the IMF could consider charging fees. In order to ensure that countries in need of TA can afford it, the Fund could establish a TA subsidy account and invite donor countries to contribute. The IMF also provides courses at regional centers (such as the Joint Vienna Institute) or in Washington (seat of the IMF Institute) and supports the transfer of know-how and expertise during technical assistance missions to transition economies and developing countries. However, the Fund could give some consideration to streamlining regional institutes as, for instance, maintaining three regional centers for Africa alone may be regarded as excessive.

[2] *Nonconcessional external debt is defined as having a grant element of less than 35 %.*

5 IMF Finances and Budget

Box 2

The Fund's Budget

The IMF's Financial Year lasts from May 1 until April 30.

*Broadly speaking, the **expenditure side** of the Fund's budget consists of administrative expenditures (for staff, buildings, etc.) and the income target, which is used to increase general reserves by 4% p.a. until they have reached a level of SDR 10 billion.*

***Income sources** consist principally of the "margin," i.e. the amount by which the rate of charge[1] is higher than the rate of remuneration[2] (payments for the funding of the Staff Retirement Plan from an earmarked reserve, which is now exhausted, also used to play a major role). The margin is fixed by the Fund for a year in advance. In addition, there is surcharge income: as stated above the Fund may charge surcharges in some cases of access to high-volume lending (i.e. for lending that exceeds 300% of a country's quota); other sources of income are the return on the Fund's Investment Account and the return on the use of its reserves for lending operations.*

[1] *The rate of charge is paid for IMF financing by program countries.*

[2] *The rate of remuneration (since 1988: 100% of the SDR interest rate) is paid by the IMF for financing provided by its (donor) member countries via the financial transaction plan (up to 100% of members' quota).*

The unexpected repayments of some large Fund debtors (such as Argentina and Brazil) resulted in a significant short-fall of expected income for future budgets. As an example, for the 2007 financial year, the IMF's budget ceteris paribus was set at SDR 962 million. Assuming that the margin is not raised, the income shortfall would now amount to SDR 442 million, or almost 50%. For the 2009 financial year, the shortfall was projected to be SDR 500 million, thus indicating that the problem will persist in the medium term.

The margin (see box) is the Fund's main source of income. In principle, the IMF may determine the margin at its own discretion. However, the Fund's nature as a supranational institution of common interest and market conditions restricts its room of maneuver to a certain extent. When Turkey, currently the Fund's largest debtor, received an ad hoc quota increase in September 2006, this move put further strains on the income side. Currently, the margin is 108 basis points. The margin would have to be raised to 360 basis points to make up for the difference between income and expenditures in the Fund's budget. After adding in the effects of the burden-sharing mechanism,[3] the margin will reach 400 basis points. In addition, some countries are subject to a surcharge of 100 to 200 basis points above the rate of charge for some of their lending. Assuming that the SDR rate stays constant at its present level of roughly 3.5%, marginal interest rates for Fund lending for those countries could rise from 8.5% to 9.5% per annum. This clearly indicates that raising the margin to such an extent is not a feasible option as any further repayments would rise proportionately and would thus exacerbate the problem further.

The IMF staff has already reacted to the budgetary problems by implementing several measures, mostly on the income side:

[3] *An upward adjustment to the basic rate of charge and a downward adjustment to the basic rate of remuneration are made to (1) offset losses of income from unpaid charges and (2) to fund certain precautionary balances.*

- establishing an Investment Account: this allows for investing the Fund's general reserves in a portfolio of government securities;
- suspending Reserve Accumulation, which includes using surcharge income (which has hitherto been placed into general reserves) for the Fund's expenses;
- reimbursing Poverty Reduction and Growth Facility (PRGF) administration expenses (in the past the PRGF administration costs were borne by the Fund); and
- finally – and this is the most worrying measure – drawing down reserves.

By implementing this package of measures, the IMF will be able to reduce its annual income shortfall for the coming years to SDR 150 to 250 million. However, the Fund's advice to its member countries in similar circumstances would undoubtedly include expenditure cuts. IMF efforts in this area have been most disappointing: The Managing Director envisages cuts of 1% to 2% over the course of the next three years. This is far too little considering that the Fund's income has been halved. One would have expected that the Fund aimed at significant expenditure savings, instead of taking mainly income-side measures, to recuperate the shortfall. In addition, running down reserves is not an option – neither in the long run as reserves will run out eventually, nor in the short term as their primary purpose is to serve as collateral for donors in case of nonpayment by creditor countries. A significant reduction in reserves would have serious consequences for the Fund's ability to guarantee such financing and for its own financial soundness. It would thus endanger the option of classifying contributions to the Fund as foreign exchange reserves on the balance sheets of participating central banks, or it would at least call for a risk-based reduction of their value.

Expenditure cuts can be envisaged in particular in areas outside the Fund's prime interests and mandate, e.g. the legal systems (Anti-Money Laundering), structural issues or the question of streamlining the cumbersome bureaucratic apparatus.

Last but not least, Staff Papers could profit from more brevity in many cases, which would have the additional positive effect that they could then be placed on the agenda of policymakers without requiring as much screening and content extraction as is the case right now. Such an approach would make the Fund a more relevant source of information for decision-making.

6 Representation and Governance

6.1 Quotas and Voting Shares

Box 3

IMF Quotas

Each member of the IMF is assigned a quota which is expressed in terms of SDRs.
A member's quota has several functions:
(a) A member's quota subscription determines the maximum amount of financial resources the member is obliged to provide to the IMF. 25% of its quota has to be paid in SDRs or in widely accepted currencies (such as the U.S. dollar, the euro, the Japanese yen or the pound sterling); the remainder may be paid in the member's own currency, see also chapter 3.
(b) A member's quota determines the maximum amount of credit that this member may obtain from the IMF. The limit of outstanding credit is 100% of its quota per year, and 300% cumulatively. However, the limit can be higher under exceptional circumstances.
(c) A member's quota largely determines its voting power. Each member has 250 basic votes plus one additional vote for each SDR 100,000 of its quota.
(d) A member's quota determines the relative share of general SDR allocations.

Box 4

Basic Votes

Each IMF member country receives 250 votes (so-called "basic votes") and one extra vote for every SDR 100,000 of its quota. From the outset, "...basic votes were to serve the function of recognizing the doctrine of equality of states…," thereby preventing that "…some members might have quotas too small so that they have virtually no sense of participation…" (Gold, 1972).

Basic votes have not been augmented by the same proportions as quota-based votes, which resulted in an all-time low of the ratio of basic votes to total votes ranging between 2% and 3% of total votes. In 1944, IMF member states agreed on basic votes which happened to amount to 11.3% of total votes; the historic high occurred in 1958 with basic votes at a level of 15.6% of total votes.

The downward trend of basic votes caused the influence of developing countries in IMF decision-making to decline (Rapkin and Strand, 2006).

As box 3 shows, IMF quotas are a major factor in IMF governance. A country's quota is directly linked to its voting power, since the number of votes depends on the size of the quota. However, what counts is not the absolute size of the quota but its relative size. Voting is generally based on weighted majority. Voting weights gain particular relevance since special majorities are frequently needed in the decision-making process. The Articles of Agreement enumerate over 50 categories where special majorities are required. In particular, decisions with a far-reaching impact in terms of policymaking (such as the allocation of SDRs, changes in quotas and the sale of gold) call for majorities of 70% or 85%, whereas "internal" or "administrative" decisions require simple majorities.

A majority of 85%, for instance, is needed in 18 categories, comprising e.g. constitutional revisions and adjustments in quotas (and votes). The U.S.A., the country with the largest quota and a voting share of currently around 17%, and the euro area countries (by joint action) are able to block major decisions. This vetoing power provides the U.S.A. with a particularly strong informal influence – a situation which might prevent countries from bringing forward issues which are likely to be rejected by the U.S.A. (Kelkar et al., 2004). In this context, Leech (2002) argues that this US-dominated setup is an institutional price which prevents the IMF from passing deeper reform initiatives and thus reduces its capacity to act.

General quota reviews are carried out at five-year intervals. The main purposes of quota reviews are to adjust for members' changing positions in the world economy, to handle the entry of new members and to conduct quota adjustments. Note that quota reviews that result in an overall quota increase not only determine the Fund's new overall quota size but also the relative quota size and therefore individual voting power. Currently, the IMF is conducting its 13th quota review, which is scheduled to be finished in spring 2008. In the past, 8 of 13 reviews have resulted in an overall increase in the size of the IMF quota (Truman, 2006a).

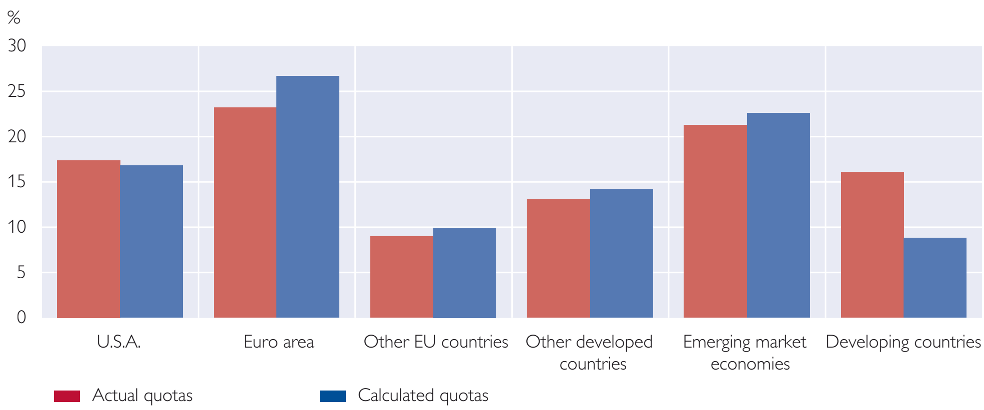
When reviewing IMF quotas, the IMF staff calculates country-specific quotas. Since 1983, when the 8th review was completed, five different formulas have been applied in the quota review. These formulas include the following variables: (1) GDP at current market prices, as an indicator of economic size, (2) reserves, as an indicator of a country's capacity to contribute to the IMF, (3) current payments, as an indicator of openness and a measure for the potential need to borrow from the IMF, (4) current receipts and (5) variability of current receipts, both as additional indicators for the potential need to borrow. For a detailed description and analysis of these five formulas, see IMF (2006c). However, calculated quotas differ significantly from actual quotas, as can be seen from chart 1.

The U.S.A. are slightly, and developing countries considerably, overrepresented in the Fund. Euro area countries, other EU countries, other industrialized countries and emerging market economies are underrepresented as their calculated quota is higher than the actual quota.

The reason why actual and calculated quotas differ is that calculated quota values only serve as a starting

Chart 1

Actual and Calculated IMF Quotas of Selected Country Groupings



Source: ECB, IMF.

point and actual quotas are – because of their direct impact on voting power and financial resources – the outcome of long and complex negotiations.

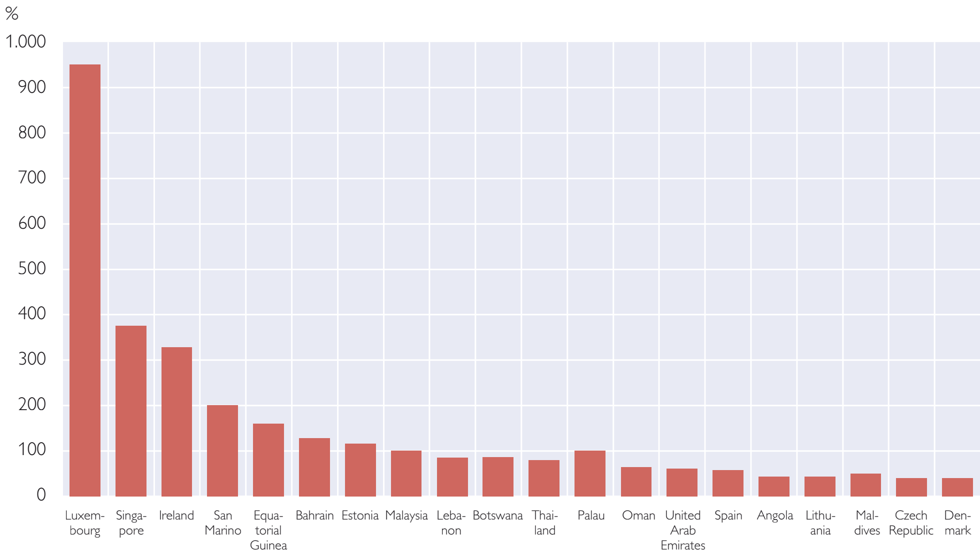
The question whether all 184 IMF member countries are adequately represented at the IMF has recently been a matter of heated debate. It has frequently been argued that the importance of the emerging market economies for the world economy is no longer accurately reflected in their representation in the Fund. This phenomenon has been termed "underrepresentation." At the same time it is argued that the European countries as a whole, for instance, are "overrepresented." As far as quotas are concerned, this argumentation is not borne out by facts: A comparison between (formula-derived) calculated and (negotiated) actual quotas shows that Europe as a whole is not overrepresented and that some European countries are in fact sizeably underrepresented (charts 2 and 3). Of course, representation can also be "measured" by a constituency's number of Executive Directors on the Board, and there the critics might have more of a point (see below).

Chart 2 and 3 show the 20 most under-/overrepresented countries at the IMF. The ratio of under-/overrepresentation is presented as a percentage of the calculated quota.

Truman (2006b) ranks the 60 countries with the highest calculated quotas according to the size of their quota and points out that these 60 countries hold 92% of current actual quotas and 95% of calculated quotas. If current quotas were adjusted according to their calculated values, the 60 countries would gain three percentage points in quota shares from the other 124 member countries. Quota shares of 9 of the 10 top-ranking countries (which – with the exception of China and Singapore – are all industrial countries) would rise from 52% to 59%. The quota of 16 countries in this sample would increase by at least 25% and the quota of 21 countries would fall by at least 25%.

Chart 2

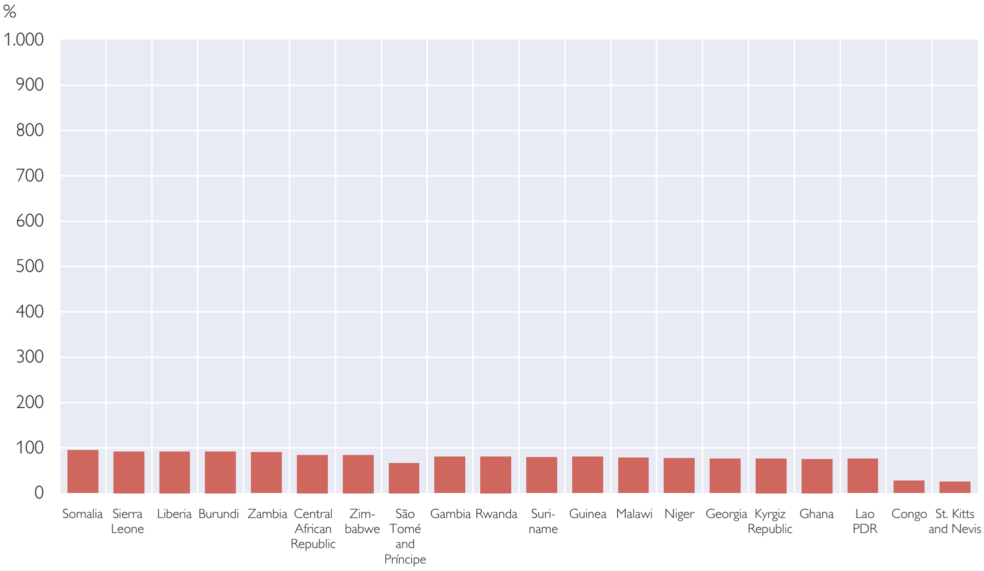
The 20 Most Underrepresented Countries at the IMF



Source: IMF.

Chart 3

The 20 Most Overrepresented Countries at the IMF



Source: IMF.

In another classification, Rapkin and Strand (2006) group IMF member countries according to income levels and add OPEC countries as a separate group (table 1).

The upper middle income countries are the only country group where current and calculated quotas are in line; high-income countries are underrepresented and OPEC, lower middle and low-income countries are overrepresented in terms of their relative economic position in the world economy.

The adequacy of quota formulas is mainly dealt with in the report of the Quota Formula Review Group (QFRG), an external group of technical experts chaired by Richard Cooper in 2000 established by the Interim Committee of the IMF after the completion of the 11th general

Table 1

Selected Economic Indicators, Current and Calculated Quota

Country/group	Population	Trade	GDP based on PPP	GDP	Current quota	Calculated quota
U.S.A.	4.71	16.51	20.33	32.06	17.46	17.80
Japan	2.10	5.88	6.87	13.57	6.30	7.27
Germany	1.36	8.69	4.49	6.02	6.11	7.02
France	0.98	5.21	3.17	4.28	5.05	4.37
United Kingdom	0.98	6.96	3.07	4.68	5.05	5.72
EU (15 countries)	8.37	38.43	20.95	25.52	30.60	34.16
Euro area (12 countries)	7.16	29.11	17.09	19.59	23.65	23.65
High income (12 countries)	15.18	75.53	52.77	78.87	63.45	73.77
OPEC (11 countries)	8.51	3.51	3.66	3.37	9.77	4.69
Upper middle income (31 countries)	4.53	6.54	5.51	4.66	6.24	6.53
Lower middle income (50 countries)	37.49	12.11	22.25	10.49	14.71	12.16
Low income (59 countries)	34.29	2.31	9.06	2.61	6.15	2.89

Source: Rapkin and Strand (2006); population and PPP/GDP: World Bank (2006); trade, GDP, current quotas, calculated quotas: IMF (2006c).

quota review, see Cooper et al. (2000). The mandate was to review the quota formulas, "…*with a view to providing the IMF Executive Board with an independent report on their adequacy…*" The experts group's room for maneuver, however, was rather limited, as it was asked to consider only adjustments that do not necessitate an amendment of the Articles of Agreement.

The main points of the report of the QFRG can be summarized as follows:

Although they emphasized the pivotal role of GDP in measuring a country's ability to contribute to the Fund, the members of the QFRG did not unanimously agree on how GDP should be converted into a common currency. The members of the QFRG discussed various aspects of converting GDP on the basis of market rates versus PPP-based measures, but only a minority of QFRG members favored PPP-based measures. The QFRG also proposed a new, simplified quota formula which contains only two variables: GDP, as a measure for contribution to IMF resources, and the variability of current receipts, as a measure for external vulnerability. Nevertheless, the proposal of the QFRG did not receive much attention neither inside nor outside the IMF (Truman, 2006a, p. 67) and was rejected by the Executive Board (Van Houtven, 2002, p. 8).

As mentioned above, the quota – as a single measure – is intended to serve multiple purposes (box 3). Kelkar et al. (2004) put forward the question whether separate measures for each objective would possibly produce better outcomes than one single parameter. Rapkin and Strand (2006), for instance, suggest linking a country's contribution to IMF financial resources directly to its relative, GDP-based position in the world economy. The scope of access to IMF resources should be determined by balance of payments items, e.g. the reserve position. The individual weight on voting should also be contingent on a country's relative economic weight in the world economy, e.g. its GDP.

For the purpose of taking account of the openness of an economy, the current quota formulas incorporate current payments (imports) and current receipts (exports). When measuring these variables in the euro area, Rapkin and Strand (2006) and Kelkar et al. (2004) argue that trade within a currency union artificially enlarges the openness measure without generating the need for financial support from the IMF as the member states of a currency union would not be subject to a balance of payments crisis. However, Cooper et al. (2000) point out that the Articles of Agreement only provide for IMF membership of sovereign states and not of any other entities. The QFRG also argues that having a common currency does not preclude participating countries from encountering balance of payments difficulties of a type for which the IMF is able to provide help. When discussing this issue, the IMF Executive Board noted that the identification of balance of payments requirements would indeed be more difficult for currency unions than in the case of individual members with their own currencies; the Executive Board pointed out, however, that circumstances could arise in which – based on indicators like exceptional financing and movements in interest rate premiums – such a need could emerge (IMF, 2000). Moreover, the "no bail-out" clause would make financing by the ECB, unavailable for euro area countries.

Other reform proposals to increase the voting share for low-income countries are geared toward raising the number of basic votes. At the Bretton Woods Conference in 1944, each IMF member state was given the same number of basic votes, namely 250 (see box 4). The primary notion of this allocation of basic votes was to acknowledge the sovereign equality of member states. As mentioned above, initially basic votes accounted for 11.26% of total votes. However, as there is no automatism to sustain this ratio – although the introduction of such an automatism is currently the subject of heated discussion – the share of basic votes dropped steadily to finally reach a level of around 2% of total votes. In order to restore the original approach, proposals have been made to increase basis votes in a one-off measure and/or to define a floor of basic votes that would have to be maintained even if regular quota increases are on the agenda. The idea behind these proposals is that the influence of basic votes remains unchanged in particular for developing countries in times when quotas are raised. Critics argue that the selection of an absolute number or ratio of basic votes would be arbitrary and subject to political dispute. Not to forget that a change in the structure of basic votes would call for an amendment of the Articles of Agreement, thereby requiring a majority of 85% of votes.

Overall, there is general agreement among international policymakers that adjustments to quotas are necessary but should be equitable and objective. Under these circumstances, the discussion about, and establishment of, a new quota formula seems to be the only way to square the circle. It is equally clear that in order to achieve its objectives, the new quota formula must show a higher proportion of quota for emerging market economies. Some countries are pushing quite strongly for attributing greater weight to GDP – possibly to the exclusion of any other indicator. It must be said quite clearly that such an approach will not lead to a shift in calculated quotas toward emerging market economies or developing countries. In fact, the contrary is true: Industrialized countries, in particular the U.S.A., would gain prominence in such a scenario. Despite the fact that some industrialized countries might voluntarily reject an increase in their quotas during the next quota review process, it cannot be guaranteed that such forbearance will happen automatically during every future quota increase discussion. Moreover, the criterion of objective and equitable quota allocations would be seriously called into doubt; in fact, it would be irrevocably breached. A better solution would be to include a set of indicators in the quota formula which reduces the calculated quota of industrial countries while increasing it for emerging market economies. An appropriate indicator in this respect might be a country's reserve position. This approach would also serve the useful purpose of increasing the financing available for the most likely type of crisis in the past decade (namely a capital account crisis) – on the assumption that countries most likely to be hit by a capital account crisis would also be those most likely to have taken the precaution of increasing their foreign exchange reserves. There are, however, other specific economic reasons that would contest the inclusion of reserves into the new quota formula. Moreover, it might also be difficult to get political acceptance for this approach. This is doubly doubtful when considering that the European countries have already emphasized the future role of GDP and openness indicators in the new quota formula in their speeches at the 2006 Annual Meeting in Singapore.

6.2 Representation on the Executive Board: Constituencies and Chairs

Decision-making at the IMF is conducted by the Board of Governors, which consists of one representative from each member country (either the Minister of Finance or the Governor of the Central Bank), and the Executive Board, which is the primary decision-making body. In the following, we focus on the Executive Board.

The Executive Board consists of one representative from the five countries with the largest IMF quotas (currently the U.S.A., Japan, Germany, France and the United Kingdom), appointed by the respective country itself, and 19 other members that are elected by constituency groups formed by the remaining countries. These constituency groups comprise both industrialized and developing countries and usually elect their Executive Director on the basis of the highest voting share within their constituency. The position of the individual constituency group is usually formed by intra-group consultations. Western Europe accounts for eight Executive Directors, Asia for five, the Middle East and Latin/South America for three, respectively, North America and Sub-Saharan Africa each account for two Executive Directors, and Russia for one. Recent academic research on how best to reform the IMF centered – inter alia – on questions like: Should the role of the Executive Board be strengthened (e.g. Van Houtven, 2004), should the size of the Board be increased to take account of the rising number of members, or – on the contrary – should the size be lowered or seats be reallocated to render decision-making more effective and to make the whole institution more representative (e.g. Truman, 2006b).

Some proposals aim at reducing the number of Executive Directors from the EU and raise the number of Executive Directors from African countries instead. At present, EU countries directly control 32% of the votes of the Fund. Since non-EU countries are included in EU-constituencies and EU countries are also present in non-majority EU constituencies, EU countries can potentially influence a further 12.5% of the votes. Truman (2006a) therefore concludes that the European Union is overrepresented in the IMF Executive Board. Various suggestions have been made to reshuffle EU countries' IMF membership and create a single chair for the EU and/or the European Central Bank (ECB) (e.g. Leech and Leech, 2005, or Horng, 2005). Truman (2006a) mentions that Europe would then be better able to speak with one voice and could potentially exert more influence. Currently, however, no decisive move in that direction is to be expected from European policymakers. This needs to be stressed in light of the fact that intense debates are going on at many EU/euro area bodies (Ecofin Council, ECB, European Commission) on external representation, in particular on a single euro area chair at the IMF. A thorough analysis of a possible single European representation at the IMF is clearly beyond the scope of this paper. However, in a nutshell, it is obvious that the Euro area's "political" weight in the Fund is presently far below that of its combined actual quotas. This imbalance is attributable to the lack of effective, continual cooperation despite – or possibly because of – a plethora of coordinating bodies (EURIMF[4] in Washington, EFC[5], SCIMF[6], IRC[7], the IRC Expert Group, ECB and European Commission). A few intermittent bright spots do not change the mostly gloomy picture – a fact that is partly due to lack of enthusiasm for euro area coordination by those euro area countries which are also members of one of the Gs (G-7, G-8, G-20). Mostly, it is attributable to parochial interests which can abound since there is no absolute need to speak with one voice on the Executive Board and at the meetings of the informal bodies listed above. All of the above means that a fundamental change can be expected only when a common euro area chair is established at the Executive Board, enforcing closer cooperation due to the necessity of expressing one – coordinated – opinion at the Board and elsewhere. Smaller euro area countries with a good representation at the Board (such as Austria) are pressing for the early establishment of a single chair but have been vehemently against interim solutions (such as establishing fewer euro area constituencies) which would in all likelihood be at their cost. The problem with a single chair is that IMF membership is confined to sovereign countries and the euro area does not have the legal status of a country. Also, the combined euro area quota would be nearly twice as high as the U.S. quota and would thus require that the Fund's seat be transferred to Europe (the Articles of Agreement specify that the IMF seat is in the member country with the largest quota). Since both facts are equally unpalatable and unacceptable for the U.S.A., a single euro area chair can only be deemed a long-term project. In principle, it could also be the U.S.A. which takes the lead in changing the structure of the Executive Board. The current number of 24 seats on the Executive Board ultimately depends on the U.S. stance, since every two years the extension from 20 (as originally foreseen in the Articles of Agreement) to 24 seats hinges on a special majority of 85% which could be blocked by the U.S.A.'s 17% voting share. A reduction to 20 seats could possibly improve the efficiency of certain procedures at the Executive Board, e.g. by shortening the reaction time between the eruption of a crisis and the implementation of measures to resolve it (in particular the establishment of a program and the provision of financing). Moreover, internal reforms, concerning for instance frictions between departments with similar portfolios or the specification of internal competences, could possibly be accomplished in a more efficient way. Competition between the Fund and other international institutions (in particular the World Bank) also needs

[4] *Informal Group of IMF Executive Board Eurogroup Representatives.*

[5] *Economic and Financial Committee.*

[6] *EFC Sub-Committee on IMF and Related Issues.*

[7] *International Relations Committee.*

to be reduced and ideally abolished. Such a move does not exclude close cooperation in areas where the work of two institutions unavoidably overlaps. All these issues could possibly be handled more easily by a leaner Executive Board. Nevertheless, a reduction to 20 seats would lead to the liquidation of the four constituencies with the smallest voting power, currently comprising 43 members who would have to join other constituencies. Moreover, the four smallest constituencies are not European constituencies. A resizing of the Executive Board to 20 would in fact increase European representation at the Fund in the first instance, although as a consequence political pressure might rapidly increase on Europe to reduce its voice and representation at the Fund.

Earlier, we argued that constituencies, which consist of a combination of industrialized and developing countries, form their opinion by intra-group consultations. Together with the weighted voting in the Executive Board, a system of consensus formation has evolved in which major decisions tend to be taken during informal negotiations rather than on the basis of formal rules. One the one hand, this consensual decision-making process might favor the participation level of developing countries (e.g. Van Houtven, 2002), but on the other hand it reduces the transparency and accountability of the IMF. Informal negotiations might tend to be for the benefit of those countries that are able to buttress their initiatives or policy preferences with greater voting power (Woods, 1999). Therefore, it is often argued that it is the Executive Directors from the G-7 who retain the real power within the decision-making process.

A related issue that is often raised in the literature is the appearance of special majorities in the decision-making process, which would discriminate against developing countries. In the past, as a consequence of political tradeoffs, the Articles of Agreement have been amended on several occasions to increase the number of decisions requiring special majorities; a strict coherent and logical framework for special majorities is lacking, however. Therefore, Rapkin and Strand (2006) propose to rationalize the current special majority provisions. They also raise the issue of U.S. dominance, arguing that the U.S.A. exert a disproportionately strong influence on the IMF not only through its large voting share, its seat in the Executive Board, the large proportion in the IMF staff of U.S. citizens and/or staff members trained at U.S. universities, but also through the direct transmission of U.S. concerns to the IMF management/staff and to individual members. This phenomenon is called the "Treasury effect" (see also Evans and Finnemore, 2001). A possible solution to avoid the dominance of one country would be to set the special majorities just beyond a country's total vote or to wait – in the case of the U.S.A. – until the voting share falls below 15%, and to refuse to raise the threshold for special majority voting to above 85%. Nevertheless, the obvious dominance – in terms of quotas and voting shares – of industrialized countries in the Executive Board does not imply that developing countries have been manipulated or treated in an unfair way. Rapkin and Strand (2006) argue that the wedge between the actual and the calculated quotas can largely be attributed to repeated attempts to provide higher quotas and more voting rights to smaller and poorer members.

It is clear that reform proposals that aim at a formal amendment of the Articles of Agreement might face political opposition in the beginning. Note that in the past developing countries have taken recourse to IMF resources to a larger extent than industrialized countries. No industrialized country has asked the IMF for financial resources since 1978. Industrial countries, which contribute more to IMF resources and dominate rule-making, act as creditors, while less developed countries, which contribute less to IMF resources, primarily act as debtors. Therefore, industrialized countries could hesitate to pave the way toward increasing the influence of developing countries on IMF operations, maintaining that giving more control over the institution to the borrowers could undermine the global financial system's confidence in the IMF.

7 Conclusions

At its Annual Meeting in Singapore in September 2006 (IMF, 2006d), the IMF recognized that the quota of four countries – China, Korea, Mexico and Turkey – had to be raised on an ad-hoc basis. The quotas of these four countries were raised by 1.8% of total current quotas. China, Korea, Mexico and Turkey were the only countries that were underrepresented both on the basis of the five existing quota formulas and on the basis of all four variables that are currently used in these formulas. Moreover, the Executive Board will work on a new quota formula which should be completed no later than by the spring 2008 meeting of the International Monetary and Financial Committee (IMFC). The new quota formula should give significantly higher weight to GDP while ensuring that the other variables, in particular the openness of members' economies, will also play an important role. On the basis of the new formula, the Board of Governors will decide on further quota increases no later than by the 2008 Annual Meeting for those countries that have requested that their quotas be increased with a view to achieving a further alignment that takes the individual countries' relative positions in the world economy into account. Furthermore, the Executive Board has been requested to make a proposal for a doubling – at least – of basic votes for each member and to ensure that the ratio of the sum of basic votes to the overall sum of votes will remain constant in the event of any further changes in members' total voting power.

In addition, the IMFC agreed on an increase in staff resources for those constituencies that have to deal with a heavy workload. Furthermore, the two African Executive Directors, who represent 43 countries, may also appoint a second Alternate Executive Director.

Considering this resolution and further reports by the Managing Director, a reform of the IMF is well under way. The IMF recognized that IMF surveillance should put greater weight on analyzing and discussing global economic issues. By taking account of international spillovers, surveillance should in future be multilateral rather than purely country-specific. Exchange rates and policies should also be the focus of renewed interest. Whether the IMF will have the actual power and ability to effectively cope with this expanded role remains to be seen.

There is no doubt that IMF quotas will have to be adjusted to take account of the changing economic weight of many member countries in the world economy. As mentioned above, negotiations on a new quota formula started after the 2006 Annual Meeting in Singapore. Low income countries should be given more basic votes in order to prevent the IMF from loosing legitimacy. However, with the IMF's intention to put greater weight on GDP in the new quota formula the stage is set for complex, difficult and time-consuming negotiations.

The IMF should furthermore streamline existing procedures for providing assistance to emerging market economies by increasing existing credit-lines. Currently these procedures are still prone to internal and external vulnerabilities. Instead of introducing new facilities, the easiest option would be to increase their quotas.

As far as Europe is concerned, and in light of the fact that it is unlikely that a single euro area chair on the IMF's Executive Board will be established any time soon, closer coordination and a better focus on the issues on the Executive Board's agenda by all the various groups and forums tasked to follow IMF issues will be essential.

Finally, the IMF will need to reform its financing system and budgeting procedures to ensure that expenditures will be adequately curtailed to enable the Fund to work efficiently despite income shortfalls, which might well be not transitory but of a permanent nature.

The fact that for sixty years the IMF has been able to change with the times and the sometimes violent shift of the international monetary and financial system all the while coping with new tasks while keeping its core functions intact and relevant allows considerable scope for optimism that it will continue to weather present and future crises – both institutionally, for its own sake, and externally, for the benefit of the international financial and monetary system.

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