

“Staff Commentary on the External Review of the Quota Formulas” prepared by the Treasurer’s Dept. in consultation with Legal, Policy Development and Review, Research and Statistics Departments-IMF, June 6,2000 Washington, D.C.

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Endnotes:

1/- See "Review of the Fund's Experience in Governance Issues", SM/01/30 March 29, 2001 IMF Washington D.C.

2/- See "The Governance of the IMF" Department of Economics Discussion Paper No. 73, July 2001, Oxford University).

3/- Under the Bank's current practice, the capital subscription of a new member consists of two components. The first is an obligatory subscription which the new member must make at the time it joins the Bank. This obligatory subscription has two parts. The first is derived from the member's quota in the Fund and is currently equal to 88.29% of the member's Fund quota. The second part is based on a fixed number of 195 shares, which represent the portion of the membership shares corresponding to the increase in the subscriptions of members authorized in conjunction with the Bank's 1988 general capital increase. The second component, subscription of which is optional, consists of 250 shares with respect to which no payment is due at the time of subscription. All shares of the Bank's capital are valued at US\$120,635 per share.

4/-The Quota Formula Review Group (QFRG) was formed by eight experts, consisting of Richard Cooper (Professor at Harvard University) as chairman; Joseph Abbey (Executive Director, Center for Economic Analysis, Accra, Ghana) Montek Ahluwalia (Member, Planning Commission, New Delhi, India); Muhammad Al-Jasser (Vice-Governor, Saudi Arabian Monetary Agency); Horst Siebert (President, Kiel Institute of World Economics, Germany); Gyorgy Suranyi (President, National Bank of Hungary); Makoto Utsumi (Professor, Keio University, Japan); and Roberto Zahler (former President of the Central Bank of Chile).

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largely debtor developing countries with a minority vote and limited influence on policies. Consequently, decisions on major Fund support programs are often taken outside the Fund, on a discretionary basis, without rules. This power distribution raises questions on the legitimacy, transparency and accountability of Fund governance.

The good functioning of the Fund requires a better balance between the different interest groups. Therefore, a point of departure for the necessary negotiation leading to the re-apportionment of quotas and revision of basic votes could be an agreement that the groupings of industrial and developing countries, or of potential debtor and creditor countries, each have about half of the total vote at the Board. A further stage could be the revision of quota formulas, particularly the weight to be given to GNP (measured by PPP) and other variables. But since it would be difficult to come to an agreement on quota formulas without reference to what would happen to determination of the share of basic votes in the total, this would have to be a simultaneous exercise.

In the face of the major changes that have taken place in the economic and political panorama of the world, a more representative and transparent decision-making process is required to enhance the democratic legitimacy of an institution so involved in the economic governance of its members.

The concentration of power in the hands of a few countries also impairs the adjustment process between deficit and surplus countries. Although the IMF can bring considerable pressure to bear on the economic policies of the developing countries seeking financial assistance, it cannot induce the largest deficit country to correct its imbalances - does it make sense for the richest country in the world to be the biggest debtor?- nor surplus countries to reduce their external imbalances.

Short-term self-interest and expediency appear to have blurred the Bretton Woods vision of international cooperation as a means to improve the workings of the world economy. The notion that national goals are often best attained through international cooperation tends to be forgotten. This situation is unsatisfactory. To improve the governance of the Fund in terms of participation, transparency and accountability, and to enable it meet the new challenges of the world economy will require a major reform of the quota and decision-making structures.

If globalization is to work for all countries, the success of the Fund as a multilateral institution is crucial. Democratic legitimacy and participation are not contrary to the strict application of sound policies and clear principles in the exercise of the Fund's competences.

Consequently, one could suggest that a realistic approach to the problem of the distribution of power might start from an finding an acceptable overall outcome, one that is acceptable to both developed and developing countries and then work backwards to define the precise manner in which this may be reached, i.e. the weight to be given the components of voting power (i.e. basic vote and quotas), that would produce the desired result. While this procedure may seem somewhat lacking in objectivity, it is probably the only realistic approach to this matter, and would be far from unprecedented

Will the G-7 and other industrial countries which hold a privileged position be prepared to yield part of their power to the broader membership of the Bank and the Fund? There are sound political and economic reasons for their doing so. Much has changed in the political map of the world since 1945. As a number of former colonies became sovereign countries, and the Soviet Union gave way to a number of independent economies in transition, the membership of the Bank and the Fund expanded from 45 to 184 countries.

The structure of the world economy has also changed considerably since the Bretton Woods Conference of 1944: the developing countries now account for a growing share of the world's output and trade, with China, India, Brazil and Mexico among the world's ten largest economies measured in real terms while other newly industrializing countries overtake others as major economic players, without attaining adequate representation in the Bank and Fund.

Trade has grown beyond expectations and as official flows declined, the growth of private international financial markets made possible by information technology has been explosive, and vastly expanded international capital markets have taken a major unforeseen role, giving rise to new opportunities and to difficult challenges.

Because these political and economic changes have not been appropriately reflected in the decision-making structure of the Fund, the governance of the Fund and the legitimacy of Fund decisions have become increasingly questioned. Too often the design of programs is seen by member countries more as inevitable impositions, than as the result of an exercise in monetary cooperation, in which their full participation gives them a sense of ownership.

It is hardly coincidental that while the need for support of a significant group of developing countries has risen the size of the Bank and IMF have shrunk dramatically relative to world trade, and even more in relation to international capital movements. Over the past more than twenty years, the Fund's operations have been conducted exclusively with the developing countries and, more recently, also with countries in transition. Moreover, in recent years, the Fund has extended its conditionality to issues of governance. This situation has widened the divide among IMF members. On the one hand is a small group of creditor industrial countries with a majority vote; on the other is the large number of

to members, making the institution far more relevant to their problems. Total quotas could be adjusted more or less automatically at three yearly intervals to keep them from lagging significantly behind the expansion of the international economy. Additionally, total capital flows to prospective borrowing countries, could also be considered in determining countries potential need for Fund support. (This would not preclude any industrial country from turning to the Fund for support.)

b) Restore the role of basic votes to their original function. This should lead to increasing them to an agreed proportion of total voting rights, and provide that in future, basic votes will increase in the same proportion as total quotas. The increase in the share of basic votes, since it favours smaller members and reduces the relative position of the larger economies is a potentially divisive issue for the developing countries themselves. To be acceptable to the developing countries as a whole it would have to be part of a package by which it is accompanied by a significant increase in the quotas of the larger developing economies, through the revision of quota formulas to include PPP based GNP estimates.

iv) Use PPP based GDP estimates in the quota formulas in order to avoid the current underestimation of the economic size of developing countries and emerging market economies. This should help correct their under representation at the Board. Increasing the stake of developing countries in the Fund should also increase their contributions, consistent with their ability to contribute and lessen the concern of current creditor countries over the risk of Fund credits.

## **V. Final Considerations**

A politically neutral or “objective” approach to the distribution of voting power could be attempted, starting from the assignment of a given proportion of the total vote to basic votes, taking into account that the original 44 members held 11.3% of the vote and that the current membership is 184 countries. But, of course, this is a political decision since there are no objective criteria for the determination of the number of basic votes to be assigned to each member.

The quota formulas, on the other hand, should reflect the size of the economies of members, in particular their GDP, their exposure to trade and capital movements as well as their ability to contribute to the Fund. However, all participants in the discussion are likely to look at what the effect of any proposal on their relative position in the distribution of power before expressing a view on the matter.

i) Restructure the Executive Board

The representation at the Board could be regulated in a way that an increase in the number of Directors representing developing countries be matched by an equal reduction the number of Directors from industrial countries. The region with greatest number of representatives at the Board is Europe, which currently holds 7/8 chairs, and some 70 per cent greater vote than the US, (while the GNP of the Euroland is similar to that of the US). Thus Europe is the obvious candidate for a reduction in the number of votes and chairs it holds.

An additional reason for suggesting a reduction in the number of European Directors is the process of monetary unification that has resulted in a monetary union among twelve countries, that now have a common interest rate and exchange rate policy vis a vis the rest of the world. While one might think of all members of the European Monetary Union being represented by one Director, it would suffice to reduce the number of European Union Directors to less than half of the current number i.e. Couldn't Belgium, Luxembourg, the Netherlands and the Scandinavian countries be represented by one Director instead of three? Could France and Germany share a Director? Of course, this would require a reshuffling of existing constituencies.

In order to be able to give adequate attention to the needs of the countries it represents, no Executive Director should represent more than say, ten countries. In addition, the staff in the offices of Executive Directors that represent more than one country should be strengthened significantly, in proportion to the number of countries represented. These measures should permit Directors representing large constituencies to play a more active and effective role in policy discussions.

While important, increased voice at the Board for developing countries is not by itself sufficient; to be effective greater voice must be accompanied by increased votes. This writer recalls occasions when a major industrial country would not be prepared to engage in the discussion they could lose on logical grounds After listening to the arguments, the Director would simply state they had not changed their position on the issue.

ii) Revise Quota Formulas

Some suggestions for improving the proposed formula, that address its main shortcomings are presented below:

a) Relate overall quotas to world trade and capital movements or to world GDP. A first approach would be to ensure that the size of the Fund should not fall below an agreed proportion of world trade or of world GDP. Note that simply establishing a ratio of say 15 percent of imports would more than double Fund resources, enabling it to reduce the costs of adjustment

attained as long as decisions are taken by a very small group of industrial countries, the G-7, meeting outside the IMF. Furthermore, the current power structure, which places a single country in a dominant position, impairs the accountability of the Fund for its decisions and recommendations.

Is the reform of the governance of the Fund possible? Or rather, to what extent will the Fund be reformed? In recent years, criticisms of the Fund's handling of the Asian crisis mounted, and more recently, its handling of Argentina and reform proposals gained ascendancy.

For many observers in developing countries, the Fund has been seen as increasingly unrepresentative, imposing austerity on developing countries to protect the interests of western creditors. On the conservative side, the Meltzer Report castigated the Fund for fostering moral hazard by bailing out private investors in emerging markets with large injections of money, thereby absorbing the losses arising from bad investment decisions.

While these criticisms have created a climate of opinion that favors reform, the political difficulties that have prevented reform in the past remain. They involve overcoming the vested interests and resistance of major industrial countries to give up control, and of some others to give up certain "acquired rights", particularly in regards to voting power and representation in the Executive Board. Nevertheless, there is a clear perception among senior officials, both in developing and in industrial countries, that some measure of reform is necessary, indeed indispensable, to secure the legitimacy of Fund decisions and the countries' ownership of programs. The recent Development Cttee. Communique refers explicitly to "the need to broaden and strengthen the current participation of developing countries and countries with economies in transition in international decision-making and norm setting".

Reform is also required *inter alia* in order to increase transparency of decision-making and in the appointments to senior positions, as well as to give a voice in policy discussions to certain groups of virtually disenfranchised countries, particularly African and other low income countries.

The increased participation of borrowers in decision-making is increasingly perceived as essential for the ownership of Fund programs required for their success. Current discussions on the reform of conditionality and the recent creation of an Office of Independent Evaluation in the Fund may be seen as a recognition of this need.

What elements should a reform of the governance of the Fund include?

While the reform of the Fund is a highly political subject, experience suggests that for it to be successful certain objective elements should be kept in mind. The following suggestions are put forward to contribute to the discussion of the subject:

- 2- the issue of the distribution of voting power and appropriate participation in decision-making
- 3- the consideration of short-term capital movements in the measurement of vulnerability.
- 4-Their arguments for the exclusion of the consideration of PPP based GDP from the ability to contribute to the resources of the Fund seem irrelevant.

What have they produced?

Through the choice of variables, the group has proposed a formula that would lead to a further concentration of power in the hands of industrial countries. Since this does not reflect the changes that have taken place in the world economy, in particular the growth of the developing countries as a group, nor the rapid growth of some of the larger economies among them, it is not difficult to predict that their recommendation will be rejected by the developing countries as a whole.

Moreover, the report fails to provide for the solution of the problems posed by the the extraordinary expansion of financial markets, in particular, the volatility of short term capital movements.

Seen together, their judgements appear to reveal a bias in favour of the preservation of the status quo, by which a small group of industrial countries holds the majority of the voting rights limits the growth of the Fund and excludes the majority of Fund members from having appropriate participation in decision-making.

How to explain these shortcomings? It is difficult to believe that the members of the QFRG were not aware of where the national interest of their countries lay.

#### **IV. On Reforming the Governance of the Fund**

As has become clear, the governance of the Fund falls short of its own standards and recommendations in terms of transparency and accountability. Transparency requires that decisions be the result of an open discussion with broad participation. Accountability requires that those taking decisions face up to their consequences. Legitimacy requires that the views and interests of all IMF members, which are mostly developing countries and economies in transition, be given appropriate consideration.

International institutions must reconcile countries' own political objectives with the wider interests of the international community. These objectives will not be

(ii) The Variability of Receipts - *The variability of international receipts is proposed as the demand side variable and is measured as the standard deviation from trend of current account receipts over a 13 year period, with the trend measured by the centered five year moving average. In countries with a large in bond industry, one may consider whether the revenues of exports from in-bond industries or “maquiladoras” should be included as a whole or only their net exports considered. However, if the second were the preferred solution, in some sense it would not take into account the countries external vulnerability as it would not take into account the variations in employment produced by the economic cycle; and given the high correlation with the level of economic activity, it would be duplicating the measurement of GDP.*

The Report admits the possibility of refining this variable “by adding to receipts some measure of autonomous net inflows of capital, e.g. net long-term borrowing plus foreign direct investment, assuming that reasonably accurate information was available on a timely basis.” While these are undoubtedly relevant variables, and this is the traditional way of looking at balance of payments vulnerability, they are not the whole story. These variables can not open the way to the consideration of the major financial crises that have dominated Fund financial operations in recent years. Excluded from consideration is the volatility of short-term capital flows, which as is widely recognized, has been the determining factor in the financial crises suffered by emerging market economies over the last few years.

Moreover, recall that the terms of reference explicitly refer to “changes in functioning of the world economy and the international financial system and in the light of the increasing globalization of markets”. The increased role of financial markets and their increasing globalization are probably the most important changes that have taken place in the international economy, so it is surprising that although they are explicitly referred to in the mandate to the group, the variables proposed refer to current account receipts and consider the possibility of including long term capital flows, but exclude short-term capital movements, the variable whose reversal has played a major role in balance of payments difficulties of emerging markets.

### C. The Results of the QFRG Proposal for Quotas

The proposal of the Cooper Report for the revision of quotas are disappointing. The QFRG do not appear to address several of the issues that require consideration, given their broad terms of reference:

1- the issue of the overall adequacy of Fund quotas

PPP-based GDP) to avoid the introduction of errors in estimation, is not a valid one.

The issue seems to be a political one. The GDP of the industrial countries is substantially larger when converted to a common currency in terms of market exchange rates than when it is based on PPP. The opposite is true for the GDP of developing countries. Consider the following table:

Comparison of PPP-based GDP and Exchange Rate-based GDP of Selected Countries in 1994

<u>Country</u>	<u>Share in World Total</u>		<u>Rank</u>	
	PPP	ER	PPP	ER
US	21.5	26.7	1	1
China	8.8	2.1	2	9
Japan	8.5	17.8	3	2
Germany	5.2	7.9	4	3
India	3.9	1.2	5	15
Russia	3.1	1.0	9	16
Brazil	3.1	2.9	10	7
Mexico	2.0	1.6	12	11
Netherlands	0.9	1.3	22	13
Indonesia	1.7	0.7	14	23

Source: Annex 5 to "External Review of Quota Formulas"  
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The main reason for this difference is that the use of market exchange rates substantially underestimates the GDPs of developing countries. This is because in developing countries the prices and wages prevailing in the tradable goods sector are higher than those prevailing in the non-tradeable goods sector, a phenomenon that is not found in developed countries. As long as the non tradeable sector represents a substantial part of the economy, the valuation of this sector at market exchange rates pulls down the valuation of this sector below its valuation at PPP based rates. Therefore, to a large extent, when the method of GDP conversion is chosen, the distribution of quotas is substantially determined.

Since the weakness of the available PPP-based GDP data in some countries is no worse than that of some of other data used in the calculations, the decision should be to work toward its improvement instead of the abandonment of the concept. There are very large discrepancies between GDP estimates based on market exchange rates and those PPP-based estimates; but if all estimates have statistical problems and one measure favors one group while another measure favors a different one, as a minimum, would it not be reasonable to consider using both, perhaps to average them?

two borrowing arrangements, the GAB and the NAB, with a number of countries in a strong international reserve position that enables them to provide additional financing for Fund operations when required. These borrowing operations were not envisaged in the Articles of Agreement, and appear to be a way to increase Fund liquidity without giving a corresponding increase in participation in decision-making to contributors.

Another argument against PPP based GDP is the “lack of data”. At present, PPP calculations are available for only 117 countries representing 95 percent of world GDP. Of course, with additional work data deficiencies can be eliminated over time. (Cooper report, page 58). You might consider that the availability of data for countries accounting for some 95 percent of the total world GDP is not a bad starting point if you can work to extend the coverage to other countries, particularly if you have several years in which to prepare the appropriate estimates. Note that the Bank and Fund already publish figures on GDP measured on a PPP basis for the vast majority of their membership.

Recall the situation as regards balance of payments data prevalent at the time of the Eleventh Review of Quotas,” data for current receipts and payments through 1994 were used in the quota formulas. Balance of Payments data supplied for publication in the IMF’s Balance of Payments Yearbook were not available for 53 countries (out of the 183 that participated in the quota review). These gaps were filled by information provided by area department desk economists, based on official information, and by staff estimates” (External Review of the Quota Formulas -Annex 7, Balance of Payments Data used in the Quota Formulas, page 77) Could not the same be done for PPP-based GDP estimates?

Consider on the other hand, the range of the exchange rate fluctuations and misalignments among major currencies. Simply recall that the exchange rate between the dollar and the Euro has fluctuated between 1.18 US dollars per Euro to 0.82 US dollars per Euro, a variation of 37 percent in a lapse of some two years. This factor alone would introduce substantial distortions in market exchange rate conversions of GDPs measured in these currencies and in others linked to these currencies. Moreover, market exchange rates-based conversions have well known shortcomings that are magnified in the case of developing countries, where large depreciations are not the exception. In recent years these included inter alia devaluations in Mexico, by 115 per cent; in Indonesia, by 228 percent; in Korea, 96 percent; Thailand 87 percent; Russia, 135 percent; etc. Since large depreciations introduce major distortions in GDP converted at market rates which are only partially-and unevenly- corrected by three year averages, it seems that the argument of the majority, that prefers the use of exchange rate for conversions (rather than the use of

*“The majority view argued that while PPP based conversion rates were appropriate for measuring relative per capita income for comparing economic well being across countries, they were not appropriate for indicating a country’s ability to contribute to international endeavours. Second, market prices properly reflect the costs of moving goods from one place to another, and equating prices of equivalent goods regardless of location, as is done in PPP calculations, gives a seriously misleading indicator of the ability to contribute to international undertakings... The IMF is a monetary institution, requiring financial resources for use when members are in financial difficulties in their relations with the rest of the world. A country’s ability to contribute is therefore determined by its capacity to provide funds at market exchange rates,” (Cooper Report page 58)*

In view of the majority, PPP based GDP, as a measure of a country’s ability to contribute would produce serious anomalies, suggesting for example that China’s could contribute one third more than Japan, or that India could contribute more than France. Are these criticisms valid?

While it may be the case that in some unspecified sense the ability of Japan to contribute is greater than that of China and that the ability of France to contribute is greater than that of India, note that this is not related to the level of international reserves, since this variable is excluded “since they may fluctuate from year to year and may reflect international short term borrowing.”

In any event, and contrary to what is suggested, the relationship between actual contributions as determined by quotas and the ability to contribute as a proportion of GDP is very far from a being a binding restriction. Consider firstly that quotas are a very small proportion of GDP, only 1 per cent at the time of the Eleventh Quota Review in 1998 measured in market exchange rates and an even smaller proportion today. Secondly, note that since conversions of GDP at market rates produce significantly smaller GDP’s than PPP based conversions; the potential contributions by developing countries are such a small proportion of their GDP that the argument loses significance. Thirdly, since only 25 per cent of the contributions or quotas is paid in convertible currencies, a fact that further weakens the ability to contribute argument, the main argument against the use of PPP-based GDP, to the point where it becomes irrelevant. In any case, countries are free to accept or reject quotas proposed and any country that did not feel able or did not wish to accept an increase in its contribution could decline any proposed increase in its quota.

Moreover, recall that the desire to limit quota increases and to adjust quota shares to changed conditions in the international economy has led the Fund to seek to supplement its available resources by entering into

exceptional support was required to prevent the crisis and the ensuing recession. Consequently, the resources and access rules of the Fund are not adequate to enable it to provide sufficient and timely financing to its member countries suffering from trade imbalances or from the volatility capital movements and to allow them to adjust without resorting to a sharp reduction in aggregate demand leading to a downturn in economic activity and to avoid the adoption of *measures destructive of national and international prosperity*.

As we have seen in the cases of the Mexican, Korean and other crises, Fund resources have proven inadequate to provide the support required by countries that come under a speculative attack, and to allow them to *avoid measures destructive of national and international prosperity*. Fund resources have had to be supplemented from other sources, with the resulting increase in complexity, delays and at times, unwarranted conditionality demanded by certain creditor countries for participating in the financial rescue. (See M. Feldstein). In most cases, the countries affected have suffered a massive currency depreciation, followed by a deep recession associated with income losses equivalent to several percentage points of GDP, a sharp rise in unemployment, and often a banking crises as a result of a wave of bankruptcies, while their trading partners faced substantial losses in exports to them.

#### B. The Variables Included in the Proposed Formula

(i) GDP - The work of the QFRG led them to review the variables included in the formulas and to suggest a welcome simplification of said formulas. The QFRG agreed unanimously that the most relevant variable for measuring a country's ability to contribute to the Fund is the country's GDP. However, the group differed as to how GDP measured in domestic currency was to be converted into a common currency to determine the size of the economy and the relative ability of the country to contribute. The majority favoured conversion at market exchange rates, averaged over several years, but a minority preferred to measure GDP for purposes of the quota calculations using PPP-based exchange rates. They considered that market exchange rates do not necessarily equalize prices of tradeable goods across countries, even after taking into account transport costs and quality differences and that this creates an index number problem in which the GDP in developing countries is understated in relation to developed countries if market exchange rates are used.

They noted that while real growth rates in these countries have been significantly higher than in industrialized countries, the expected increase in relative size of GDP of developing countries is eroded by exchange rate depreciations when converted at market exchange rates. (Cooper Report, pages 57-58).

- “To propose, as appropriate, changes in the variables and their specification to be used in the formulas.”
- “To *examine other issues directly related to the quota formulas.*”(my italics).

The Report was submitted to the Managing Director and to the Executive Board of the Fund on the 28 of April 2000. Because of its importance and since it will be considered by the Board in its next quota review, which should be completed by early 2003, it seems necessary to offer some comments on its scope, methodology and recommendations.

#### A. The Size of the Fund

Note that the work of the QFRG is necessarily developed in the framework of the Articles of Agreement, which set out the purposes of the Fund. The first question to address would be the adequacy of Fund resources in relation to the tasks it has been assigned, i.e. Is the size of the Fund , the sum total of quotas adequate to enable it to fulfill its mission? Is it consistent with its purposes?

Recall that these include: “To give confidence to members by making the general resources of the Fund temporarily available to them... *providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.*” (Article I, section V of the Articles of Agreement) (My italics).

In this regard, the first thing to note is the sharp decline in the size of the Fund in relation to world trade that took place over the last half century.(See Table below)

#### **TOTAL IMF QUOTAS AS A PERCENTAGE OF TOTAL IMPORTS**

Year	1944	1950	1965	1970	1978	1990	1998
Percent	58	17	15	14	9	6	6

Source: IMF Report to the Executive Board of the Quota Formula Review Group

It would seem that countries with the largest quotas, the creditor countries, have opted to reduce their relative contributions to the Fund. And, since the severity of the adjustment required tends to be a function of the amount of financing available, as the availability of financial support declined, the adjustment process became more severe and the rate of compliance with Fund programs declined. (See Buira 2002).

Moreover, this decline took place at a time when the importance of capital market flows to emerging market economies rose sharply and their volatility made recipient countries increasingly vulnerable to crises of confidence, giving rise to reverse flows, frequently leading to the emergence of financial crises, where

quotas:determination of voting power, determination of contributions to the Fund and access to Fund resources.

However, since at Bretton Woods the membership felt there was merit in having contributions and access to resources based on the same formula, such a far-reaching departure from the traditional role of quotas might make an agreement considerably more difficult to reach.

The formula developed by R. Mikesell in 1943 had the political objective of attaining the relative quota shares that the US President and Secretary of State had agreed to give the “big four” wartime allies, with a ranking which they had decided: Thus, the US was to have the largest quota, approximately \$2.9 billion, the UK including colonies an amount about half the US quota, the Soviet Union a quota just under that of the UK; and China somewhat less.

To achieve this purpose, the formula produced by Mikesell, after many iterations, was based on: 2% of National Income, 5% of gold and dollar holdings, 10% of average imports, 10% of maximum variation in exports, and these last three percentages to be increased by the ratio of average exports/National Income! It is worth noting that with variations in the weight given to these variables and some changes in the definition (i.e. GDP for N.I.) of the main variables, the IMF continues to use the original formula, which is combined with four others which give different weights to the same variables, plus an element of discretion is used in selecting the formulas to be applied in each case, for determining members quotas. Consequently, the determination of quotas lacks transparency.

Not surprisingly, as we shall see below, current quotas are far from representative of the actual sizes of economies, of their ability to contribute resources to the Fund or of their importance in world trade and financial markets. Moreover, as quota increases over the years have been predominantly (70%) across-the-board or equiproportional, a large element of inertia has tended to perpetuate the initial quota structure. While current quota formulae are difficult to defend or justify by any reasonable criteria, there are strong vested interests that make changes difficult.

The terms of reference for the study given to the Quota Formula Review Group established by the Managing Director in 1999 were broad and included the following main areas:

-“To review the quota formulas and their working, and to assess their adequacy to help determine member’s calculated quotas in the IMF in a manner that reasonably *reflects member’s relative position in the world economy* as well as their *relative need for and contributions to the Fund’s financial resources*, taking into account *changes in the functioning of the world economy* and the international financial system and in the light of *the increasing globalization of markets.*”

Since the issue of basic votes would appear to be a major issue in the governance of the Fund it is surprising that, despite the broad mandate given to the Quota Formula Review Group,(3) appointed by the Managing Director in 1999, their Report fails to consider the possibility of revising basic votes.

The only reference to basic votes contained in their Report states that: "The IMF's cooperative nature suggests that potential debtor countries should continue to have a significant voice in IMF decision-making, a feature that would be dropped by basing quotas solely on the ability to contribute (unless redressed by increasing substantially the fixed or basic votes to which each country is entitled, which now accounts for about 2 percent of total votes—a change that would require amendment of the Articles). With quotas and hence voting power, based solely on the ability to contribute, some feel that the perspective of prospective borrowing countries would not be properly reflected in the management of the IMF."

Thus while recognizing that the cooperative nature of the international institution calls for having prospective borrowers represented in decision-making in the Fund, the authors of the Report appear to believe that with basic votes accounting for 2.1 percent of the total vote, a figure that includes the votes of developed countries, potential debtors have *a significant voice in decision-making!* It is difficult to take this argument seriously. One may ask in what parliamentary body would such a small representation (less than 1.9 percent on account of basic votes) of a major interest or party be considered to give it an adequate participation in decision-making?

### **III. Review of Quota Formulas**

Since quotas are the major determinant of voting power, any review of the subject must consider the appropriateness of current quota formulae in terms of transparency, of the relevance of variables included and of the weights given to these and of whether their results reflect the relative positions of countries in the world economy.

The discussion of quotas is necessarily complex since at the time of Bretton Woods Conference, quotas were assigned several important roles, i.e. the determination of countries contributions to the Fund, that of access to Fund resources, and their relative voting power. The logic of having only one formula for determining these different roles has often been questioned. As suggested by R. Mikesell (1994) and in keeping with the well known postulate of Prof. Tinbergen(1952), of having one policy instrument for each policy objective, it would make considerable sense to separate the three functions performed by

present 17.3% to 16.1% of the total, it would preserve the US veto and maintain a veto for the EU as a whole and maintain a small majority of the total vote in favour of creditor, mostly industrial countries.

By giving developing countries a significant participation in decision-making and thus attaining increased legitimacy for the decisions of the Fund, this formula would appear to go a long way in attaining a better balance in the distribution of voting power.

However, it would produce a result that would not be representative of the relative position of individual countries in the world economy. Since it would significantly alter the voting power in favour of smaller developing countries and against the larger developing economies, the sole increase in basic votes without a revision of the quota formulas would probably not be acceptable to them, nor would it increase their contributions to Fund resources. Recall that although measured in real terms, China, India, Brazil and Mexico are among the ten largest economies in the world, their contributions to the Fund are minimized by current quotas.

Moreover, the sole increase in basic votes would alter the power balance between developed and developing countries without requiring an increase in the commitment of resources by the beneficiaries. Furthermore, while the smaller economies of Africa, Asia and Latin America would benefit most, the larger ones would suffer a decline in their relative position. For this reason, this proposal is unlikely to have the support of the developing countries as a block. Thus, it would seem that to be acceptable, any substantial increase in basic votes would have to be accompanied by a revision of the quota formulas that would better reflect relative weights in the global economy.

In any event, once an increase in basic votes is agreed, in order to prevent the future erosion of the share of basic votes in the total, the Articles could be amended to include a provision by which in every quota review, total basic votes would increase by the same proportion as total quotas.

Provisions to the effect of protecting members participation in decision-making may be found in a number of other international financial institutions. Note that being sensitive to the political dimension of its work, MIGA would allocate developing countries as a group the same voting power as developed countries if all members of the World Bank joined the Agency; note that the Asian Development Bank's Articles of Agreement provide that the relative importance of basic votes will remain constant over time as a proportion of the total vote (Article 33- 1) and also note that the Articles of Agreement of the Inter-American Development Bank provide that no increase in the subscription of any member will become effective if it would reduce the voting power of certain countries or groups of countries below given percentages of the total. (See External Review of Quota Formulas-Annex, Box 3.1 page 38 ).

Although the Fund has a very wide membership, note that current quotas and voting power are not representative of the real size of the members' economies and therefore they restrict the participation of developing countries in decision-making. Current quotas, by the systematic underestimation of the size of developing countries economies, limit their participation in decision-making, as well as their contributions, as we shall see below. (Section on quota formulas)

We shall now consider the application of the first three principles above to the issue of increasing the role of basic votes; we shall later consider the issue of quotas. The following options come to mind:

I-Restore the 1945 proportion of member's basic to total votes for each member

Since basic votes were 11.3% of total vote, divided by 44 members, each member had 0.2568% of basic votes. If this is multiplied by 183 members = 47% of total vote. Since this would raise the total of basic votes to (47%) nearly half of total voting power when basic votes of developing countries were added to quotas, this formula would give the developing countries a large majority of votes, some 78.3%. (The sum of 40.83 % of vote on account of basic votes plus 37.5% of vote related to quotas) This result would not be desirable, since it goes against the first of our principles above. Moreover, it would not be accepted by the industrial countries .

II-An intermediate solution that would partially restore the role basic votes, would be to increase basic votes to the equivalent of 18.3% of total voting rights, thus each member country would have 0.1% of the total voting rights. This would mean raising the basic votes of each member country from 250 to 2,166.7. However, this proposal would also have little prospect of acceptance since by itself it would give developing country members almost 15.9% of the vote, a net increase of 14.1% on account of basic votes and when added to 37.5% of vote related to quotas, would also result in their attaining a clear majority of the vote, i.e. 53.4%, and thus of a large measure of control over the Fund. An added difficulty for the acceptance of this proposal is that it would reduce the total vote of the US below the 15 per cent required to veto certain decisions. (US vote would fall from 17.16 to 14.74% of total voting power.  $(17.16 \times 14.1 = 14.74\%)$ )

III-A third possibility would be to restore basic votes to the 11.3 per cent of total vote they represented in 1944. This would signify a more than fivefold increase in the basic votes of each member, from the present 250 to 1338 votes, equivalent to 0.00617 of the total voting power.

The result of such an increase in basic votes would be to raise the voting power of developing countries on account of basic votes to 9.8% from the current 1.8 % or a net increase of 8%, which added to their quota based votes would increase developing country participation from the current 39.3 to 47.3 per cent of total vote. Such an increase would seem to approach the upper limit of what could be politically acceptable, for while it would reduce the US voting power from the

- 5) Could the transparency and accountability of governments, which the IFIs consider essential to good governance, be compatible with conditionality?
- 6) If countries face situations in which they have no choice but to accept conditionality, could governments be held domestically accountable and responsible for the effects of policies imposed from outside?
- 7) Who should governments be accountable to, their electorate or some external institution in which they are underrepresented? (See Buira, A. 2002).

Obviously, such an arrangement would leave much to be desired.

d) Mixed systems

In view of the limitations of the above extreme cases, it appears that corner solutions are to be avoided. To attain:

- (i) a degree of democracy and representativeness that would provide the necessary legitimacy and transparency, as well as
- (ii) the market credibility required by the good functioning of an institution for international monetary cooperation, voting structures require a fine balance between creditors and potential debtors. To this effect, certain principles may be suggested:
  - 1) Debtor and potential debtor governments should have a considerable voice, but not an automatic majority or the dominant voice in decision-making. Leaving aside other considerations, this seems indispensable to secure market credibility of Fund supported programs.
  - 2) The institution should not be automatically dominated by a group of creditor countries. This seems necessary to ensure representativeness and legitimacy of decisions and a sense of ownership essential to the success of Fund programs
  - 3) Consequently, the total voting power of creditor and potential debtors should be in approximate balance. This would enhance the probability of each case and each program being judged on its merits.
  - 4) Contributions to the Fund and access to its resources should be closely related to the real size of the members' economies and
  - 5) The size of the Fund should expand in step with potential need, i.e. related to the expansion of world trade and the growth of international capital movements.

perceived as unlikely to take into account the needs and interests of smaller members and of debtor and potential debtor countries.

Therefore, the question arises: Could a Fund entirely based on voluntary contributions be truly considered as an international institution for international monetary cooperation or as an instrument of those in control?

In a sense, it could be argued that such a Fund could be no different from a commercial institution, except in the sense that its shareholders would be governments. But very likely, instead of pursuing profits, the Fund would condition loans to the adoption by borrowers of certain policies that members holding a controlling interest wished to foster.

Two possible lending policies could ensue: 1) If the goal of shareholders with a controlling majority were the pursuit of profits, the cost of lending could be sharply increased to discourage borrowing by higher credit risk members or more likely, 2) loans could be made at "below market" rates of interest, subject to acceptance by debtors of certain economic and/or political conditions of interest to the controlling group, conditions not necessarily in the best interests of the borrowing members. Of course, the amounts disbursed would be the minimum necessary to attain their policy objectives.

Therefore, more than a rules based institution of monetary cooperation to which all members in need could turn to for assistance in dealing with their payments difficulties, such a Fund would be a discretionary foreign policy tool of the countries in control.

### c) Political Issues

The size of the Fund would probably be a function of the economic and political returns expected by contributors, either in terms of interest rates or more likely, of their economic and geopolitical objectives, including support for friendly governments and influence on the policies of borrowing members. (For instance, in terms of foreign policy, or of opening of their markets to their exports and their investments). This "pure market" arrangement, with very limited participation in decision-making by the majority of member countries would give rise to a number of important political issues in relation to the economic programs it supported, i.e.:

- 1) Could program ownership by a country be made compatible with externally imposed conditionality? Can externally imposed policies or values become internalized in recipient countries?
- 2) Is external conditionality compatible with democracy?
- 3) To what extent is IFI conditionality power without responsibility?
- 4) Should economic policy decisions that affect all be taken by foreigners outside the domestic political process?

basic votes are of very little significance. Consequently, the voice of small countries in the discussions has been substantially weakened and their participation in decision-making reduced to the point of becoming negligible. A similar process of erosion of the role of basic votes has taken place in the Bank over time as a result of capital increases. The developing countries have repeatedly, and fruitlessly, raised the question of the need to increase the number of basic votes in order to maintain a better balance in decision-making.

Let us review several options for the reform of the “basic vote” structure of the Fund. Consider first the two extreme solutions:

a) One country one vote

By the application of the principle of the legal equality of states, which is the rule in most international institutions, there would be no weighted voting and formally, all members would have the same say in the affairs of the institution. However, the fact that states differ greatly in size and economic power means that if as a result of the principle of equality of states all financial contributions to the Fund are equal, they would have to be set at a very low level, a minimum common denominator, to be accessible to all members. Consequently, the resources of the institution would be insufficient to allow the Fund to attain its purposes. Moreover, the combination of insufficient resources (and presumably, largely political character of decisions made) would signify limited market credibility of Fund decisions. This could in turn, aggravate the effect of the limitation of available financial resources on members seeking Fund support.

If despite having equal vote financial contributions were not equal, you would probably find that larger members, expected to make larger contributions, would tend to condition these to the adoption by the institution of certain policies or policy directives, as appears to have been the case in the UN and several UN agencies and programmes (UNESCO, International Criminal Court, Kyoto Protocol on Global Warming, ban on land mines, etc.). Thus, it would seem that, while politically representative of the membership, the principle of one member one vote would not be a sound basis for the effective functioning of the Fund.

b) Voting power solely determined by voluntary contributions

In a sense, this is a pure market approach. As a result of voting power being based entirely on voluntary contributions, the control of the institution would probably be in the hands of a small number of rich member countries and reserve currency countries. Consequently, the system of decision-making could not be considered as democratic nor representative of the interests of the membership as a whole.

As a result, the legitimacy of Fund conditionality, its other policies, recommendations and regulatory functions would suffer. These would be

comprise. These would be closely paralleled by the reform of the Bank governance.

The fundamental question to be discussed in this paper may be stated as: how to attain political legitimacy in the decisions of the IFI's and secure a greater ownership of economic programs without weakening their credibility in financial markets or their efficiency in attaining their policy goals. To this effect, this paper will consider the revision of the two elements that determine the voting structure of the Fund, i.e. the number of basic votes allocated to each member and the revision of the current quota formulas. Since each of these options favours one group of countries over another, which of the two is preferred, or what combination is acceptable to member countries, is essentially a political choice.

## **II. Votes and Decision-making**

Recall that in 1944 at the Bretton Woods Conference a compromise solution was adopted between two approaches to the determination of voting power, one which would relate it solely to members contributions or quotas and another based solely on the legal principle of the equality of states. The compromise based voting rights on a combination of the two: it gave each member country one vote for every \$100,000 of quota (later for every SDR100,000) plus 250 basic votes. Basic votes, and the voice in decision-making they gave smaller countries were also considered to be necessary in view of the regulatory functions of the Fund in certain areas. (See J. Gold).

Similarly, Article V section 3(a) of the Bank's Articles of Agreement provides that "each member shall have 250 votes plus one additional vote for each share of stock held". All shares of the Bank's capital are valued at US\$ 120,635 per share. Note that in 1979 all members of the Bank were offered to subscribe 250 "membership" shares to avoid dilution of the voting power of the smaller members as a result of the 1979 capital increase. New members are also authorized to subscribe 250 shares.

The expansion in membership from 45 to 68, caused the share of basic votes to rise from 11.3 per cent in 1945 to 15.6 percent in 1956 simply because no significant increase in quotas had taken place. But with the nearly 37 fold increase in quotas since then, the share of basic votes in the total has declined (to 2.1 percent) despite the quadrupling of the membership. This has substantially shifted the balance of power in favor of large quota countries, away from the compromise agreement contained in the Articles in order to protect the participation of small countries in decision-making.

With the passage of time, inflation and growth have combined to increase the size of the quotas, but as the number of basic votes has remained constant, their relative participation in the total has declined. As a result, today quotas (shares in the case of the Bank) are virtually the sole determinant of voting power and

# A NEW VOTING STRUCTURE FOR THE IMF

Preliminary Draft

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## **I. Introduction**

Since 1997, following the approval of the Guidance Note on Governance by the Executive Board, the IMF has given increased attention to governance issues in its member countries. The promotion of transparency and accountability are at the core of the Fund's efforts to ensure the good use of public resources as well as the domestic ownership of programmes. In recent years the Fund has developed and applied its instruments for promoting these objectives to an extent well beyond what was envisaged at the time the Guidance Note was approved. (See endnote 1).

The Fund now helps countries identify weaknesses that may exist in their countries' institutional and regulatory frameworks that could give rise to poor governance, and provide support in the design and implementation of remedial measures. Given the strength of vested interests that benefit from the lack of transparency and accountability, overcoming these weaknesses often requires that the countries undertake significant structural reforms.

With resources of over \$280 billion and an expanded mandate, the Fund is possibly the most powerful of all international institutions. It exerts a significant influence on such multilateral economic and politically sensitive matters as wage policies, taxation and public expenditure levels, public sector prices and tariffs, subsidies and pensions, privatisation policies, the exchange regime and the exchange rate, interest rates and monetary policy, trade policy, financial sector regulations and others. When countries face difficult times, Fund support may prevent a crisis. In view of its great influence, it is of interest to consider to what extent the Fund's own governance meets standards of transparency and accountability required to ensure the legitimacy of its decisions, the ownership by member countries of the programmes it supports and the good use of the public resources at its disposal. To do so, we must begin by understanding its voting structure and the rules by which it is governed. This requires that we review the role of basic votes and quotas in the determination of voting power, the current distribution of voting power, the requirement of special majorities and how they affect political control and accountability. (See Endnote 2).

In view of the overwhelming importance of quotas in determining voting power, we shall review the formulas for the determination of quotas and consider the proposal for their revision put forward by the Quota Formula Review Group appointed by the Managing Director in 1999. Finally, we shall suggest the main elements that a reform of the voting structure and governance of the Fund should