

May 2006

Bretton Woods Reform: Sifting through the Options in the Search for Legitimacy

Legitimacy and accountability are critical in proposals to change the governance of the IMF

Hardly a day seems to go by without the future of the IMF being questioned by key insiders such as Mervyn King, governor of the Bank of England, or Lorenzo Bini Smaghi, executive board member of the European Central Bank. NGOs and academics have been writing on Bretton Woods reform for years, so why the sudden interest by policy makers and by the management of the institutions themselves? This Briefing Paper reviews the challenges facing the IMF and its continued *raison d'être* and then focuses on two current proposals to change formal representation on the Board. Whilst seemingly mundane and complex to the outsider, these are actually critical to addressing the larger question of accountability and legitimacy.

The current discussion begins with threats to the institution's basic existence, unlike earlier debates over the effectiveness and equity of its policies (structural adjustment in the 1980s and 90s and response to major financial crises during the late 1990s). There are at least three new challenges that have emerged to test its legitimacy, at least one of which may be structural rather than cyclical: Asian surpluses, the Fund's own funding and its relevance to current world problems.

Threats to the IMF

First, the massive accumulation of foreign exchange reserves by Asian and other regional economies has dwarfed the IMF's resources, making it increasingly unlikely that these countries would draw on Fund resources in the case of a crisis. It has reinforced momentum for regional liquidity arrangements, such



'Mexico: one of the countries currently under-represented at the IMF'

as the bilateral swap facility amongst ASEAN + 3 nations, the so-called 'Chiang Mai' initiative, and an 'Asian Monetary Fund' (floated by Japan after the East Asian financial crisis but dismissed by the US and Europe). Reduced participation in the Fund by Asia and other large developing economies, such as those in Latin America who have also accumulated large reserve levels, would damage the relevance of the Fund.

Second, the IMF's financial situation is increasingly precarious. Early repayments of large debt tranches by Argentina and Brazil left the Fund with fewer outstanding interest bearing loans to serve as income. A decreasing propensity to borrow by members, for reasons both of national 'pride' and excess liquidity, signals that the Fund will have problems rolling over interest income to finance its ongoing needs without a massive increase in contributions, unpalatable to most members.

A third threat has been the Fund's apparent

Key points

- Despite recent decisions about reforming the goals of the IMF, debate on governance reform will continue in the run up to the Autumn meetings
- Although there are different options on how the IMF should be reformed, the key considerations are accountability, transparency and efficiency.
- A key challenge is to increase the voice of the smallest countries.

Overseas Development Institute

ODI is the UK's leading independent think-tank on international development and humanitarian issues.

incapacity to address pressing issues in the international economy. An example is the growing problem of global imbalances (notably China's surplus and the USA's deficit). Changes to the Articles of Agreement agreed at the Spring meetings to allow the fund to engage in 'multilateral surveillance,' i.e. to weight in on economic issues which involve more than one country, should go some way towards formally addressing this deficiency. However, the risk is that despite these new powers, non-borrowing countries like the United States, other industrialised nations and countries like China, with large savings and no need to borrow, can simply ignore IMF advice, research and chastisement, as they have done in the past.

Do we need the IMF? Yes, but.....

There are two fundamental reasons to preserve, strengthen and reform the Fund. First, few other institutions have the capacity to produce authoritative research on issues of critical import to the global economy, such as the current issues of macroeconomic imbalances. The new powers granted under the multilateral surveillance mechanism should, in fact, increase their relevance and capacity on this critical issue.

The second reason for retaining the Fund is that its core business of lending to offset cyclical deficits remains strong. There have been few fundamental changes in the ways markets price risk and make investment decisions, or in the ways that global capital moves across borders. The current situation of high liquidity, high commodity prices and low global interest rates is most unlikely to last forever. Far from slipping into obscurity, the Fund is likely to be even more important in future crises, in which higher levels of global integration create more potential for contagion and systemic risk.

.....governance is important

The more complicated question is how the IMF should be governed and its current (some would say ongoing) crisis of legitimacy addressed. The voluminous literature on IMF reform ranges from the mundane to the boldest 'paradigm shifting' proposals. Most have dealt with the formal issue of votes and representation on the Board of Directors, so-called 'chairs and shares,' though proposals have also been put forward on transparency, the selection of leadership, and 'intellectual portfolio' (i.e. who staffs the Fund and what ideas they propose).

The discussion of 'chairs and shares' is critical, because the largest shareholders of the Fund dictate its mandate, goals and programmes; redistributing formal representation to emerging market developing countries is likely to change its mandate and ideas. One proposal for change has been made by the Fund management with support from the UK Treasury (full, given the role of Gordon Brown as Chairman of the Financial Committee) and the USA (qualified). The suggestion is for an ad hoc increase in quota votes for large emerging market countries (predominantly in Asia), with an eventual review of the quota formula. The second, an alternative articulated by the G24 - a group of large developing countries within the IMF and World Bank that play an active role in articulating alternative governance structures and policies for the institution - and other large developing countries is to adjust the quota formula to include both a higher weighting for GDP and to measure GDP in purchasing power parity (PPP) terms.

The status quo

Shares

The formula used to determine the quota allocations is based on political negotiations which took place at the time of the Fund's founding in 1944. GDP has a low percentage of weighting, while 'openness,' measured as average imports and exports, plays a larger role. The overall result of the formula is to provide disproportionately large representation to small, open economies, like those of many European countries (table 1). Each country is also awarded a number of 'basic votes' and, whilst this is intended to reinforce equality of treatment, over time their share of the total has decreased from some 15% in the 1950s to less than 3% today, despite periodic increases.

Chairs

Each country is grouped into ad hoc and non-binding voting constituencies to which are distributed the 24 seats on the Executive Board. Although formal votes are almost never taken on the Board, voting power is important because it is noted informally.

Among the notable problems with the status quo are the large number of African countries which

Table 1: Current Distribution of Votes, by Region

	% Quota Votes	% Basic Votes	% Total Votes
G7 Countries (US, Canada, Japan, UK, France, Germany and Italy)	46.17	3.80	45.29
Other Developed	15.61	10.33	15.50
Total G7 + Developed	61.78	14.13	60.79
Africa	5.20	27.72	5.67
Asia	10.32	16.85	10.46
Middle East	7.65	8.70	7.67
Latin America & Caribbean	7.48	17.39	7.69
Transition Economies	7.56	15.22	7.73
Total Developing Countries	38.22	85.87	39.23

Source: IMF

report to one executive director (creating an enormous work burden and therefore a capacity constraint to work on strategic rather than country specific programme-related issues) and the spread of European Union members over some 10 chairs (some of which contain no other EU members, as is the case for Spain, Ireland and Poland). Additionally, many chairs include countries which are both net borrowers and net lenders to the IMF and are therefore likely to have different priorities.

The Proposals

IMF Management / UK and US Governments

The IMF Management seeks an agreement on ad hoc quota increase for large Asian and other developing economies during the Autumn meetings, following on from their announcement at the Spring meetings that changes are required ‘to reflect important changes in the weight and role of countries in the world economy.’¹ A recent addition to their proposal has been to accommodate an ‘eventual’ discussion of the quota formula, something the US has insisted be part of the governance reform from the outset. The US position has tended to see quota increases as a zero sum game, with existing quotas reshuffled from ‘overrepresented’ states (some of Europe’s smaller economies but also countries such as Saudi Arabia, Brazil, Australia, Argentina and Russia) to ‘underrepresented’ states (notably China, Mexico, Turkey and South Korea). Ensuring that no new contributions are made is advantageous for the US, which would face major resistance in finding new funds, as such an allocation requires Congressional approval.

The G24

The G24 and other large developing countries, by contrast, oppose this ‘two step’ reform proposal and think that the issue of quotas should be addressed at the same time as the formula. Quota reallocation should be determined not on an ad hoc basis but rather as part of the formula review. The G24’s proposes a simple formula that would take greater account of GDP (measured in purchasing power parity terms) and, simultaneously, ‘the vulnerabilities of developing countries to movements in commodity prices, the volatility of capital movements, and other exogenous shocks’ through an analysis of export and capital flow variability.²

Current discussions by G24 members at the Board level tend to favour a formula in which 90% is determined by GDP, with the remaining 10% based on volatility. Table 2 shows the G24’s calculations on how varying weights for GDP and volatility would affect representation within the IMF and World Bank. Each country’s representation in the Fund is

Table 2: Potential distribution of quota with different weights in GDP (measured in PPP) and volatility (Basic votes maintained at current levels)

	GDP = 0.60 V = 0.40	GDP = 0.70 V = 0.30	GDP = 0.80 V = 0.20	GDP = 0.90 V = 0.10	GDP = 1 V = 0
G7 Countries	26.26	30.51	34.76	39.01	43.26
Other Developed	7.86	7.99	8.12	8.25	8.38
Total G7 + Developed	34.12	38.50	42.88	47.26	51.64
Africa	15.07	12.27	9.47	6.67	3.86
Asia	20.76	22.15	23.54	24.93	26.31
Middle East	8.27	7.17	6.06	4.96	3.85
Latin America & Caribbean	9.95	9.42	8.89	8.36	7.84
Transition Economies	11.83	10.50	9.16	7.83	6.49
Total Developing Countries	65.88	61.50	57.12	52.74	48.36

Source: Buirra 2005

determined by a mix of GDP calculated in PPP terms and volatility. Representation of small, vulnerable economies increases the greater weight placed on volatility. Basic votes are not changed and representation in this table is calculated at the regional level.

The purchasing power parity element would increase the power of developing countries generally (and especially India and China) whilst the greater weight placed on volatility would favour small, open and undiversified economies (e.g. many countries in sub-Saharan Africa). It is notable that in these calculations, if GDP and volatility are weighted at 90% and 10% respectively, as is currently preferred by G24 members, the US representation actually increases to 18.7%. The other substantial gains from the use of PPP are India and China, whose shares would increase to 5.2 and 11.4% respectively.

The use of PPP as a determinant of Fund representation has been rejected in the past because of statistical problems with the data, which are claimed to be more ‘subjective’ than market values (which is pure representation of economic power) and also suffer from inconsistencies and gaps (notably for India and China during previous decades). However, it was recently suggested by the US Ambassador to the United Nations, John Bolton, that the UN should use PPP GDP to measure the necessary contributions from each member state in its fees.³ The proposal was promptly dismissed by China and other major countries, whose contributions would increase dramatically under this formula. The paradox of developing country support for PPP in the Fund and lack of support of such a metric in the United Nations has to do with the fact that Bretton Woods representation is ‘cheap:’ it does not require ongoing financial resources to maintain power in the institutions.

Table 3: Governance implications of IMF reform proposals

	Participation	Accountability	Transparency	Efficiency	Viability
IMF management	Increased participation for selected MICs	Limited improvement for large MICs.	No change.	No change as chairs remain the same	High
G24 / MICs	Increased participation for developing countries, especially large MICs	Improvement for a limited number of developing countries. Still lack of accountability to smallest economies at 90% threshold.	Much improved as formula is based on single, transparent metric.	Unclear: Depends on how chairs are changed to reflect new shares. Could remain the same.	Moderate – Though PPP metric for GDP is unlikely to find favour

‘development friendly’ quota gain traction between now and the autumn meetings.

Ensuring that small, low income countries have a voice in the Fund will likely require reform outside of the context of chairs and shares – either through the creation of new accountability and governance mechanisms (e.g. advisory groups composed of low income country officials which have frequent

and institutionalised meetings with the Managing Director, breaking the stranglehold that large countries like the US and Europe have on this type of direct interaction), and / or by further mainstreaming country ownership in IMF programmes (the part of Fund business which is most directly related to the interests of low income countries). As the agenda for country ownership in the field of aid has largely emerged through the process of European development consensus building, it would be especially effective for European Executive Directors to continue to push for this kind of reform of the Fund’s operations.

Assessing the Proposals

How do these proposals rank on standard metrics of governance such as participation, accountability, transparency and efficiency? As detailed in Table 3, on almost all of the metrics, the G24 proposal addresses more governance criteria, particularly participation of a greater number of developing countries and transparency by improving the current opaque quota formula. The efficiency implications are less clear cut, as they depend on how the chairs are distributed given new power constellations (assuming that the number of Executive Directors stays the same, which would at least have no negative implications for efficiency). However, in the proposed G24 formula, where volatility only comprises 10%, the overall representation for non-Asian developing regions is still relatively low, which means that the voice of such countries will continue to be minimal despite the fact that the policies of the institutions have a direct impact on such countries.

Thus, clearly neither of these proposals is sufficient if the end goal of IMF reform is to make the institution accountable to all of its members. A revised formula, even based on G24 principles of taking into account PPP and volatility, merely increases the voice of new economic powers and does not address the fact that the highly indirect representation of many countries through constituencies necessarily limits the Fund’s accountability.

However, there is a possibility that changes to chairs and shares could be combined with more innovative governance reform outside of the Executive Board structure. Momentum for a change to chairs and shares could be capitalised upon, especially if proposals from the G24 to adopt a more

Key Reference

Buira, Ariel (2005). ‘The Bretton Woods Institutions: Governance without Legitimacy?’, in *Reforming the Governance of the IMF and World Bank*, Buira, A. ed. London: Anthem Press.

Written by ODI Research Fellow, Lauren Phillips (l.phillips@odi.org.uk)



Overseas Development Institute

111 Westminster Bridge Road, London SE1 7JD

Tel: +44 (0)20 7922 0300

Fax: +44 (0)20 7922 0399

Email: publications@odi.org.uk

Briefing Papers present objective information on important development issues. Readers are encouraged to quote or reproduce material from them for their own publications, but as copyright holder, ODI requests due acknowledgement and a copy of the publication.

This and other ODI Briefing Papers are available from www.odi.org.uk

© Overseas Development Institute 2006
ISSN 0140-8682

Endnotes

1. <http://www.imf.org/external/np/sec/pr/2006/pro681.htm>. There is some level of confusion as to whether increases for China, Turkey, Mexico and South Korea were already decided both among those present at the meeting and reports emerging from the meeting (including the closing press conference). There seems to be a lack of consensus, which is necessary for any change.
2. Paragraph 10, G24 Communiqué October 2004.
3. Pisik, Betty (2006) ‘US Eyes Sharing of UN Budget’, Washington Times: 6 April.