IMF Quota Reform: The Singapore Agreements

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Theme: This document analyses the changes in the quotas of certain countries as agreed at the annual meeting of the International Monetary Fund in Singapore in September 2006, as well as the announced changes in their method of calculation within two years.

Summary: The Singapore Agreements imply a far-reaching reform in IMF member countries' quotas, which are clearly obsolete. Members have agreed to undertake the reforms over two phases. Phase one, effective immediately, implies an increase in the relative weighting (and, therefore, voting power in the institution) of countries which were seen to be most under-represented: China, Korea, Mexico and Turkey. In the second phase, over a period of two years, reforms will be introduced in the formulae used to determine the quotas in order to render them simpler and more transparent, as well as corrections in the quotas of a wider group of countries who are under-represented in accordance with the new formulae. There will also be an increase in the so-called 'basic votes', the linear component of voting power which benefits in particular smaller and poorer countries. The discussion looks set to be difficult, due to the diverging interests at stake, but the process launched should be welcomed since the reform is necessary to strengthen the legitimacy and representativeness of the IMF.

Analysis: The IMF quota reform was approved with the favourable vote of 156 countries, accounting for just over 90% of the total of votes at the institution, and amply exceeding the 85% threshold required for this kind of decision. However, 23 countries voted against, including India, Egypt, Brazil and Argentina, as well as most of the other Latin American countries.

The source of the problem lies in the complexity of the formula, which is due in part to the diversity of functions assigned to the quotas, as well as the significant elements of inertia incorporated into their calculation. This inertia means that quotas only reflect the relative weighting of the various countries in the global economy partially and with a considerable time lag.

IMF quotas have a three-fold purpose: (1) set the amounts of member countries' contributions to the institution's resources, as well as assigning Special Drawing Rights (SDR), the IMF accounting unit in which most of its currency reserves are denominated; (2) set maximum access to loans which the Fund makes available to its members in the event of a crisis; and (3) determine the voting power in its governing bodies. This multiplicity of objectives means that quotas must reflect a difficult balance between different interests (in particular between debtor and creditor countries), which has often triggered conflict.

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In line with these objectives, each country's quota is set in accordance with four variables: GDP, foreign currency reserves, openness of the economy and variability of current account receipts. GDP is justified as an approximation of the size of each economy, reserves as an indicator of its capacity to contribute to the institution's resources, openness as a reflection of its degree of integration in the world economy (which the IMF seeks to further) and variability as a measure of each country's vulnerability to sudden changes in revenue sources, which could end up by unleashing a crisis.

The weightings of these variables are not fixed, but are determined using a complex mechanism. The four variables are combined with different weightings in five formulae: the original (called the Bretton Woods formula) and four additional formulae introduced in the early sixties, so that each country's calculated or theoretical quota is the highest between (a) the Bretton Woods formula and (b) the average of the two lowest of the remaining four formulae.

The system is evidently too complex and opaque, and it generates results which might seem surprising: the calculated or theoretical quota of Belgium is twice that of India, and Austria's quota exceeds that of Brazil. The effective quota may, in turn, differ persistently from the calculated quota, for reasons explained below. The system's opacity and the discrepancies between quotas and the real weighting of each economy have led to intense debate among member countries in recent years. Some of the main issues under discussion have been as follows:

- Consideration of GDP valued at market exchange rates or Purchasing Power Parity (PPP), in other words, taking into account the lowest price levels of the least developed countries. This latter option has been advocated by the emerging and developing countries, whereas industrialised countries have generally supported the use of market exchange rates. The differences between the two methods of calculation can be considerable: China's weighting in the world economy is 5% at market exchange rates and 15% in PPP terms, to give the most obvious example.
- Inclusion or otherwise of gold and currency reserves in the formula. Although traditionally it was considered that reserves provided an indication of a country's capacity to contribute to the institution's resources, there is now a widespread view that with free circulation of capital and easy access to international financial markets, the relationship between reserves and foreign solvency is less clear. Certain recent developments in the international financial system (such as several countries issuing reserve currency in a floating exchange rate system, the creation of the European Monetary Union and the accumulation of huge reserves in certain emerging countries) further hamper the interpretation of reserve figures.
- Inclusion of a financial component to the variables measuring openness and volatility, which were originally calculated based only on current account data. Although there is a general agreement that this would be desirable, particularly in the case of variability, there are many doubts as to reliability of the available statistical indicators.

These issues have been debated repeatedly in recent years, to no avail. The most comprehensive analysis of this problem is the so-called Cooper Report,[2] drafted by a group of experts in 2000. This report proposed a modification of the formula to simplify it considerably, so as to limit it to just two variables: GDP (at market rates) and variability (both in real and financial terms), with fixed weightings of two-thirds and one-third, respectively. But the proposal did not receive enough support, partly because it would have meant profound changes in voting power.

Precisely the considerable inertia of the voting power mechanism is one of the main problems in the current system, and it is also one of the main obstacles to reform, since any modification must be supported by countries which are often more interested in maintaining the *status quo*. This inertia –which makes it difficult for the most dynamic economies to increase their weighting over time, as one might expect– is the result of various elements: (1) countries' quotas in absolute value cannot be reduced, unless the countries themselves choose to do so, so that relative adjustments can only be obtained with an increase in the total volume of quotas; (2) general increases in quotas are carried out every five years, but only if there is a need for liquidity in the IMF (this has happened in just over half the cases); and (3), furthermore, general increases in quotas contain an element known as 'equiproportional', which is distributed in line with existing quotas, and a 'selective' element, which is assigned in line with the new calculated quotas, so that only this latter component –which on average has accounted for just 27% of the total in the last seven general increases– helps correcting the accumulated discrepancies. Although *ad hoc* increases are possible, in addition to general increases (like the one just agreed to in Singapore), the fact is that they have only been used exceptionally, since they require the support of 85% of votes. As a result of all the aforementioned elements of inertia, discrepancies have emerged between the countries' effective quotas and their so-called 'theoretical' or 'calculated' quotas (those that would be applicable if they were updated with the very latest information available). This process has gradually undermined the legitimacy of the institution. As an example, before the Singapore Agreements, Spain's effective quota accounted for 1.43% of all votes, while its theoretical or calculated quota was 2.27%, which entails a deviation of 0.84 points in absolute terms and of 59% in relative terms.

But the problems of adequate representation of IMF member countries go beyond the mere calculation of their quotas. The Fund's Executive Board comprises 24 executive directors, eight of which represent just one country (US, Japan, Germany, France, the United Kingdom, Saudi Arabia, China and Russia), while the rest of the countries group together freely in constituencies whose voting power depends on the sum of that of the countries in question. The system for calculating quotas and the historic configuration of these groupings (which gave an advantage to founding members) affords industrialised countries, particularly European ones, a weighting in the Executive Board which emerging and developing countries consider to be excessive. In this regard, it is hard to understand the recent debates without considering the specific problems of two groups of countries: East Asia and Low Income Countries (LICs).

For countries in East Asia, the reform of the IMF is a necessary step to strengthen the legitimacy and relevance of this institution in the world economy. In the wake of the Asian crisis in the second half of the nineties, these countries adopted quite a critical position towards IMF policies, whose conditions they saw as too interventionist, if not inappropriate, and whose financing they perceived as clearly insufficient. Once recovered from the crisis –more swiftly than expected– the region's economies showed considerable dynamism (boosted particularly by China and India) and a huge capacity for self-insurance, as evidenced by the vast increases in their currency reserves, a policy which seems related to the desire not to depend on the IMF support in the event of future crises. Furthermore, these countries have launched regional swap arrangement initiatives –such as the Chiang Mai Initiative– which call into question the IMF role in the region. Asian countries, in short, are calling for a voice and weighting in the IMF decision-making process much more in line with their increasing leadership in the global economy.

The problem for Low Income Countries (LICs) is entirely different. If the theoretical quotas were applied entirely, developing countries as a whole would see their voting power halved (from 16% to 8% of the total), which would clash with their demands for a more prominent role in the institution. Part of this problem is the result of economic growth in this group of countries below the world average in recent decades (although this trend does appear to have started correcting in more recent years); but a significant part of their loss of influence is also attributable to the reduction in the relative weighting of the so-called 'basic votes', which is a linear component of voting power (not included in the formula and which benefits the smallest and least developed economies) whose weightings have steadily fallen as general quotas have increased. From 11.3% of total voting power when the institution was created in 1944, basic votes declined in relative weighting terms to 2.1% in 2005. Accordingly, reform of the method of calculating quotas and the voting system approved in Singapore entails a two-fold objective: (1) to realign quotas with the economic weighting of member countries; and (2) to increase the voice of LICs within the institution. In line with this second objective, the second phase of the quota review will include, according to the Singapore Agreement, an increase in basic votes (to at least double), as well as other elements which underpin the technical capacity of the African representatives in the Fund.

The first stage of the reform underway has therefore closed with an *ad hoc* increase in votes for countries identified as the most under-represented: China, Korea, Mexico and Turkey, since they were under-represented in all the four variables of the current formula (Spain was under-represented in all of them except reserves). The increase was 1.8% in total quotas, distributed among these four countries so as to correct one-third of their deviation between effective and theoretical quota.

The second stage, which is set to conclude in the next two years, will entail the arduous task of reforming the formulae, so that they reflect in a simpler and more transparent fashion the relative position of the various member countries in the world economy. The negotiations in the second phase will certainly be tough, but the fact that an agreement has been reached in the first phase is a positive sign that there is at least a will to solve the problems. Once the formulae have been reformed, in this second phase there will be another *ad hoc* increase for the most under-represented countries. This increase will however be conditional on the increase in basic votes, which in turn requires an amendment to the IMF Articles of Agreement. This last aspect could be problematic, since it would require parliamentary ratification in certain countries, particularly in the United States, where ratification of the fourth amendment –referring to the one-time allocation of SDR– is pending in Congress since 1997.

As indicated at the beginning of this analysis, the proposed reform of the IMF quotas has received broad support among its members, but one group of countries –particularly middle income Latin American, Arab and Asian countries– has opposed the move, either because they consider that the reform tends to consolidate the privileges of more developed countries within the institution, or because they are against a two-phase strategy, or because they have serious doubts in regard to the implementation of the second phase, or due to a combination of all these objections. This position against the reforms by a significant group of countries shows just how difficult the current reform process is and highlights the need to balance very different interests.

Conclusions: At the annual meeting in Singapore, significant steps were taken to unblock one of the most complex and delicate areas of the IMF corporate government, namely the setting of member countries' quotas. The under-representation of some emerging countries has been partially corrected, but much more profound reforms are pending in a second phase. Specifically, the reform of the system for calculating quotas (on which there is a broad agreement that it has become outdated, opaque and excessively inertial, and that its results inadequately reflect the real weightings of the economies in the world) is an indispensable step in strengthening the legitimacy of the institution. Following this reform –which should be concluded in two years' time– there will be a revision of the quotas in order to make them reflect better these relative weightings, while at the same time the voice and representation of Low Income Countries will be enhanced.

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