

**IMPROVING IMF GOVERNANCE AND INCREASING THE INFLUENCE  
OF DEVELOPING COUNTRIES IN IMF DECISION-MAKING**

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The IMF has a generally well-thought out governance structure and is a relatively effective organization that has been able to adopt and implement complex decisions in a cooperative and timely fashion. The constituency system allows reconciling the legitimacy of an almost universal membership with efficient decision-making and collegiality of a not-too-large Executive Board. Weighted voting based on relative economic strength gives confidence to creditor countries to commit financial resources to the IMF, while consensus decision-making confers some protection to the interests of minority groups, making weighted voting acceptable to debtor countries, and may lead to better decisions that are easier to implement. Special voting majorities of 70 percent for certain key decisions also help to protect sizeable minorities.

There are, however, a number of important governance deficiencies and areas that need improvements. The influence of developing countries in decision-making is less than desirable given the major role played by the IMF in these countries and the growing importance of such countries in the world economy. Conversely, there is excessive influence of a small group of large industrial countries. A large part of the membership does not actually participate in a meaningful way in the choice of the main officer of the institution. The IMF expanded its conditionality to areas beyond its core areas of expertise, while in other key aspects its mandate remain undeveloped and would benefit from upgrading, such as with respect to international economic cooperation. The cost of the Fund's activities falls disproportionately on borrowing countries, although this topic will not be dealt with in this paper.

It is no secret that the G-7 exercises great influence in the IMF decision-making process that has become excessive even considering the group's large aggregate voting-share. Although, the G-7 countries remain somewhat short of a voting majority, it is highly unlikely that any issue –either policy or country matter- would be approved in the IMF if the group firmly opposes it. The G-7 appears in some instances to act as a self-appointed steering committee of the IMF. It drives the policy agenda of the Fund, and often acts as a voting bloc. Decision-making in members of this group tends to be kept in their capitals, which raises complex questions regarding governance and accountability.

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<sup>1</sup> This paper has been prepared at the request of the Director of the G-24 Secretariat to be used to inform discussions in the group.

<sup>2</sup> While I am Executive Director of the IMF, the views expressed here are completely personal and should in no way be attributed to the IMF, its Executive Board or any of the countries that I represent. I wish to thank Jacques Polak, Abbas Mirakhor, Willy Kiekens, Roberto Steiner, Alexandre Tombini and Charles de Silva who were extremely kind to devote their time to read a first draft, and who made many valuable comments and suggestions to improve the text. They, however, should not be associated with the views expressed here and are in no way responsible for the mistakes and improprieties that remained in the text, all of which are my exclusive responsibility. I also thank Janice Bramson who helped me with proof reading.

Given its mandate, financial resources, and organizational structure, the IMF is amongst the most powerful official international bodies, perhaps second only to the UN Security Council. Like the Security Council, this power is, in practice, exercised mostly with respect to developing countries. The IMF takes decisions that affect the lives of hundreds of millions of people in developing countries. Developing and emerging market countries are playing an increasingly important role in the world economy and raising their share of global output and trade. They are also home to the majority of the world's population. Yet, their influence in the IMF has not increased correspondingly. The aggregate voting power in the IMF of emerging market countries, developing countries, and transition economies has oscillated between 37 and 40 percent.

As the IMF is a relatively effective international organization, there has been a tendency for important shareholders to use the institution for objectives that go beyond the purposes for which it has been originally created. Even when these objectives are laudable international goals, conforming to what could be considered international public goods, and not simply national foreign policy interests of powerful shareholders, such practice undermines legitimacy and accountability, while at the same time reducing the Fund's efficiency in its core areas.

The topics discussed in this paper to improve the governance of the IMF center around: increasing the independence and accountability of the Executive Board; moderately improving the aggregate voting-share of developing countries; making the selection process of the Managing Director more open and transparent; nurturing the consensus decision-making approach; improving the efficacy and representation of the constituency system; further focusing Fund conditionality on measures required to ensure repaying capacity; and upgrading the IMF's role as the main forum for international economic policy cooperation.

Reform of international organizations is a difficult and complex undertaking that can only proceed in a balanced and often incremental fashion. There has to be a package of reforms encompassing some benefit for a substantial number of member countries, so as to make the reforms feasible. It requires marshalling the highest qualities of political cooperation amongst member countries. Above all, it depends critically on obtaining support from the large industrial countries, without whose consent little reform is possible. Mobilizing strong support from public opinion internationally and inside countries seems to be key to help this process. At the same time, while the reform process is by nature incremental, there may be value in discussing bold proposals that initially look ambitious and unfeasible in order to raise public debate and to allow such proposals to be later refined into a feasible and balanced package of reforms. This is the approach taken in this paper where several proposals would require an 85 percent majority of the IMF voting power and may currently appear far-fetched.

*a) Strengthening the autonomy, accountability and effectiveness of the Executive Board:*

While the highest decision-making body of the IMF is the Board of Governors, the daily business of the Fund is conducted by a resident Executive Board, which exercises under delegation all the powers not specifically reserved to the Board of Governors in the Fund's Articles of Agreement. The main functions of the Executive Board include: approving all policies of the IMF; discussing reports related to bilateral surveillance of member countries' economic and financial policies, and multilateral surveillance of the international monetary system; approving all loans extended by the IMF and regular reviews of the implementation of such loan programs, which condition their disbursement; electing the Managing Director; and approving the budget, and the administrative and personnel policies of the IMF.

The Executive Board is currently composed of 24 Executive Directors, of which five are appointed, without a fixed term, by the member countries with the largest quotas, and 19 Directors are elected by all other 179 member states for a term of two years. The elected Executive Directors can be reelected for an indefinite number of periods, and there are no limitations either with respect to time of service of appointed Executive Directors. About 12 Executive Directors are elected by and represent only emerging market and developing countries.<sup>3</sup> The five appointed Executive Directors represent only large industrial countries. Seven Executive Directors, while being nominated by industrial countries, are elected and simultaneously represent industrial countries, emerging market, transition economies and developing countries. In terms of geographical balance, Europe is represented by nine Executive Directors, Asia by five Directors, the Americas by five Directors, sub-Saharan Africa by two Directors, and the Middle East by three Directors<sup>4</sup>.

Some rules and practices related to the appointment, election, term duration of Executive Directors and their relationships with their capitals do not seem to be the most appropriate from the point of view of strengthening the autonomy, accountability, and effectiveness of both Executive Directors and the Executive Board. The five Directors appointed by the members with the largest quota have no fixed term and can be removed at will at any time by the authorities that appointed them. As mentioned earlier, some industrial countries retain the decision-making power in their capitals and convey narrow instructions to their representatives that reduce their autonomy and limit their ability to participate in the consensus building process. The 19 elected Directors have no limit for reelections, which might generate incentives that would also limit their autonomy. Executive Directors who represent multi-country constituencies may enjoy considerably more autonomy in defining their positions, but questions are often raised about the mechanisms by which they are held accountable to their constituent countries.

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<sup>3</sup> There might be a small variation in the number of Directors who are nationals of developing countries due to the rotation schedules of some constituencies.

<sup>4</sup> If Egypt is counted as an African rather than an Arabic country the number of African chairs would be three and the Middle East would have two chairs. It should be mentioned the chair of Iran encompasses African countries as well (Algeria, Ghana, Tunisia and Morocco).

Executive Directors perform a double role. They are international officers entrusted with the responsibility of ensuring that all operations and activities of the Fund are guided by the purposes of the Articles of Agreement and, simultaneously, they act as representatives of the views and interests of the countries that appointed or elected them. While in the long run these two roles hopefully would likely converge<sup>5</sup>, there might be divergences in the short run between the interests of a particular government, or even the national interest of a given country, and the international objectives of the community of nations. In these instances, the Executive Director has to be able to exercise balanced judgment and to act as an international officer while taking into due consideration the long-term national interests of the countries he or she represents.

The issue, in some ways, is analogous to the question of the operational autonomy of central banks to pursue long-term price stability without being affected by time inconsistencies created by the short-term interests of the government of the day. In these instances, the best practice adopted by many countries and often recommended by the IMF has been to ensure the operational autonomy of central banks, a solution that could well be applied to the Executive Board of the IMF, which exercises certain functions of lender of last resort. The Statute of the European Central Bank, for instance, prohibits the members of the Board from taking advice from their respective governments.

There is no provision in the Articles of Agreement with respect to the dual role of Executive Directors. While a direct prohibition for Executive Directors receiving advice from the countries that appointed or elected them would clearly be inappropriate, there is merit in including an explicit provision in the Articles of Agreement requiring that, in discharging their functions, Executive Directors appropriately balance the international purposes of the IMF and the economic, monetary, and financial national objectives of the countries that they represent. An easier to implement alternative would be to include such a provision in the voluntary Code of Conduct that Executive Directors have drawn for themselves.

While the possibility of reelections may compromise independence, the two-year term for elected Executive Directors is too short for a Director to master all the complexities of the IMF operations, to establish productive relations with management, the staff and fellow Directors, and to become fully effective. Similarly, the possibility that presently exists that a large part, or even the entire Board, would change in a single election may not be appropriate for an efficient operation of the Board.

It seems that a superior system would be that appointed Directors are appointed for a fixed term during which, like their elected colleagues, they cannot be removed; that the term of both appointed and elected Directors is longer, say six years; that no Director can serve for more than one term; and that elections are carried out every two years for a staggered renewal of a third of elected Directors each time. All these proposals would require amendments to the Articles of Agreement and, therefore, a majority of 85 percent of the voting power. The introduction of these changes could be simultaneous with the activation of the Council, which would offer member countries political oversight over

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<sup>5</sup> If this were not the case the Articles of Agreement would have to be revised and amended.

the Fund's activities, given that according to the Articles of Agreement the Executive Board should not adopt any decision inconsistent with actions taken by either the Board of Governors or the Council.<sup>6</sup> The Executive Board would be more independent in running the daily business of the Fund, but if there were major issues in which fundamental interests of member countries were inappropriately affected by a too independent Board with insufficient accountability, the Council could still be able to redress the situation. A provision could also be established that an Executive Director could be removed from his office by the Council, with the decision being taken by a majority in terms of number of Councilors rather than voting power. This type of arrangement would seem to appropriately balance independence and accountability for the Executive Board.

Another way of strengthening the autonomy and effectiveness of the Executive Board, which does not depend on changing any rules, would be for the countries to appoint and elect officials that, in addition to being highly capable, have an even higher stature and seniority in their own countries, which would help them to withstand pressure. The proposals presented here for extending and giving a longer fixed term to Executive Directors could act as a further incentive for countries to appoint their most able representatives as Executive Directors.

Power without accountability often leads to abuse. It is not possible to advocate greater power and autonomy for the Executive Board and Executive Directors dissociated from stronger and more effective accountability. Conversely, it is not logical to demand more accountability if those who are to be held accountable are not given the appropriate means to achieve the goals for which they will be accountable. Strengthening the autonomy of the Executive Board and of Executive Directors should go hand in hand with increasing their accountability, and vice-versa.

Refocusing the IMF on its core areas of expertise and its traditional mandate of ensuring domestic and external macroeconomic stability of member countries and the well-functioning of the international monetary system is another important aspect to strengthen accountability, and will be considered in section (f) below. If an institution pursues a wide range of objectives that involve significant trade-offs among them, it is more difficult to establish a system of accountability based on ensuring independence of decision-makers who are to be judged by the quality of the decisions taken and the results achieved. Effective output accountability requires a relatively narrow number of non-conflicting objectives in relation to which the decision-maker can be held accountable.

In discussing accountability, there are at least three issues that are necessary to specify: accountability to **whom**, in relation to **what**, and **how**. Clearly, while each Executive Director should be accountable to the countries that appointed or elected him or her, the Executive Board as a body should be accountable to the higher organs in the Fund's governance structure and to international public opinion at large. In relation to **what** accountability should be judged, the Fund's Articles of Agreement provide the main yardstick. The Executive Board as a group should be accountable for ensuring that the

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<sup>6</sup> Section (g) below deals in greater detail with the Council.

Fund in all its activities is guided by the purposes, rules, and limitations enshrined in the Articles of Agreement and that it tries to achieve those purposes in an even-handed manner that is most efficient and cost-effective. Individual Executive Directors, in addition to being accountable for the same, should also be accountable for how well they perform their representation role.

Regarding **how** to achieve accountability, the usual instruments are enhanced transparency, public appearance and testimony, regular reporting, and evaluation by independent third parties. The Executive Board has already advanced considerably in relation to transparency of its activities. However, additional steps should be taken in improving regular reporting and providing for independent third party evaluations.

The Executive Board has already created a joint Board-staff group to improve the IMF's annual report, which should be the main instrument for the accountability of the Fund and the Executive Board with respect to the Board of Governors and public opinion. The report should give more preeminence to how well the Fund is faring with respect to adhering in its activities to the purposes envisaged in the Articles of Agreement, and to include a specific section on the Executive Board's work that should be seen and designed as one of the main instrument for accountability of the Board. This could give the Board of Governors and the IMFC a chance to provide an opinion on how well the Executive Board is discharging its responsibilities.

Regarding independent third party evaluations, the Executive Board could ask its Evaluation Committee to arrange an external evaluation of the Board's effectiveness in discharging its obligations according to the Articles of Agreement, to be conducted by a group of eminent persons familiar with the Fund and the Board's work, say, every five years.

Executive Directors have already taken important steps to improve their individual accountability by drafting a voluntary Code of Conduct and establishing an Ethics Committee to oversee compliance. Such Code, however, deals solely with the personal behavior of Executive Directors in issues such as financial dealings, avoiding conflicts of interest, maintaining confidentiality of information, treatment of colleagues and subordinates, and other standards of personal ethical conduct. It does not include any provisions with respect to the professional conduct of Executive Directors.

One alternative to increase the accountability of individual Executive Directors to their constituents with respect to how well they discharge their representation duties could be to include in such Code provisions related to best practices in representation, and the obligations to present regular reports to the constituency and to appear and testify in public and private meetings if asked by the constituent countries. Executive Directors may also wish to submit themselves to a process of anonymous and totally confidential evaluations by their fellow Directors and by their constituents on how well they discharge their professional duties to be used as a feedback on their performance.

While the decisions to implement the above proposals related to increasing the accountability of the Executive Board and of Executive Directors do not involve changing the Articles and can be taken by a simple majority, they should be adopted only with a very broad consensus.

*b) Moderately increasing the aggregate voting power of developing countries:<sup>7</sup>*

The *voting power* of member countries is based on their quotas and basic votes. Quotas, which are the main component of voting power, are related to a country's relative economic strength in the world economy. Quotas are calculated according to formulas, but for almost all countries their *actual quotas* differ from their *calculated quotas*. Every five years the Fund conducts a general review of quotas to determine whether a quota increase is needed. If there is a general quota increase, a part of such increase is done in an equiproportional fashion, that is, based on the current distribution of actual quotas, and part is done in a selective fashion, that is, based on the calculated quotas with an aim of bringing actual quotas more in line with calculated quotas. On average, the equiproportional component of quota increases has been around 70 percent. Equiproportional quota increases delay the convergence of actual quotas to calculated quotas, introducing an element of inertia favoring the existing quota distribution.

A country's quota determines how much the country should contribute to the IMF's resources, how much the country is able to borrow from the IMF (access to resources is defined as multiples of the quota), what will be the country's share in any allocation of SDRs (Special Drawing Rights) and, last but not least, what is its voting power.

*Basic votes* are the same for all countries. Each member of the IMF receives on joining 250 basic votes. Basic votes are based on the idea of the equality amongst states and resemble the United Nations system of one country one vote. When the Fund was created, basic votes represented 11.3 percent of the total voting power. The proportion of basic votes peaked at 15.6 percent in 1958, but currently is only about 2 percent. The decline in the importance of basic votes was a result of the repeated increases of the Fund's quotas, which had a much larger effect on the voting structure than the increases in the number of members. An increase in basic votes raises the voting power of small countries. Out of the total membership of 184 countries, for 25 members basic votes represent more than half of their voting power, but these members account for only 0.4 percent of the total voting power in the IMF, whereas for 60 countries basic votes account for 20 percent of their voting power, while these countries represent only 1.9 percent of the total IMF voting power<sup>8</sup>.

Industrial countries represent about 60 percent of the voting power, while emerging markets, transition economies and developing countries account for about 40 percent of the voting power. The United States have the largest voting share with 17.2 percent,

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<sup>7</sup> The references in this section to developing countries should be meant to include emerging market countries and transition economies as well.

<sup>8</sup> Kelkar, Yadav and Chaudhry 2004, page 739.



while the Executive Director representing mainly francophone African countries has the smallest voting share of 1.2 percent. In terms of geographical balance, Europe<sup>9</sup> has 39.1 percent of the voting power, the Americas have 29.6 percent, Asia accounts for 18.0 percent, the Middle East for 8.6 percent, and sub-Saharan Africa for 4.4 percent.<sup>10</sup>

Increasing the influence of developing countries in the decision-making process would contribute to good governance. While there is more than one way to achieve this aim, the most important and straightforward one would be a measured increase in the aggregate voting share of developing countries. Narrowing the voting majority of industrial countries, while preserving their ultimate control of the institution, would make it somewhat more difficult to impose majority decisions and could create incentives to strengthen the tradition of deciding by consensus rather than by voting. To be politically feasible, an increase in voting power of developing countries needs to respect three constraints: to maintain the majority of voting power in the hands of industrial countries; not to endanger the current veto power held by the United States; and to benefit a large number of developing countries. There could be an objective, for instance, to increase the aggregate voting power of developing countries from the current 40 percent to 45-47 percent.

It would be essential to use the opportunity to correct existing distortions in the individual quota shares of a number of emerging markets, such as Korea, Turkey, China, South Africa, Iran, Mexico and Brazil, whose quota shares are out of line with the increased importance of these countries in the world economy, as well as with their potential need for IMF resources. While the quota shares of some of industrial countries also do not adequately reflect their position in the world economy, the case of emerging markets is more pressing because their actual quotas are restricting their normal access to IMF resources, and forcing some of these countries to pay higher interest rates, face shorter repayment periods, and accept more demanding procedural rules to receive IMF loans.

The strategy for achieving a greater voting-share for developing countries in the Fund would have to combine three instruments to muster sufficient support within the group: a new, simplified, single quota formula; *ad hoc* selective quota increases for emerging markets whose actual quotas are most out-of-line according to the new formula; and an increase in basic votes. With the exception of a new quota formula, which can be approved by simple majority, the other two decisions mentioned here require an 85 percent majority to be approved. This indicates that they can only be approved as a **package**, and would depend on the highest qualities of cooperation of all members, especially those whose quota shares would be reduced by the proposed changes.

As quota shares and voting power represent a zero sum game, where some countries have to lose what others would gain, there should be a reasonable case not only to identify the

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<sup>9</sup> Including Russia and the Eastern European transition economies, but excluding Spain that forms a constituency with Mexico, Venezuela and other Latin American countries, and Ireland that forms a constituency with Canada.

<sup>10</sup> The sum does not add to 100 as certain countries have been suspended from their voting rights due to arrears and did not vote in the last election of Executive Directors.

countries that would potentially benefit, but also those countries that would have to adjust downward. The most straightforward case would be for a gradual reduction of the aggregate quotas of Western European countries, which currently is around 36 percent.

As mentioned earlier, Europe -in particular Western Europe- is the continent with the largest aggregate quota. This was justified on historical grounds, since the Fund was created mainly to facilitate and finance the adjustment process and the liberalization of the current accounts of Western European countries after World War II. Since then, however, the situation has changed dramatically for the better. The last time a Western European country borrowed from the Fund was in 1976. Current and capital accounts in Western European countries have been totally and successfully liberalized. More importantly, 12 (to become possibly 25) European countries have adopted a single currency to trade amongst them. The current quota formulas unduly overestimate the quota shares of the European Monetary Union member countries by treating trade conducted amongst them in a single currency as foreign trade. The current 15 members of the European Union have an aggregate quota share close to 30 percent. This is much higher than the quota share of the United States, with little economic justification, as both have GDP of a similar size.

Any possible adjustment in the quota shares of members of the European Union would have to be phased in gradually over a long period. The first step could be a small, *ad hoc* selective quota increase for a few developing countries, whose actual quotas are most out-of-line according to a new quota formula.

Regardless of what positions are with respect to increasing the voting power of developing countries, there is a strong technical case for *changing the quota formulas*, which are complex and opaque and have several specific problems. There are too many formulas; they contain too many variables; some variables are not directly related to the functions of quotas and produce unwarranted distortions; the specification of some variables seems biased and inappropriate; and the weights used, while being a matter of judgment, have been chosen in a totally *ad hoc* fashion and appear difficult to justify. The quota formulas discriminate against developing countries whose aggregate calculated quotas have tended to fall.

These problems go back to the creation of the IMF. Raymond Mikesell, the secretary of the Committee on Quotas in the Bretton Woods conference and the author of the original Bretton Woods formula, confessed in his memoirs that his superior at the US Treasury gave him the quota results for the four largest shareholders, which had been agreed by the highest political level in the US, and that he had to go through several trials using different weights and combinations of trade data until the quota formula produced the predetermined results. He also acknowledged that the lack of candor regarding quotas was unfortunate as it created considerable controversy and mistrust, and that assigning quotas had been the most difficult and divisive task of the conference (Mikesell 1994, pages 22, 35 and 38).

Developing countries have long complained about the quota formulas and asked that they be revised. At their insistence, the Interim Committee stated, in its September 1997 press communiqué, “that the formulas used to calculate quotas be reviewed by the Board promptly after the completion of the eleventh quota review”. In 1999, the Fund commissioned a quota formula review to a group of outside experts chaired by Richard Cooper.

The group produced a valuable report suggesting a reduction in the number of formulas to one, reducing the variables in the formula to three: GDP valued at market exchange rate as a measure of capacity to contribute, and variability of external current receipts and long-term capital flows as measures of potential need of Fund resources, attributing to GDP twice the weight of all other variables (Quota Formula Review Group, 2000).

However, the formula proposed in the Cooper report produced an undesirable quota distribution, as it would increase the aggregate calculated quota share of G-7 countries to 59 percent, compared to an aggregate calculated quota of 54 percent according to the current formulas and an aggregate actual quota share of 47 percent. At the same time, the aggregate calculated quota share of developing countries would increase only marginally in relation to the calculated quotas produced by the current formulas, but would still remain below their aggregate actual quota share. Given such outcome, the Cooper report did not command support. However, this result was mainly due to the fact that the report looked at only one instrument –quotas- as required by its terms of reference, and adopted an inappropriate specification for GDP, valued at market exchange rates. If the proposals in the report are combined, for instance, with a simultaneous increase in basic votes, and/or with a specification for GDP valued at PPP exchange rates, or a variant of it, the aggregate gain of industrial countries would disappear or be smaller. Therefore, the Cooper report still represents a valuable input on which to build.

The current five formulas are based on six variables: the last observation for GNP at current prices converted at market exchange rate; a 12-months average of official reserves; a five-year average for current external receipts; a five-year average for current external payments; variability of external current receipts measured over a 13-year period; the GDP/export ratio. The weights attributed to these variables vary in each of the five formulas.

There are a number of problems with this choice of variables. The inclusion of current external receipts and the GDP/export ratio as measures of capacity to contribute is the main inadequacy. While GDP is a measure of value added, current external receipts is a gross variable, which involves double counting. The problem is the greatest with respect to members of a monetary union or entrepôt states that engage in vast amounts of imports and exports, with the same goods crossing borders several times in different stages of production. The Cooper report estimated that in the case of EMU members, quotas would fall by about 9 percentage points if intra-union trade were excluded. The argument that external current payments indicate the extent to which GDP can be used to meet external obligations is dubious, as what would count here is value added in the tradable sector.

Ideally, the quota formula should contain only a few economic variables that are closely related to the functions that quotas should perform. I would suggest no more than three variables. GDP should be the single most important. It is a comprehensive measure of the capacity to contribute. It is also a measure of potential need for Fund resources and a good criterion to determine voting power in a financial institution. As a measure of vulnerability, and, therefore, of potential need for Fund resources, a proxy could be the variability of the current account. This variable would capture different types of shocks that member countries may be exposed to, such as a fall in export values or volumes, or a fall in capital flows leading to compression of imports. International reserves could also be a variable included. Reserves have traditionally played an important role in Fund quotas and are an essential element of the external position of many countries.

An issue that is important for developing countries is how GDP would be valued. Market exchange rates that are currently used tend to underestimate the contribution of non-tradable sectors of developing countries. Even with respect to tradable sectors, market exchange rates may not fully equalize prices across countries even after allowances are made for the costs of transportation and differences in quality. A better alternative would be to use PPP exchange rates, which are already extensively used by the Fund in several reports such as the World Economic Outlook. Calculations of GDP at PPP exchange rates are available for 176 countries.

A political problem with the use of PPP exchange rate would be that it would change dramatically the ranking of quota shares of important countries. China, for instance, would become the second largest IMF shareholder, overtaking Japan. One solution to this, proposed in Kelkar, Yadav and Chaudhry, 2004, would be to use some agreed combination of PPP and market exchange rate.

With respect to weights, as GDP is the most important variable, it should have a weight that is more than half the total weight. In the 1960s, in order to circumvent the difficulties in reaching consensus on weights, multiple quota formulas were introduced. All formulas are based on the same variables, but in each formula the weights are different. The practice of multiple formulas should be abandoned. This is a non-transparent way of assigning weights. With multiple formulas, the same variable would receive different weights and each member would choose the one that it is more favorable. Normalizing individual quota shares through averaging to sum to 100 percent has the effect of de-linking the chosen economic variables from the quota distribution.

The creation of a new, single, simpler and more transparent quota formula, with fewer variables more directly related to the functions of quotas and giving greater weight to GDP, would increase the calculated quotas of large member countries, industrial countries and emerging markets alike, at the expense of small countries. However, the introduction of some weighted average of market and PPP exchange rates to value GDP would moderate the increase in calculated quotas of large industrial countries and boost the increase in calculated quotas of large emerging markets. It would also cause most of this adjustment to fall on small European industrial countries rather than small

developing countries. This change in the quota formula would require a simple majority and should be the first step in the strategy.

The second step, which would require an 85 percent majority, could be an *ad hoc* selective quota increase for countries whose quota shares are most out of line with the new formula. This would probably increase the aggregate actual quota share of developing countries by some 5-percentage points. It would also increase the actual quota shares of large industrial countries, but probably by a smaller amount.

The third step, which would also require an 85 percent majority and an amendment of the Articles, should be an increase in basic votes to a higher proportion of the total voting power than the current 2 percent. This would have the effect of diminishing the voting shares of large member countries, industrial and emerging countries alike, that is, all countries whose individual quota shares are higher than the average. As there are more small developing countries than small industrial countries, the end result would be an increase in the aggregate voting share of developing countries. Increasing the proportion of basic votes to, for instance, 6 percent of the total voting power would represent an increase in the aggregate voting power of developing countries by some 2 percentage points.

The combination of an *ad hoc* quota increase for emerging markets based on a new formula with an increase in basic votes could generate an increase in the aggregate voting power of developing countries of around 7 percentage points, while correcting distortions in individual quota shares of the countries most out of line.

*c) Making the selection process of the Managing Director more transparent and inclusive:*

The Managing Director is the Chairman of the Executive Board and the chief operating officer of the Fund, conducting the ordinary business of the Fund under the direction of the Executive Board. While having a vote only in the unlikely event of a tie, the Managing Director exercises a large influence on the decision-making process, given the nature, considerable authority and prestige of his office. The main source of influence of the Managing Director is his direct command over the staff. Usually, all issues discussed by the Executive Board are based on written proposals presented in papers prepared by the staff, which are previously approved by the Managing Director or one of the three Deputy-Managing Directors who assist the Managing Director.

The informal agreement between the United States and Western Europe whereby the latter chooses the Managing Director of the IMF while the former appoints the President of the World Bank restricts the effective participation of other member countries in these important choices. This arrangement has been increasingly challenged by the excluded member countries and would eventually have to change.

On the occasion of the succession of Michel Camdessus, Executive Directors members of the G-11, a country group representing the developing countries, took the unprecedented step of publicly proposing three criteria that should be adopted in the selection process: the process should aim to choose the best person for the job, irrespective of nationality, with a plurality of candidates from all regions being in the best interest of the institution; all Executive Directors should be informed in a timely manner about the candidates and their credentials; all Executive Directors should be consulted in the process of selecting a candidate.

The wide dissatisfaction with the existing closed and non-transparent selection process led to the formation of a Joint Working Group of Fund and Bank Executive Directors to propose better procedures for the selection process. The group presented a report that was endorsed by the Executive Board in 2001, although such endorsement did not constitute a formal decision adopting the specific recommendations. The report proposed that once a vacancy occurs, Executive Directors decide on the required qualifications of the candidates, establish a small advisory group to assist in the selection, and decide on the key steps and procedures of the selection process. The advisory group would be formed by eminent persons familiar with the Fund and would have a balanced geographical representation. The Dean –the longest serving Executive Director- would be an observer in the advisory group and act as the liaison with the Executive Board. The advisory group could hire external expertise for the search. The advisory group would review all candidates and provide strictly confidential assessments to the Executive Board without ranking the candidates. The Executive Directors would agree on a shortlist, establish a deadline for candidacies, and decide on the modalities to publicize the final shortlist. The final stage would be the formal selection of the Managing Director from the short list of candidates.

Due to the sudden departure of Horst Kohler, Executive Directors agreed not to apply for his succession the idea of forming an advisory search group. However, the support for the thrust of the Joint Report was maintained by a large number of Executive Directors. This included the principles that had been suggested earlier by the G-11 Executive Directors, which had been incorporated in the report. A group of Directors including the G-11 Executive Directors plus the Executive Directors representing Australia, Russia, and Switzerland expressed public support to those principles. Therefore, the process proposed by the working group, while yet not tested, seems still to offer the best prospects for making the selection of the Managing Director more open to greater participation of all member countries. Thus, the objective should be to implement the process proposed in the Joint Report in the next succession, i.e. when the incumbent Managing Director decides that he will not run for reelection. As the joint nature of the report indicates, any decision in the Fund would have repercussions at the World Bank.

*d) Preserving and strengthening consensus decision-making:*

The adoption of decisions in the IMF, in addition to formal voting power, is influenced by an informal tradition of *consensus decision-making*. The IMF procedural rules require

that the chairman normally ascertain the sense of the meeting rather than placing the issue to the vote. While the sense of the meeting is understood to be the position that, if put to vote, would carry the required majority, an effort is normally made to avoid a narrow simple majority. Thus, while consensus in the sense adopted in the Fund would not require unanimity, it is generally understood that it means a large majority and the absence of explicit, significant and strong dissent. There is an elaborate counting system for gauging support to positions in terms of numbers of Executive Directors rather than voting power, which is normally used to indicate support for specified positions, although on occasion the Summing Up of the meeting<sup>11</sup> refers to a majority of Executive Directors. When major disagreements emerge in the discussion of a policy topic, the chairman would try, either in the same or in subsequent meetings, to suggest orally or in additional staff papers possible avenues for a reconciliation of positions and would encourage further consideration of the topic. Additional papers would be prepared and further meetings would be held until a broad consensus emerges. In addition to the chairman, the Dean usually also plays an important constructive role in consensus building, seeking to suggest alternatives to generate a convergence of views.

The consensus building approach is used mainly for policy decisions. The discussions on bilateral and multilateral surveillance, where no decision is taken, involve no attempts at consensus building. With respect to loan decisions, the proposals presented by the Managing Director are generally accepted.<sup>12</sup> The potential rejection of a proposed loan is internalized by the staff and management so that only loans that have an almost 100 percent probability of being approved are actually brought to the Executive Board. In practice, the power of the Board of rejecting a loan is exercised *ex ante*. In order to avoid problems and not to preempt the Executive Board's powers, informal consultations with the Executive Board are now conducted prior to the negotiations being finalized for loans that involve what is considered an exceptionally large access (more than 100 percent of quota annually or 300 percent of quota on a cumulative basis). In addition, in large or contentious cases, management undertakes even earlier informal consultations with the G-7 countries.

The consensus decision-making approach to the adoption of policy decisions has important advantages both for industrial countries and developing countries, as well as for the Fund as an institution. For developing countries, which have a minority voting position, the consensus decision-making approach may yield a voice that is larger than their share of votes and a possibility of having greater influence in policy decisions. This, of course, depends critically on having able Executive Directors who have solid technical expertise, strong ability for oral debate, high powers of persuasion, and diplomatic skills.

For industrial countries, consensus decision-making helps to preserve the system of weighted voting that distinguishes the IMF from other international organizations, by making such system more acceptable to debtor countries. Moreover, as it is applied

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<sup>11</sup> The summing up is the summary of the views expressed by Executive Directors, and certain portions of it have the legal value of a Board decision.

<sup>12</sup> However, there are sometimes abstentions, which on occasion may be large, such as in the loans for Mexico in 1995 and for Argentina in 2002.

mainly to policy decisions, it does not disenfranchise the voting majority of industrial countries in the type of decisions that would matter most to them as creditors, namely the decisions on IMF loans.

For the institution as a whole, by increasing the legitimacy and acceptability of policy decisions, consensus decision-making has the advantage of increasing the likelihood that those decisions will be effectively implemented. This is very important since the IMF relies mainly on the cooperation of member countries to implement its decisions, especially those that are not associated with lending. While the consensus decision-making approach is more time-consuming and requires more effort up front, it may lead to better decisions. It forces Executive Directors to better argue and justify their positions in terms of the substance of the case rather than voting power. Executive Directors have to articulate the rationale of their positions and to respond to those Directors that counter-argue or present different ideas. This strengthens the power of ideas and contributes to every angle of a problem receiving appropriate scrutiny and attention, ultimately leading to better decisions. It may also act as an incentive for all member countries to appoint or elect to the position of Executive Directors able representatives, thus strengthening the status and the quality of the Executive Board.

A few commentators have proposed abolishing the consensus decision-making approach on the grounds that consensus and compromise are inimical to accountability. The idea is that forcing Directors to take formal votes to make clear their positions would increase accountability.<sup>13</sup> I disagree that consensus and compromise are inimical to accountability. As argued above, consensus decision-making forces participants to make explicit their arguments. As long as all discussions are registered in the Board minutes, there should be no loss of accountability. On the contrary, by forcing Directors to justify their positions, this method could help strengthen accountability. Moreover, the approach applies mainly to policy decisions. With respect to lending decisions, Executive Directors occasionally register their dissenting position by abstaining, with the abstentions being registered in the summing up and in the minutes.

The consensus decision-making approach rests solely on tradition and seems to have experienced some erosion in recent times. The reasons for such erosion are unclear. However, several factors may be at work: the disposition to compromise by member governments and Executive Directors may have decreased; the disposition of the chair of the Board to spend the additional time and to undertake the additional work required by consensus decision-making may have diminished; and the tendency of countries to pre-establish inflexible positions within country groupings to exercise a voting majority may have increased. Given that no member country commands a majority alone, and considering that the behavior of the chair, in the end, would conform to the majority, it seems that, out of these factors, the operation of country groupings is the most important one.

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<sup>13</sup> See, for instance, Woods 1998 pages 88-91, De Gregorio, Eichengreen, Ito and Wyplosz 1999, and Bradlow 2001.



Indeed, the functioning of informal country groupings is a major factor in the Fund's decision-making process. There are a number of informal country groupings operating in the IMF, such as the G-7, the G-10, the G11, the G-24, the G-20, and regional caucuses such as the EURIMF and Asian-Pacific Group. Country groups are an inevitable reality in the global economy, which goes beyond the IMF. They may be helpful coordinating devices and could contribute to generate consensus around initial positions amongst their members. However, depending on how they function, country groupings may detract from consensus decision-making. If initial positions are non-negotiable and used solely to exercise inflexible majorities, there are the risks that issues would not be analyzed on their own merits except inside the groups, and that the decision-making becomes more confrontational and polarized. The actions of country groupings should be conducted in a way that does not undermine objective decision-making based on merit of individual cases and preserves the role of the Executive Board.

As mentioned earlier, the way the G-7 operates in some instances creates difficulties to consensus decision-making. The G-7 Finance Ministers regularly adopt and publicize decisions for common positions with respect to initiatives to be introduced in the IMF that later are pushed on the entire IMF membership without enough opportunity for compromise. The G-7 actions set the dynamics for the behavior of both other country groupings and management. The country groups of developing countries (the G-11 and the G-24) have the incentive to act similarly, but in practice they can do this only in order to take defensive action. Similarly, in order to avoid defeats or embarrassment in Board meetings, management consults informally with G-7 Executive Directors prior to bringing proposals to the Executive Board and prior to undertaking similar informal consultations with the other Executive Directors, who often are not consulted at all prior to the Board meetings, which detracts from good governance.

It is important for all Executive Directors, the Managing Director, and his Deputies to be more aware and appreciative of the long-term benefits of consensus decision-making, and to make an effort to strengthen consensus decision-making on policy decisions. There is also merit in going somewhat beyond attitudes, and trying to achieve greater institutionalization of the tradition of consensus decision-making.

The IMF procedural rules could be amended to instruct the chairman to avoid narrow majorities with respect to policy decisions. In policy decisions, whenever there is a divergence between the majority of voting power and the majority of the number of Executive Directors, and the majority of voting power is a narrow one, the chairman should be required to postpone the decision once in order to try to reach consensus. The chairman and the Dean should be formally given the task of actively seeking to generate consensus during this period. The summings up should avoid using language referring to majority, and should generally stick to the methods of indicating support in terms of the number of Executive Directors. These are modest proposals to institutionalize what, in practice, used to happen. If a policy topic is decided by majority voting rather than consensus, then the minutes of the Board meeting and the voting results identifying the positions of each Director could be publicized soon after the decision.

Finally, when there are informal consultations between management and informal groupings of Executive Directors with respect to policy initiatives, there should be a procedural rule instructing the Managing Director to hold similar meetings with all other Board members to ensure that there is no asymmetry of information amongst Executive Directors. The procedural rules proposed here would apply only to policy initiatives and not to lending decisions, with respect to which publication of minutes with divergent views could unsettle markets, and rigid rules with respect to informal communications could complicate negotiations.

*e) Improving the constituency system:*

An important feature of the IMF's organizational structure is the *constituency system*. A constituency is a group of countries that join to elect an Executive Director. The elected Executive Director represents the constituent countries' interests in the Fund, and casts as a unit these countries' votes in Executive Board decisions.

Constituencies may be based on informal arrangements or on a written agreement amongst the participating countries. The understandings to form a constituency usually establish the commitment of member countries to vote for a single candidate for Executive Director, the rotation schedule amongst member countries to nominate the candidate for Executive Director, and the rotation schedule for the distribution of the positions of Alternate Executive Director, Senior Advisors, and Advisors within the office of the Executive Director. The constituencies usually meet regularly, normally twice a year prior to the spring and Annual Meetings, to decide common positions on topics under discussion on the Fund's agenda and other matters of interest to member countries. In addition, there is usually permanent dialogue and consultation between the Executive Director and the members of a constituency, who are regularly canvassed in advance regarding major policy topics to be discussed in the Executive Board.

There are 16 Executive Directors who represent constituencies and eight Executive Directors who represent single countries. The latter are the five Directors appointed by the countries with the largest quotas (USA, Japan, Germany, France and UK) and three Executive Directors elected by single countries, which have sufficiently large quotas and prefer to elect alone an Executive Director (Saudi Arabia, China and Russia). Of the 16 constituencies, there are seven that mix industrial countries, emerging markets, transition economies and developing countries (headed by Belgium, Netherlands, Canada, Italy, a Nordic European country which is currently Sweden, Australia or Korea, and Switzerland), and nine that are composed mainly of emerging markets and developing countries (Mexico or Venezuela or Spain, Tanzania, Malaysia or Indonesia, Egypt, Brazil, India, Iran, Argentina or Chile or Peru, Equatorial Guinea)<sup>14</sup>.

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<sup>14</sup> The Directorship in the two sub-Saharan African constituencies currently with Tanzania and Equatorial Guinea rotate with most members of the constituency participating in the rotation schedule.

A number of issues, however, have been raised with respect to the constituency system and surely there is room for improving its efficiency in representing member countries.<sup>15</sup> Do multi-country constituencies that mix industrial countries, transition economies, and developing countries manage to adequately reflect the views of all of them, or would more homogeneous constituencies improve representation? Do constituencies where there is a dominant country offer proper representation for the smaller members? Is there an ideal size of a constituency in terms of number of countries in order to maintain efficiency and appropriate representation? Should the number of elected Executive Directors be increased further so as to give more representation to developing countries and transition economies and to reduce the size of constituencies that seem too large? How can Executive Directors elected by multi-country constituencies be made more accountable to their constituents? How to ensure that the voices of all members of a constituency are heard? What can be done further to strengthen the operational capacity and effectiveness of multi-country constituencies?

There are diverging views regarding the role of mixed multi-country constituencies. Some point out to the fact that, by having to represent both types of countries and having first hand experience with problems of debtor countries, some mixed multi-country constituencies function as a middle ground between industrial countries and developing countries and, therefore, strengthen consensus building (Van Houtven, 2002, page 21 and De Larosière, 2004, page 29). Developing countries participating in mixed constituencies may succeed in leveraging the voting power of the dominant country to support their positions. Examples are the positions taken by the chair headed by Belgium on the issue of the financial structure of the Fund, by the chair headed by the Netherlands on the topic of streamlining conditionality, and by Switzerland and Australia on the question of the election of the Managing Director. Others stress that often some mixed constituencies tend to adopt positions akin to those of industrial countries, and that developing countries and transition economies that are members of those constituencies would be better served if they were part of a more homogeneous constituency.<sup>16</sup> There are elements of truth in both arguments and it is difficult to decide which one should receive the greatest weight. Possibly the only solution would be to let the countries that belong to mixed constituencies decide for themselves. But for that choice to be viable, it would be necessary to create the conditions so that those countries can appoint representatives with the same level of seniority and for the same length of time in a more homogeneous constituency as they currently are able to do in mixed constituencies.

Emerging markets, developing countries, and transition economies that belong to mixed constituencies account for an aggregate voting share of 6.9 percent. As the Articles of Agreement require that an Executive Director casts all votes that elected him or her as a unit, these votes would generally go to the industrial countries camp, if it is true that mixed constituencies tend to align more often than not with those countries' positions. In that case, if developing countries and transition economies that belong to mixed constituencies were to form new constituencies or to move to constituencies whose

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<sup>15</sup> See Woods and Lombardi 2004.

<sup>16</sup> See Gerster, 1993, page 124, and Woods and Lombardi, 2004, pages 21-22

Executive Directors come from developing countries, this would increase the voting strength of the group of developing countries in the Executive Board by 6.9 percentage points.

A related issue is whether constituencies where there is a dominant country allow for proper representation of the smaller countries. There are some multi-country constituencies representing developing countries, such as those chaired by Brazil, Egypt, Iran and India, where the Executive Directors always come from these dominant countries.<sup>17</sup> Like in the previous paragraph, again this is a question that is difficult to answer. This, however, is a problem of a different nature from the one raised by mixed constituencies, and it would require a different solution. While most mixed constituencies also tend to be dominated by a single country electing the Executive Director, the main difference is that developing countries' constituencies dominated by a single country are homogeneous constituencies where the interests of all members tend to be naturally aligned. All countries share similar socio-economic conditions, normally have closer cultural traditions, and belong to the same geographical area, although there might still be differences such as large and small countries, oil producer and oil consumer. However, if the smaller countries in a homogeneous multi-country constituency where there is a dominant country are not adequately represented, it seems more likely that the issue would be more one of an inadequate job performed by the Executive Director than a structural problem of conflicting interests amongst the constituency members. The solution to this problem, to the extent that it exists, would then also have to be different. Rather than redesigning the constituency itself, the case would be to have better mechanisms to hold the Executive Director accountable.

A third topic related to the composition of constituencies is that the two multi-country constituencies representing African countries are too large with 21 and 24 countries each, whereas the average size of multi-country constituencies is 11 members. This increases the burden of the Executive Director, especially because most of the countries are engaged in long-term borrowing relationships with the Fund, which are quite demanding in terms of work. The simplest way to begin tackling this issue is to increase the human and material resources available to these constituencies, which has already been done, but this alone may not be sufficient.

The issues posed by constituencies that are too large and by mixed constituencies raise the question of whether the size or composition of the Executive Board or the distribution of countries amongst constituencies should be changed. These are complex and difficult questions to tackle. The organization of constituencies has been appropriately left mostly to the political decisions of member countries, and there are only a few rules in the Articles of Agreement that impact the formation or operation of constituencies. The composition of constituencies has varied considerably in the history of IMF with several instances of countries changing constituencies.<sup>18</sup>

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<sup>17</sup> While the dominance of Brazil and India appears to result from the fact that these countries have a voting majority within the constituency, this is not the case of Egypt and Iran.

<sup>18</sup> See Woods and Lombardi 2004, page 3.

There are two rules that affect the formation of constituencies. First, the minimum and maximum shares of votes that each elected Executive Director should receive that are set in the Articles at 4 and 9 percent of total votes respectively. These proportions may be changed for each election by the Board of Governors. The other rule governs the total number of elected Executive Directors, set in the Articles of Agreement at 15, a number that the Board of Governors may also increase or reduce by an 85 percent majority, and which since 1992 has been set at 19 Directors.

The number and composition of multi-country constituencies are a function of the above rules, as well as of the distribution of voting power amongst the countries that elect Executive Directors, of the number of positions available in the offices of Executive Directors to be shared amongst participating countries, and of geographical and cultural factors. Probably the provision of financial development assistance and technical assistance by industrial countries to small developing countries may also exercise an influence in the composition of constituencies. Moreover, there might be rigidities in the form of written long-term constituency agreements, whereby countries agree to participate in a given constituency for a certain period of time.

It seems that the current distribution of countries amongst constituencies represents an equilibrium, given the above rules, constraints, and preferences of member countries. A change in those variables, for instance an increase in the number of elected Executive Directors, would certainly affect the current distribution. However, given the large number of variables and the complex interplay amongst these variables, a change in one variable alone may affect the distribution in an unpredicted way, and not necessarily lead to the result that the proponents of such change might have in mind.

There has been, for instance, a suggestion to create a 25<sup>th</sup> chair in the Executive Board to allow one additional Executive Director to be elected by African countries with the formation of a new constituency, given the large number of members of the two sub-Saharan African constituencies. A move of some of these countries to the constituency chaired by Egypt would not solve the problem, as that constituency already encompasses 14 members. Giving Africa a fourth chair in the Executive Board would certainly increase and make more efficient the representation of that continent. Moreover, an additional chair for Africa would lead to a majority in the number of Executive Directors from developing countries, while industrial countries would still retain a majority of the voting power.

However, a mere increase in the number of Executive Directors, without any change in voting power, would not necessarily guarantee the outcome of giving Africa one more chair. The additional chair could, for instance, end up going to the European transition economies that are currently members of mixed constituencies. These transition economies together hold around 4.5 percent of the voting power, an aggregate voting share similar to that of the two sub-Saharan African constituencies. It seems plausible and justifiable that some of the transition economy countries could try to join to elect an Executive Director of their own if an additional chair is created. Many of these countries are also users or potential users of Fund resources and the case could be made that their

representation would improve if, instead of being part of a mixed constituency, they would form a constituency of their own. The influence in the Executive Board of the group of debtor countries and potential users of Fund resources would be equally increased in this way. A similar situation could develop with respect to Asian countries that currently belong to a mixed constituency. This indicates that any increase in the size of the Executive Board has to be part of a larger and carefully negotiated package of reforms that would also alter quotas and increase basic votes.

In addition, consideration should be given to the issue of whether it is desirable, from the point of view of efficiency of decision-making, to further increase the size of the Executive Board. As a result of the increase in the number of members from 45 to 184 countries, the Executive Board has doubled in size since the creation of the IMF. The original number of 12 Executive Directors had increased to 20 by 1964. In 1978, it was increased to 21 Directors to allow Saudi Arabia to elect alone an Executive Director, given that the Saudi riyal was one of the two currencies most used by the Fund in the two preceding years. In 1981, another increase to 22 Directors was done to allow the People's Republic of China to elect an Executive Director. The increase to the current size of 24 Directors was a result of the breakdown of the former Soviet Union, and of Russia, other transition economies, as well as Switzerland joining the Fund in the period 1990-1992.

If it were feasible, rather than further increasing the size of the Board, a preferable alternative would certainly be an amalgamation of some chairs currently occupied by Executive Directors representing Western Europe, especially members of the European Monetary Union, in order to open space for an additional chair for Africa and another one for the European transition economies.

In addition to the questions of the size and composition of the Executive Board and the distribution of countries amongst constituencies, there are also the issues of how to make all constituencies more efficient in representing the interests of member countries and how to make elected Executive Directors more accountable to their constituencies.

The efficiency of constituencies depends on the amount and quality of the human and material resources that are available to them as well as on the working routines that they follow. The personal qualifications of Executive Directors, Alternates, Senior Advisors, and Advisors are one of the most important factors. The Board has already agreed on job descriptions and minimum qualifications for the positions of Senior Advisors and Advisors to be used in a voluntary way as guidance by countries appointing candidates to those positions.

Training is already provided by the Fund to Senior Advisors and Advisors. One area, however, where improvements could be considered is to strengthen the capacity to deal with Fund issues in the capitals of developing countries. Support from capitals is an advantage that is enjoyed by the chairs representing industrial countries. A technical assistance program could be considered to help establish in the Ministries of Finance and Central Banks small units to deal with Fund issues that would offer support to the offices of Executive Directors. Where those units already exist, on the job training could be

provided for the staff of those units that could come to Washington for a short period of time to work temporarily in the offices of Executive Directors, attend a few Board meetings, and undertake especially tailored training programs in the IMF Institute.

With respect to best working practices, an effort has already been done to obtain information on how EDs' offices are organized and how they operate so as to identify working procedures that might be of interest to other offices. This effort could be deepened.

Regarding the accountability of Executive Directors, some proposals have already been presented in section (a) above. In addition, the Secretary could compute and publicize regularly statistical information relating to the amount of work produced by all EDs' offices. Moreover, the minutes of the Executive Board could be made available immediately to member countries regarding the interventions and statements of their own Executive Director.

*f) Keeping IMF conditionality focused on repayment capacity:*

The IMF has been placing increasing emphasis on major structural and institutional reforms in its member countries in areas that are clearly outside its mandate and areas of expertise. The IMF has been increasingly involved with structural reforms in a number of new areas, such as privatization, labor market reforms, judicial and legal reforms, bankruptcy regimes, corporate governance, and fighting corruption.

The process of expansion of the IMF outside its core areas has several roots. First, as the IMF is a relatively effective institution endowed with considerable leverage due to its lending capacity, there has been a tendency for important shareholders to use the agency to try to solve international problems that go beyond the Fund's mandate and expertise. Second, economic theory has been increasingly arguing that well-designed institutions that align private and social incentives play a key role in spurring long-term economic growth. Economic growth, in turn, is an important factor to maintain macroeconomic domestic and external stability, which is the IMF's mandate. Some people deduct from these two premises that, therefore, the IMF has an active role to play in promoting whatever structural and institutional reforms may be beneficial to growth. This type of logical fallacy can, of course, be used to justify the involvement of the IMF with anything that may affect economic growth, from political reforms to public safety. However, there are no good reasons to imagine that everything that is important or good in the world should be done by the IMF, while there are good arguments why this should not be the case.

The Fund should, indeed, be involved in promoting structural and institutional reforms that are within its mandate and core areas of expertise, that is, reforms with respect to fiscal institutions, monetary institutions, financial institutions, and exchange rate regimes. However, the IMF should refrain from expanding into areas not closely connected with its mandate of maintaining balance of payments equilibrium and domestic

macroeconomic stability, as this raises major problems of legitimacy, governance, and efficiency.

Member countries endowed the IMF with certain powers and instruments and partially relinquished their sovereignty in favor of the IMF in a specific and limited way and for predefined purposes. The use of these powers and instruments outside these specified circumstances or for purposes for which they have not been provided is an illegitimate encroachment on the sovereignty of members.

Moreover, the involvement of the IMF in new areas that are not related to its expertise raises the serious risk of spreading the institution too thin, and reducing its overall efficiency. As it is well known, there is a point where greater efficiency requires specialization and division of labor.

It is inappropriate for the IMF to go beyond its mandate in either its surveillance or lending activities. However, when this happens in surveillance, the consequences are less serious, since the IMF lacks instruments to impose its views. However, if the IMF uses its lending power to require conditions that are not necessary to safeguard the revolving nature of its resources and/or go beyond its areas of expertise and mandate, then this raises serious governance issues.

The IMF Articles of Agreement authorize the IMF to condition its lending on appropriate safeguards to ensure that those resources are used temporarily, that is, that the IMF is repaid in the agreed period of time. This authorization is the basis for IMF conditionality, which, therefore, should be related to ensuring that the country will have a sufficiently strong macroeconomic and external position to allow it to repay the Fund during the envisaged repayment period. This should include conditions that are required for countries to regain or maintain access to private international capital markets. Establishing conditions that are not necessary to ensure domestic and external macroeconomic stability sufficient for repayment goes beyond what is envisaged in the Articles.

The Articles also require that the main counterparts of the IMF in member countries should be the Ministries of Finance and Central Banks. The reason for this requirement is that the IMF is supposed to deal exclusively with economic and financial issues, for which Ministries of Finance and Central Banks are internally accountable in their own countries. However, if the IMF includes in its loans conditionality that goes beyond economic and financial issues this may create accountability problems for the country concerned. This is because the Fund's counterpart agencies in member countries - Ministries of Finance and Central Banks- were not designed to be accountable for issues other than economic and financial ones. Hence, the use of conditionality in areas outside the IMF's core areas of competence, in addition to creating problems of governance for the Fund itself, may also generate the same type problems in its member countries.

As cogently put by a distinguished commentator, the economic structure and the nature of the institutions of a country are for the legitimate political institutions of that country to



determine, and the country's need for financial resources does not give the IMF the moral right to substitute its technical opinion for the domestic political process, and to impose conditions that, though perhaps helpful, are not needed to deal with the balance of payments problems that the IMF is mandated to help solving (Feldstein 1998, page 27).

During the 1980s and 1990s, there has been an excessive and inappropriate expansion of IMF structural conditionality to topics that were not linked with the capacity to repay and that went beyond its core areas of expertise. This process seems to have started with the IMF's involvement in helping to solve the 1980s Latin American debt crisis. It was aggravated in the 1990s when, as a result of the breakdown of the Soviet Union, the IMF was involved in helping to build market institutions in Russia and Eastern European countries. It further worsened in the late 1990s during the Asian crisis when the IMF included an inordinate number of structural conditions in its loans for the Asian countries.

The excessive use of structural conditionality seems to have been a major reason for the bad public image of the IMF as a policeman of developing countries and as an enforcer of interests of creditors and international financial markets. An unfavorable international image is another factor that, in the long run, will reduce the IMF's effectiveness and efficiency.

As a response to this situation, the Executive Board approved in 2002 new Conditionality Guidelines requiring that structural conditionality be streamlined and limited only to topics that are critical to achieving the macroeconomic objectives of the program. The Guidelines also establish that structural conditionality should be generally limited to the Fund's core area of expertise. They also determine that the burden of the proof that conditionality is critical for achieving macroeconomic objectives of the program should fall upon the staff.

The new Guidelines have generated some welcome reduction in the number of structural conditionality, but this seems not to have gone far enough. There still seems to be a large number of structural conditions, and especially prior actions, that are not required for ensuring payment capacity and are outside the Fund's core areas of expertise in programs for low-income or middle-income small developing countries. This may be partly a question of implementation and enforcement of the existing guidelines. In fact, the previous 1979 Guidelines were more restrictive than the 2000 Guidelines, but were not able to deter the problem of multiplication of structural conditionality.

The Conditionality Guidelines are reviewed every two years. It is important to use these reviews to insist on further streamlining in structural conditionality and to avoid a weakening of the rules in ways that would allow the use of more structural conditions. In terms of improvement in the existing Guidelines, two aspects would be worth considering. First, to require that structural conditionality should be critical to achieving the macroeconomic objective of ensuring the repayment capacity during the repayment period, rather than other macroeconomic objectives. Second, to limit the use of structural conditionality only to the Fund's core areas of expertise.

Using such an approach does not mean that the IMF would overlook the question of increasing the potential rate of growth of the economy, to which all kinds of structural reforms may be necessary. It means only that the IMF would pursue the objective of raising potential growth with the same instruments that it uses in its non-borrowing members, namely persuasive policy advice and technical assistance, rather than using financial leverage.

*g) Turning the IMF into the main forum for international macroeconomic policy coordination:*

One of the main purposes of the IMF is to promote international cooperation on monetary and financial affairs, being the machinery for consultation and collaboration on these issues. However, of all IMF functions this is the one that is least developed. This function is currently performed by means of exercises of multilateral surveillance of global economic and financial conditions. Two major reports are prepared twice a year for that purpose, the World Economic Outlook and the Global Financial Stability Report. These reports are discussed by the Executive Board and later taken up by the IMFC, both of which make generic exhortations to certain countries or group of countries to pursue policies that are considered appropriate from their own perspective, but that are also required from a global point of view. There is, however, a clear need to enhance the effectiveness of multilateral surveillance.

In addition to the Executive Board, the main forum where these exercises of multilateral surveillance take place is the International Monetary and Financial Committee (IMFC). The IMFC is composed of 24 members, usually Finance Ministers or Central Bank Governors, appointed by the countries or group of countries that appoint or elect an Executive Director. It was created in 1999 as the successor of the Interim Committee. The Interim Committee was established in 1974 with a mandate to oversee the management and adaptation of the international monetary system, and was part of the reforms to deal with the breakdown of the Bretton Woods system of fixed but adjustable exchange rates and use of capital controls. The IMFC is an advisory body to the Board of Governors, and works in close relation with the Executive Board, discussing and expressing opinions on issues that have already been discussed by the Executive Board, and suggesting new topics to be examined by the Executive Board and to be later brought up for discussion in the IMFC.

Like its predecessor, at best the IMFC has a mixed record in promoting international cooperation in economic, monetary, and financial issues. In the late 1970s and early 1980s, the Interim Committee had not been successful in convincing industrial countries to pursue fiscal discipline, to reduce inflation, and to adjust exchange rate to reflect their fundamentals. Similarly, nowadays, the IMFC does not seem effective either in promoting a sufficiently high level of international cooperation that would lead to faster fiscal consolidation in the United States, greater exchange rate flexibility in Asia, and the adoption of bolder structural reforms in Europe and Japan so as to increase its potential rate of growth.

The functions of the IMFC are those of cooperation, that is, exchange of information, consultation, mutual encouragement, collective exhortation, and generic pledging to certain policies. The IMFC does not play any role in international macroeconomic policy coordination, that is, in countries collectively agreeing, implementing, and monitoring, in an even-handed manner, changes in their domestic policies that due to economic interdependence they believe would be beneficial to all of them. Given the high and rising levels of globalization of production, trade, and finances, it seems that international policy coordination could yield a superior outcome than either simple cooperation, or policy independence, where each country pursues totally independent policies and takes the policies of other countries as given. While the IMFC does not have an explicit mandate for policy coordination, like the Interim Committee, it is entrusted with overseeing the management and the adaptation of the international monetary system, which creates the leeway for the exercise of policy coordination.

One question is whether the reason why the Interim Committee and the IMFC were not able to play that role is associated with the fact that neither body had any legal powers or instruments to discharge their functions.

The Second Amendment to the Articles of Agreement approved in 1978 in the wake of the collapse of the Bretton Woods system established a Council with a composition similar to the IMFC. The Council would have three main functions: to supervise the management and adaptation of the international monetary system including the adjustment process; supervise developments in global liquidity; and review developments in the real transfer of resources to developing countries. It would also consider proposals to amend the Articles of Agreement and to issue Special Drawing Rights. The Council would be an intermediary body between the Board of Governors and the Executive Board. One important difference between the Council and the Executive Board is that Councilors may cast separately the votes of each country that elected him or her. The Council has never become operational, as this requires the vote of an 85 percent majority of the Board of Governors, which has never happened.

After the financial crises of the 1990s, there were several proposals to create a body of political oversight of the international monetary system, including the French proposal to activate the Council.<sup>19</sup> However, none of the proposals gained sufficient support.

On the one hand, the largest Fund shareholders did not seem enthusiastic in activating the Council. On the other hand, developing countries were afraid of the effect of the Council in overriding decisions of the Executive Board and were fearful that Ministers from industrial countries would not have either the inclination or the patience to engage in consensus building. But above all, given the poor record with the Interim Committee, developing countries were not convinced of the positive gains that could emerge from the operation of the Council in terms of a firmer management of the international monetary system and the adjustment process of the various countries. Hence, the final outcome was

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<sup>19</sup> For a summary of these proposals see De Gregorio, J., Eichengreen, B., Ito, T. and Wyplosz, C. 1999, pages 95-104.

to transform the Interim Committee into the IMFC, keeping its nature of an advisory and not decision-making body.

While the Council would have legal power to take decisions on important topics, it is doubtful if simply adding an additional political layer would effectively improve the possibilities for greater international policy coordination if the attitudes and the commitment of the major industrial countries to international economic policy coordination would not improve.

One of the main reasons why neither the Interim Committee nor the IMFC have been very successful is that, to the extent that international economic policy coordination has been occasionally exercised, the major industrial countries have kept this function closely for themselves in the G-7.<sup>20</sup> The Managing Director has been invited to present views on the international economy since the inception of the G-7, but without attending the part of the meeting destined to the discussion and deliberation.

A possible approach would be to try to strengthen the type of international cooperation that currently takes place in the IMFC, upgrading it, on an experimental basis, to the higher echelon of policy coordination. For this, the IMF would have to alter somewhat the nature of the WEO, which would have to upgrade its policy implications component. The WEO could include a small but consistent, concrete, even-handed, and monitorable set of policy actions to be taken by the major players in the global economy, including both the G-7 and major emerging market countries. In proposing a global action program, it would be critical that the IMF exercises evenhandedness amongst countries and appropriate judgment on feasibility of the proposed actions, given existing constraints. The overall purpose should be to define and agree on domestic policy actions required to increase global growth in a sustainable fashion while maintaining price stability, and to strengthen international financial stability. Hence, only policy actions that have a discernible, medium-term international impact for these objectives would be included.

The action program would be discussed in the Executive Board in a cooperative fashion and modified as appropriate, based on the countries' indications on whether or not they would be able to commit. Based on this discussion, the proposal would be revised as appropriate, and recommendations on policy actions would then be made to the IMFC. The final decision on the actions to be adopted would be taken by broad consensus in which the consent of each country concerned with respect to actions to be taken by itself would be required. While the implementation period could be longer than a year, say three years, monitoring of implementation would take place at each IMFC meeting, based on assessments by the IMF.

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<sup>20</sup> Since the G-5 was created in 1985, soon transformed into the G-7, the group engaged in some intermittent experiences at international policy coordination, as in the second half of the 1980s with the 1985 Plaza Agreement and the 1987 Louvre Accord, being the most well-known outcomes. A description of these efforts and the results may be found in Dodson 1991.

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