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Voting Reform at the Fund

The International Monetary Fund (IMF) plays a crucial role in the international financial system, including through provision of finance in the event of balance of payments crises. The Fund's influence on developing countries' macroeconomic, developmental and social policy making through conditionalities imposed on such borrowing has been and is huge.

Pro-cyclical IMF policies, contributing to output and job losses in the face of capital flight, have lead to a profound legitimacy crisis. By accumulation of foreign reserves, some developing countries' shift towards 'self-insurance' against financial shocks has reduced borrowing; the resulting decline of Fund income has forced country office closures and staff cutbacks.

This loss of legitimacy has its roots in the policy consequences of the undemocratic and unjust allotment of voting rights in the Fund, and the urgent need for reform is widely agreed upon. This policy brief reviews the issues involved and the currently discussed "compromise",[1] suggested for adoption by the Executive Directors.[2] The Executive Director's recommendations then can be evaluated, against the desirable features of *any* voting reform package.

Democratization of the Fund?

It is important to recognize that the Fund's voting structure is not tied to democratic principles. Votes are split into *basic votes*, which are independent of economic size and grant a minimum degree of representation for small and less developed countries, and *quota votes*, linked to a country's *quota* in the Fund. As quota shares – in contrast to basic votes – have been periodically increased, the share of basic in total votes decreased from roughly 11% in the mid-1940s to 2% today, worsening the gross under-representation of the overwhelming majority of its membership and the world's population.

Thus, the first question for reformers to answer is whether "enhancing [the Fund's] effectiveness, credibility, and legitimacy"[3] requires democratization. If answered in the affirmative – a step IMF leadership seems not willing to take – a variety of proposals have are worth considering. First, introducing a *double majority* would require majority for decision making in the Fund both (1) according to a "one country-one vote" scheme as well as (2) a formula-based voting structure reflecting economic size, among other variables.

Alternatively, only, a *large increase in basic votes* would move the Fund in the desired direction. Basic vote reform should include switching to a *fractional system*, meaning that the share of basic votes in total votes should be constant. Third, *proportionality to population* could be introduced, either in a mixed double majority[4] or through some (small) weight on country's population size in a formula.

Formula-driven adjustments

IMF voting rights were distributed according to a mixture of (a) economic weight and (b) political motives. Adjustments to quotas tend to be realized when changes in (a) line up with some consensus on (b). It has been practice to synthesize a "formula" that reflects *previously* agreed voting share adjustments. In this institutional and political culture, a reform should include *rule-based quota reviews*, for the Fund to gain transparency and legitimacy. A formula therefore would have to be just that, rather than an arbitrary addendum after backroom deliberations. It makes sense to argue about a specific formula in a second step.

The voting share formula is supposed to reflect the relative weights of countries in the global economy. Candidate variables include GDP, both at market prices and purchasing power parity (PPP).[5] Other variables include real and financial cross-border transactions – meaning the trade in goods and services and capital flows – as well as international reserves and other (financial) stock variables. These variables are supposed to reflect "openness" in the sense of multilateral economic involvement.[6]

The obvious difficulty is that a large number of variables might be suitable, and "[t]he goals of simplicity and transparency compete with the goals of accuracy and

[1] Much of this brief relies on arguments and calculations brought forth in Bryant (2008) and Woodward (2007). See as well www.brettonwoodsproject.org for critical reviews of the debate.
[2] See IMF (2008) for the "agreement" proposed by IMF Executive Directors late in March 2008, to be decided upon by the Board of Governors in mid-April.
[3] Strauss-Kahn press conference, stating goals of the reform. See http://www.imf.org/external/pubs/ft/survey/so/2008/NEW032808A.htm

[4] See Wood (2007), page 11.
[5] Note that developing countries record much larger figures for GDP in PPP, because "non-traded goods," mostly services, have much lower prices in the South compared to the industrialized world.
[6] As mentioned in the preceding section, population size would be another candidate variable, categorically rejected by developed countries.

completeness."[7] Another crucial dimension is *how* a variable enters the formula. Trade flows, for example, can be represented in absolute numbers, as percentage share of the world total or relative to the country's GDP.[8]

Progress to date and the suggested reform

In an *ad hoc* move, the Fund adjusted voting shares of four developing economies – China, Korea, Mexico and Turkey – at the 2006 IMF Annual Meeting in Singapore. Furthermore, a formula to provide the basis for a *second round* of quota adjustments for all member countries should be agreed to by September 2008, This *second round* compromise formula recommended for adoption by the IMF board on March 31, 2008 relies on only four variables – all measured as country shares of a global total – namely: (1) GDP, (2) cross-border trade, (3) international reserves and (4) a measure of the variability of cross-border transactions including of 3/5 – and GDP *at purchasing power parity* (PPP) – with the remaining weight of 2/5 – contributes 50% in the formula; 30% are allotted to cross-border trade, 15% to variability of international transactions and the remaining 5% to international reserves.

The choice of variables represents a step in the right direction, as GDP at PPP is included, which opens the door for future formula adjustments recognizing price differences between developed and developing countries. However, the weight attached to it (20% overall) is too small to significantly improve the current "second round" adjustments. As discussed further below, ad hoc corrections are needed to render these second round adjustments less regressive than the formula. Including cross-border trade, reserves and "international volatility" in the formula similarly presents a step in the right direction.

Most relevant, however, are the distorting ways trade – "openness" – and variability are introduced. Openness can, and is usually, measured as the ratio of, say, a country's trade flows relative to its GDP, or of its cross-border capital flows relative to its GDP. In the current compromise, these flows are measured as a share of the global total – obviously giving a huge disadvantage to *small, but open* economies. Moreover, intra-EU flows are included, exaggerating their significance for these countries.

[7] See Bryant (2008), p. 7. See his Figures 1 and 2 on the problem of choosing between different variables.

[8] Bryant (2008), page 11, suggests that variables should be designated as *core-share* and *core-adjustment* variables, the former reporting the percentage of a countries' economic variables of a global total, whereas the latter reports a ratio of two (or more) variables.

Likely, adjustments from such a formula will increase the voting shares of the richest and most influential member countries. Hence, a number of "gimmicks" have been suggested to *adjust the adjustments*:

1) A *compression factor* lowers the calculated shares of the largest IMF members.[9]
2) Any country that would be 'under-represented' following the calculated vote shares relative to the "pre-Singapore" level can enjoy an *ad hoc* quota increase.
3) "To further reinforce the objectives of the reform,"[10] (a) some of the richest countries have agreed to forego the increases they would have a right to according to 2) above, (b) some emerging economies *especially under-represented in terms of PPP GDP* will receive an *ad hoc* 40% quota increase, except (c) Mexico, Turkey, China and Korea, which will only receive an *ad hoc* 15% increase, following their first round quota adjustments.

Conclusions

The reform submitted to the Board of Governors will not even make democratization a goal for the Fund in the future. The refusal to include a population variable in quota calculations or to take a one country-one vote scheme into consideration renders this round of "reforms" a failure from the start.

The formula proposed is so fundamentally flawed that it neither paves the way for transparent, rule-based future adjustments, nor offers a step towards inclusiveness and representative governance. In fact, special gimmicks are necessary to offset the regressive nature of the formula. Besides temporarily appeasing a few large, fast growing emerging economies, the "reform" makes it abundantly clear that the Bretton Woods institutions still have a long way to go to gain legitimacy.

References

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[9] The calculated quota shares based on the "reform formula" are raised to the power of 0.95, thus marginally compressing the largest countries' voting shares relative to smaller countries.

[10] IMF (2008: 4).