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A CRITIQUE OF THE COOPER REPORT ON THE ADEQUACY OF THE IMF QUOTA FORMULAS

Ariel Buira

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Manor Road Building, Oxford OX1 3UQ
A CRITIQUE OF THE COOPER REPORT ON THE ADEQUACY OF THE IMF QUOTA FORMULAS

Ariel Buira, Department of Economics and St. Antony’s College, Oxford University

ABSTRACT

At the request of the Managing Director of the IMF, a group of experts, chaired by Professor Richard Cooper of Harvard University prepared a report on the adequacy of quota formulas, including proposals for changes. The paper reviews the recommendations of the Quota Formula Review Group and finds that the Report failed to address such key issues as the size of the Fund or overall adequacy of quotas, and the question of basic votes and the distribution of voting power. It questions the reasons for the rejection of PPP-based GDP in the proposed formula for quota determination and considers that this introduces a bias against developing countries; the exclusion of short-term capital movements in the measurement of countries external vulnerability also appears questionable.
A CRITIQUE OF THE COOPER REPORT

The Report of the Executive Board to the Board of Governors on the increase in quotas under the Eleventh General Quota Review reaffirmed the view of the Interim Committee that the quota formulas should be reviewed following the completion of that review. Accordingly, in 1999 the Managing Director requested a group of external experts to provide the Board with an independent report on the adequacy of the quota formulas, including proposals for changes if appropriate. This Quota Formula Review Group (QFRG) was formed by eight experts, consisting of Richard Cooper (Professor at Harvard University) as chairman; Joseph Abbey (Executive Director, Center for Economic Analysis, Accra, Ghana); Montek Ahluwalia (Member, Planning Commission, New Delhi, India); Muhammad Al-Jasser (Vice-Governor, Saudi Arabian Monetary Agency); Horst Siebert (President, Kiel Institute of World Economics, Germany); Gyorgy Suranyi (President, National Bank of Hungary); Makoto Utsumi (Professor, Keio University, Japan); and Roberto Zahler (former President of the Central Bank of Chile).

The terms of reference for the study given to the group were broad and included the following main areas:

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

--” To propose, as appropriate, changes in the variables and their specification to be used in the formulas.”

--“To examine other issues directly related to the quota formulas.”(my italics)

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

I-The Size of the Fund

Note firstly, that the work of the QFRG is necessarily developed in the framework of the Articles of Agreement, which set out the purposes of the Fund. Take into account that two of the three roles performed by quotas in the Fund are the provision of contributions to and access to Fund resources. Secondly, observe that the terms of reference state that the mandate of the group is a broad one and explicitly includes changes in the functioning of the world economy, and the international financial system in the light of the increasing globalization of financial markets.
The first question to address would appear to be the adequacy of Fund resources in relation to the tasks it has been assigned. i.e. Is the size of the Fund, the sum total of quotas, appropriate to enable it to fulfill its mission? Recall that the purposes of the Fund include: “To give confidence to members by making the general resources of the Fund temporarily available to them... providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.” (Article I, section V of the Articles of Agreement) (My italics).

Recall also that there has been a substantial decline in the size of the Fund in relation to world trade (See table 1); as a result Fund quotas accounted for barely 6 per cent of world imports in 1998. Consequently, the resources of the Fund are not adequate to enable it to provide sufficient credit to its member countries suffering trade imbalances to allow them to adjust without resorting to a sharp reduction in aggregate demand leading to a downturn in economic activity and to adopt other measures destructive of national and international prosperity.

<table>
<thead>
<tr>
<th>Year</th>
<th>Ratio of Quotas to Imports</th>
<th>Ratio of Quotas to GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1944</td>
<td>0.58</td>
<td>0.04</td>
</tr>
<tr>
<td>1950</td>
<td>0.17</td>
<td>0.02</td>
</tr>
<tr>
<td>1965</td>
<td>0.15</td>
<td>0.02</td>
</tr>
<tr>
<td>1970</td>
<td>0.14</td>
<td>0.02</td>
</tr>
<tr>
<td>1978</td>
<td>0.09</td>
<td>0.01</td>
</tr>
<tr>
<td>1990</td>
<td>0.06</td>
<td>0.01</td>
</tr>
<tr>
<td>1998</td>
<td>0.06</td>
<td>0.01</td>
</tr>
</tbody>
</table>

In recent years, the extraordinary growth of international financial markets and the increased dependence of a significant number of emerging market and transition economies on this source of financing has made them highly vulnerable to the volatility of short term capital. The amounts of financing required to deal with such crises are much greater than those necessary to address traditional payments imbalances.

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

Thirdly, note the QFRG is mandated to examine other issues directly related to the quota formulas. One such issue could be the inclusion of one or more variables to relate quotas with the growth of the world economy or of world trade and the development of international financial markets.
Surprisingly, although it was given a broad mandate and asked to examine “their relative need for and contributions to the Fund’s financial resources, taking into account changes in the functioning of the world economy and the international financial system and in the light of globalization of markets” the independent QFRG interpreted its mandate narrowly to preclude the consideration of the adequacy of quotas and chose to focus only on the distribution of quota shares among member countries. Did the QFRG consider the size of the Fund to be unimportant? Perhaps they knew that a review of this broader question would lead them to call for a sharp increase in the Fund resources, a result major industrial countries would not welcome.

II-The Question of Voting Power

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

With the increase in quotas the share of basic votes in the total falls, which raises the relative voting power of larger countries. With the accession of new members, the total number of basic votes rises, but not necessarily their share; nevertheless, the importance of the basic votes of any given member in the total continues to diminish. The expansion in membership from 45 to 68, caused the share of basic votes to rise from 11.3 per cent in 1945 to 15.6 percent in 1956 simply because no significant increase in quotas had taken place. But with the nearly 37fold increase in quotas since then, the share of basic votes in the total has declined to 2.1 percent, despite the quadrupling in the membership. This has substantially shifted the balance of power in favor of large countries, away from the result of the compromise agreement to protect the representation of small countries, contained in the Articles.

Consequently, today quotas are virtually the sole determinant of voting power and basic votes are of very little significance. As a result, the voice of small countries in the discussions has been substantially weakened and their participation in decision making reduced to the point of becoming negligible.

Since this would appear to be a significant issue in the governance of the Fund it is surprising that, despite the broad mandate given to the group, the Report fails to consider the possibility of revising basic votes. The only reference contained in the Report goes to say that:

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

Thus while recognizing that the cooperative nature of the international institution calls for having prospective borrowers represented in decision making in the Fund,
the authors of the Report appear to believe that with basic votes accounting for 2.1 percent of the total vote, including the vote of developed countries, potential debtors have a significant voice in decision making! It is difficult to take this dis-ingenuous argument seriously. One may ask in what parliamentary body would such a small representation for a major party be considered to give it an adequate participation in decision making? The authors of the Report appear to have forgotten the evolution of basic votes over time. Since they are not unaware of the reasons for the compromise that led to base voting rights on a combination of two criteria, perhaps they knew that the major industrial countries would prefer that the issue not be raised.

However, the preservation of the share of basic votes in the total would not be an exceptional practice among international institutions. Note that being sensitive to the political dimension of its work, MIGA would allocate developing countries as a group the same voting power as developed countries if all members of the World Bank joined the Agency; that the Asian Development Bank’s Articles of Agreement provide that the relative importance of basic votes will remain constant over time as a proportion of the total vote (Article 33-1) and that the Articles of Agreement of the Inter-American Development Bank provide that no increase in the subscription of any member will become effective if it would reduce the voting power of certain countries or groups of countries below given percentages of the total. (See External Review of Quota Formulas-Annex, Box 3.1 page 38)

Restoring the share of basic votes to the original 11.3 per cent of the total (Op. cit. page 32) would require a more than five fold increase in the basic vote of every member country (from 250 to 1323); restoring the proportion of basic votes per member to what it was in 1945 would raise the total basic votes to nearly half of total voting power (11.3 x 4.07=46 per cent). An intermediate solution that would partially restore the role basic votes were meant to have, would be to assign basic votes say 25 per cent of the total voting rights. This would mean raising the basic votes of each member country from 250 to 2,927. In addition, to prevent the future erosion of the share of basic votes in the total, a formula could be adopted by which in future, in every quota review total basic votes increase in the same proportion as total quotas. These changes would require an amendment of the Articles of Agreement.

III-The Variables Included in the Proposed Formula

After looking at issues such as the history of the formulas, how variables affect the calculated quotas under existing formulas and a number of related issues and undertaking a substantial amount of econometric work looking at issues such as the factors that have determined the evolution of quotas over time and the degree and pace of convergence of actual to calculated quotas, the QFRG decided to take a fresh approach and design a new formula. This is supposed “to reflect the underlying changes in the functioning of the world economy and the international financial system, take account of the increasing globalization of markets, and simplify the existing formulas.” (Cooper Report page55)

“We recognize that Board discussions have often focused on whether developing countries as a group have sufficient voice in the Fund and any decisions on the quota formula for the future will have impact on this issue. However, since our terms of reference do not make any reference to developing countries as a group, we have not taken this aspect into account in recommending a quota formula.” (op.cit. page 56)
They go on to state their view that: any new formula should have a sound economic basis and should reflect changes in the world economy; that the form and content of any new formula should be consistent with the several functions of quotas; that the variables contained should not give members incentives to adjust their policies adversely to IMF principles; that any new quota formula should be more transparent and easier to comprehend than the existing set of formulas and any modification of the quota formulas should be feasible, and where problems of data quality or availability arise, such modification should be contingent on the resolution of these problems.(op.cit. pages 56-57)

The QFRG set about their task by considering two variables will, in their judgment, best represent: 1) the member’s ability to contribute and 2) the member’s need for IMF resources. These are:

**GDP**

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

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

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

In view of the majority, PPP based GDP, as a measure of a country’s ability to contribute would produce serious anomalies, suggesting for example that China’s could contribute one third more than Japan, or that India could contribute more than France. Are these criticisms valid?
While it may be the case that in some unspecified sense the ability of Japan to contribute is greater than that of China and that the ability of France to contribute is greater than that of India, note that this is not related to the level of international reserves, since this variable is excluded “since they may fluctuate from year to year and may reflect international short term borrowing.”

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

Moreover, recall that the desire to limit quota increases and to adjust quota shares to changed conditions in the international economy has led the Fund to seek to supplement its available resources by entering into two borrowing arrangements, the GAB and the NAB, with a number of countries in a strong international reserve position that enables them to provide additional financing for Fund operations when required.

Another argument presented against the use of PPP based GDPs is the lack of data. At present, PPP based GDP estimates are available for only 117 countries representing 95 percent of world GDP….Of course, with effort data deficiencies can be eliminated over time. (Cooper report, page 58). You might consider that the availability of data for countries accounting for some 95 percent of the total world GDP is not a bad starting point if you can work to extend the coverage to other countries, particularly if you have several years in which to prepare the appropriate estimates.

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

Consider on the other hand, the range of the exchange rate fluctuations and misalignments among major currencies. Simply recall that the exchange rate between the dollar and the Euro has gone from 1.18 US dollars per Euro to under 0.86 US dollars per Euro, a variation of 37 percent in a lapse of less than two years. This alone would introduce substantial distortions in market exchange rate conversions of GDPs measured in these currencies and in others linked to these currencies. The problem is
only somewhat reduced but does not disappear with the use of three yearly averages as proposed in the Report. In the example below even the use of five yearly averages was not sufficient to eliminate significant fluctuations in market rate based GDP estimates. Contrast these changes with the stability displayed by PPP based GDP estimates. See Table 2

Table 2- Ratio of Japan’s GDP to US GDP
--- | --- | --- | --- | ---
Annual average exchange rate - | 33 | 54 | 67 | 62
Five year average exchange rate - | 39 | 59 | 65 | 61
PPP based estimate- | 35 | 41 | 41 | 40

Source; OECD Website ”Purchasing Power Parities” quoted in External Review of the Quotas-Annex5, page 46

Moreover, the well known shortcomings of market exchange rate based conversions are magnified in the case of developing and emerging countries, where large devaluations are not the exception. In recent years these included inter alia devaluations in Mexico, by 115 per cent; in Indonesia, by 228 percent; in Korea, 96 percent; Thailand 87 percent; Russia, 135 percent; etc. Since large devaluations introduce mayor distortions in GDP converted at market rates which are only partially-and unevenly- corrected by three year averages, it seems that the argument of the majority, for the use of market exchange rates for conversions rather than the use of PPP based GDP, to avoid the introduction of errors in estimation, is not a solid one.

The point has considerable political significance. The GDP of the industrial countries is substantially larger when converted to a common currency in terms of market exchange rates than when it is based on PPP. The opposite is true for the GDP of developing countries. To visualize the importance of the differences simply consider the following table:

Table 3- Comparison of PPP based GDP and Exchange Rate based GDP of Selected Countries in 1994

<table>
<thead>
<tr>
<th>Country</th>
<th>Share in World Total</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>21.5</td>
<td>1</td>
</tr>
<tr>
<td>China</td>
<td>8.8</td>
<td>2</td>
</tr>
<tr>
<td>Japan</td>
<td>8.5</td>
<td>3</td>
</tr>
<tr>
<td>Germany</td>
<td>5.2</td>
<td>4</td>
</tr>
<tr>
<td>India</td>
<td>3.9</td>
<td>5</td>
</tr>
<tr>
<td>Russia</td>
<td>3.1</td>
<td>9</td>
</tr>
<tr>
<td>Brazil</td>
<td>3.1</td>
<td>10</td>
</tr>
<tr>
<td>Mexico</td>
<td>2.0</td>
<td>12</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.9</td>
<td>22</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1.7</td>
<td>14</td>
</tr>
</tbody>
</table>
The main reason for this difference is that the use of market exchange rates substantially undervalues the GDPs of developing countries. This is because in developing countries the prices and wages prevailing in the tradable goods sector are higher than those prevailing in the non-tradable goods sector, a phenomenon that is not of significance in developed countries. As the non-tradable sector represents a substantial part of the economy, the valuation of this sector at market exchange rates pulls down the valuation of this sector, and therefore of GDP as a whole below its valuation at PPP based rates. This represents a major distortion inherent in the market exchange rate based GDP which would argue against its use in GDP comparisons between developed and developing countries. Since PPP based GDP estimates on the other hand, are much more stable and do not introduce a measurement bias against any group of countries, they would appear to be preferable for this purpose.

In any event, to the extent that GDP is a major determinant of quotas, when the method of GDP conversion is chosen the distribution of quotas is substantially determined.

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

2-The Variability of Receipts

In looking at the members potential need for financial support from the Fund, the QFRG finds that the single most relevant variable for measuring a country’s vulnerability to external disturbances is the variability of its international receipts. The variability of international receipts it is proposed be measured as the standard deviation from trend of *current account* receipts over a 13 year period, with the trend measured by the centered five year moving average. The Report admits the possibility of refining this variable “by adding to receipts some measure of autonomous net inflows of capital, e.g. net long-term borrowing plus foreign direct investment, assuming that reasonably accurate information was available on a timely basis.” While these are undoubtedly relevant variables, and this is the traditional way of looking at balance of payments vulnerability, they are not the whole story.

In looking at external vulnerability, one may consider:
the degree of openness of an economy,
the composition of exports
the concentration of exports
the dependence on external financing, particularly on short term capital flows.

The first of these variables, the degree of openness may be measured by the sum of imports and exports as a proportion of GDP. Obviously, a closed economy, say one where the external sector accounts for 6 percent of GDP will be less affected by external developments than a very open one, where external sector represents say 50

Source: “External Review of Quota Formulas” Annex 5 EBAP/00/52 Supplement 1
percent of GDP. In the first case, a collapse of exports will have a limited impact on
the level of domestic economic activity while in the second case an export collapse
will have major consequences in terms of output and employment. Thus, since an
open economy is more vulnerable than a closed one, the degree of openness should be
seen as a separate variable, to be distinguished from the variability of current receipts.
This variable is not considered by the QFRG.
As is well known, export composition is an element of vulnerability since exports of
commodities are subject to greater price fluctuations than exports of manufactures.
Thus, a country with a high concentration of exports in one or two primary products,
say as cocoa, coffee, copper, etc. is subject to wide fluctuations in export revenues.
Similarly, the concentration of exports in one or two markets, whether of
manufactures or primary products will result in substantial cyclical variations in
export revenues and in a high degree of vulnerability for the exporting country. While
these well known factors are not mentioned explicitly by the QFRG, only the second
and third can be subsumed in the proposal for the measurement of variations in
current revenues.

However, trade variables can not open the way to the consideration of the major
financial crises that have dominated Fund financial operations in recent years.
Excluded from consideration by the QFRG is the member’s dependence on
international financial markets, particularly the volatility of short-term capital flows,
which as is widely recognized, has been the determining factor in the financial crises
suffered by emerging market economies over the last few years.
Recall that the terms of reference explicitly refer to “changes in functioning of the
world economy and the international financial system and in the light of the
increasing globalization of markets”. Since the increasing role of financial markets
and their globalization are probably the single most important change that has taken
place in the international economy, it is surprising that although explicitly referred to
in the mandate to the group, the variables proposed refer to current account receipts.
While admitting the possibility of including long term capital flows, the QFRG
exclude the consideration of short-term capital movements, whose reversal played a
major role in balance of payments difficulties of emerging markets.

IV- Shortcomings of the QFRG Proposed Formula for Quotas
The Report recognizes the significant changes that have taken place in the world
economy since 1944, in particular the greater global economic integration, the rapid
expansion of private capital flows and their volatility that have made countries more
exposed to external shocks, particularly those countries without assured access to
private capital markets in view of a decline in official financing, and that the
correction of countries imbalances takes longer than envisaged at the Bretton Woods
conference.
Taking into account the role of quotas in the IMF, the group was requested to review,
inter alia, issues that have arisen in recent discussions by the Executive Board. Some
of the main issues in recent reviews have focused on whether the quota formulas are
currently adequate and also whether the variables in the formulas reasonably reflect
the main features of the world economy.
On the whole, the Report prepared by the QFRG, presents a proposal for the revision
of quotas that must be seen as disappointing in the light of the broad terms of
reference it received, several of the important issues that have been the object of
discussion both inside the Board as well as outside it.
Among the main issues that would require further consideration are:
1-the overall adequacy of Fund quotas
2-the share of basic votes in voting power and appropriate participation of small
members in decision making
3-the inclusion the degree of openness of an economy as a factor of vulnerability
4-the consideration of the short-term capital movements
and their volatility in the assessment of a countries vulnerability.
5-the decision to exclude PPP based GDP data from consideration for the purpose of
determining a member’s ability to contribute to the resources of the Fund is also
questionable. This exclusion results in a substantial underestimation of developing
countries GDP in quota calculations and in an unwarranted reduction in developing
countries share of quotas and participation in decision making.

Through their choice of variables, the group has proposed a formula that does not take
fully into account of some of the major changes that have taken place in the world
economy, in particular the increased participation of the developing countries as a
group in the world economy nor the rapid growth of some of the larger economies
among them. Additionally, the report fails to provide for the solution of the problems
of vulnerability posed by the extraordinary expansion of financial markets and in
particular, by the volatility of short-term capital movements.
While recognizing that original quotas were politically determined (see Report page
7,and Mikesell,R.F.) and that the resulting quota structure has tended to persist as a
result of the relative small size of selective element in quota adjustments (and the
gap between calculated and actual shares has persisted over time), the Report does not
favor changing quotas rapidly, as circumstances of individual members may change
from one review to the next. (Report, page5)
It may be fair to say that, taken as a whole, their judgments, explicit or implicit, on the
size of the Fund, the question of basic votes, the measurement of GDP, on the issue of
vulnerability appear to reveal a certain bias in favor of the preservation of the status
quo in which a small group of industrial countries holds the majority of the voting
rights, limits the growth of the Fund and access to its resources and excludes the
majority of Fund members from appropriate participation in decision- making. The
quota formula proposed, in addition to being subject to the shortcomings mentioned
above, would lead to a further concentration of power in the hands of industrial
countries.
The formula proposed by the QFRG fails to address a basic issue: the appropriate
representation of members in the governance of the Fund. The formula proposed, like
the current decision making process does not address the concerns of the vast majority
of the membership about the lack of transparency and the limited influence they have
on decision making. Indeed, if adopted it would increase these problems. Decision
making by the Fund must acquire a broader legitimacy, greater participation and
representativeness of the membership.
For the reasons above, it is not difficult to predict that their recommendation will be
rejected by the developing countries as a whole.

Towards an Alternative Proposal
By their proposal, the QFRG has made us consider what are the relevant issues involved in the revision of the quota formulas and reflect on which are the appropriate variables to be included in it. Despite the shortcomings of the formula proposed, the initiative for the simplification and increasing the transparency of formula posited by the QFRG, has considerable merit and should be accepted. Additionally, much of the historical and analytical background material may also be useful.

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

1- Relate overall quotas to world trade and capital movements or to world GDP. A first approach would be to establish that the size of the Fund should not fall below an agreed proportion of world trade or of world GDP. Note that simply establishing a ratio of say 15 percent of imports would more than double Fund resources, enabling it to reduce the costs of adjustment to members and make the institution far more relevant to their problems. Total quotas could be adjusted at three yearly intervals to keep them from lagging significantly behind the expansion of the international economy. Additionally, total capital flows to prospective borrowing countries, all members except some twenty two industrial countries, could also be considered in determining countries potential need for Fund support. (This would not preclude an industrial country from turning to the Fund for support.)

2- Restore the role of basic votes to their original function. This should lead to increasing them to an agreed proportion of total voting rights, say 20 percent of the total and provide that in future, basic votes will increase in the same proportion as total quotas.

3- Use PPP based GDP estimates in the quota formulas in order to avoid the current underestimation of the economic size and ability to contribute of developing countries and emerging market economies. This should also correct their underrepresentation at the Board. Increasing the stake of developing countries in the Fund should also lessen the concern of current creditor countries over the risk of Fund credits.

4- Include additional elements in the variable that measures the external vulnerability of countries in the quota formula. The inclusion of a measure of openness of the economy and of the dependence of countries on international financial markets, particularly on short term capital movements, would appear to be necessary.

With these simple technical changes the major shortcomings of the proposed formula could be overcome.

However, the determination of quotas is as much a political as a technical exercise, and no amount of technical work can take the place of the necessary political discussions and eventual negotiations towards a broad agreement. Will the G-7 and other industrial countries which hold a privileged position be prepared to yield some of their power to the broader membership of the Fund?

There are sound political and economic reasons for their doing so.

Much has changed in the world economy since 1945. As a number of former colonies became sovereign countries, and the Soviet Union gave way to a number of independent economies in transition, the membership of the Fund expanded from 45 to 183 countries. World trade expanded beyond expectation and as official flows declined, the growth of international financial markets has been explosive, giving rise to new opportunities and challenges. The structure of the world economy has also changed as developing countries account for a growing share of the world’s output.
and trade, and newly industrializing countries overtake others as major economic players, without attaining adequate representation in the Fund Board. The process of European integration, which is well underway, and monetary unification which has already taken place among twelve countries, prompts questions as to their appropriate representation at the Executive Board.

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

In the face of the major changes that have taken place in the economic and political panorama of the world, a more representative and transparent decision making process is required to enhance the democratic legitimacy of an institution so involved in the economic governance of its members. The success of the Fund as a multilateral institution is crucial if globalization is to work for all countries. Democratic legitimacy and participation are not contrary to the strict application of clear principles in the exercise of the Fund’s competences.
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