

October 2007

Closing the deal: IMF reform in 2007

Time is running short to finish a deal on IMF governance reform

2006 was a watershed year for reform of the International Monetary Fund. It began a serious reform process following statements from the US Treasury of its support for a change in the IMF's voting structure at the end of 2005,¹ and warnings from the Governor of the Bank of England in early 2006 that the Fund lacked legitimacy without adequate representation for large developing countries.² The process was designed to address critical legitimacy questions about the IMF, whose authority was weakened by a combination of three things: the accumulation of massive foreign exchange reserves in Asian and other emerging market countries which made 'self-insurance' against financial crises possible, early repayments of loans by the Fund's largest borrowers such as Brazil, Argentina, Turkey and the Philippines, which made its business model look insecure, and the inability of the Fund to address matters of pressing international concern, such as global imbalances.

At the spring meetings in April 2006, the International Monetary and Finance Committee (IMFC) of the International Monetary Fund declared that: 'the IMF's effectiveness and credibility as a cooperative institution must be safeguarded and its governance further enhanced, emphasising the importance of fair voice and representation for all members.'³ They asked for the preparation of further concrete reform proposals by the time of the Annual Meetings of the IMF and World Bank, which were to take place in September of that year.

In response, the IMFC adopted a programme of reforms aimed at adapting quotas and voice within the institution, which were to be completed by the Annual meetings of 2008, at the latest. The communiqué from the meetings stated that: '...this package of reforms, when implemented,



Reform at the 2007 annual meeting of the IMF and World Bank is critical.

would make significant progress in realigning quota shares with members' relative positions in the world economy and, equally important, in enhancing the participation and voice of low-income countries in the IMF as set out in the resolution.⁴ The ball was set in motion for the most significant reform of the governance of the IMF in decades, something which even a few years ago would have seemed a near impossibility.

Negotiations on how large developing countries should be represented in the IMF are still ongoing after almost a year, and while the major players are getting closer to forging a deal on a new formula to determine their voting share (so called 'quota votes') by their self-imposed autumn 2008 deadline, there is still quite a bit of distance between the ideal outcome for the Europeans, the US and large developing economies. This briefing paper looks at the risks and opportunities associated with finishing an IMF reform deal before the end of 2007. It demonstrates through a game theoretical model that a deal is more likely to occur this year than next because of the potential impact of an economic slowdown in Europe and other regions related to recent financial turbulence. Therefore, all parties should endeavour between now and the annual meetings to bridge

Key points

- Differences remain amongst key players on governance reform package.
- The window of opportunity is narrow and closing fast, and 2008 presents new challenges.
- Risk of economic downturn in OECD countries will reduce actors' incentive to undertake reforms.

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Box 1: Six risks and opportunities for IMF reform in 2007 and 2008

Political:

- New Managing Director could push through reform as first act
- Change in chair of G20 could delay negotiations next year
- US Presidential and Congressional elections could make reform impossible next year
- General reform fatigue to set in 2008

Economic:

- New purchasing power parity data to be released at end 2007 could compromise a deal
- Economic downturn in Europe and other regions could lessen appetite for reform

the gap between their ideal points, and put in place a substantial and forward-looking reform programme.

The current window of opportunity

There is currently a favourable window for completing the IMF governance reform process, that is likely to fade as 2007 comes to a close. There are six factors, some opportunities and some risks, that make the last three months of 2007 crucial.

The first is an opportunity. Dominique Strauss-Kahn, new Managing Director of the IMF, intends to focus on the reform of the IMF and can take advantage of his ‘honeymoon’ period to help push through a deal. Forging a deal amongst members would simultaneously help him score a major victory at the outset of his directorship and provide him more credibility with the membership after the rather bruising appointment battle.

A second opportunity is the continuity provided by coming to an agreement under the current G20 chair, South Africa. The G20 has been the primary body in which the quota / governance reform process has been negotiated, both under the current chair South Africa and under the 2006 chair, Australia. It is understood that next year’s chair will come from the Latin American region, most likely Brazil. A major advantage for the South African chair in appearing to be an honest broker in the negotiations has been that the country’s representation stands to lose from almost any new formula or ad hoc quota increase that is currently being discussed. Latin American countries, by contrast, and Brazil in particular, stand to gain significantly from a formula which takes into account purchasing power parity (PPP), which could make compromise between developing country constituents and Europe / other developed countries more difficult.

The third factor is a risk. The release of new PPP data could dramatically increase estimates of China, India and other developing countries gross domestic product (GDP) at PPP, thereby making a deal on a quota formula which includes a PPP element less palatable for European and other developed countries. The International Comparison Programme (ICP) will release the new data at the end of 2007; preliminary data coordinated by the Asian Development Bank

(ADB) for the Asia and Pacific estimate that China and India together comprise 64% of regional GDP. The incorporation of such data into a formula in 2008 would make a compromise between developing and developed countries more difficult.

Another risk is related to US domestic politics. 2008 is a year not only of US presidential elections, but also of Congressional elections. As is the case with many national legislatures, the US Congress must approve changes to the IMF’s Articles of Agreement. The preferences of the Congress are particularly salient, however, because the US is the only individual member of the IMF which has sufficient representation to veto a decision in the IMF. The spectre of a Congressional vote against a hard won negotiation package which would block reform because of US veto power is more likely during an election year when attention is diverted to domestic politics.

There are also two more generalised risks: that of reform fatigue and global economic slowdown. With regards to the first, the negotiation process on the quota reform deal has to date been very intense and time consuming for G20 member governments and the Executive Board of the IMF. Thus, there is a risk, that if a deal is not completed in a timely fashion, reform fatigue will set in, reducing the incentives of all parties to come to an agreement, and entrenching the positions of recalcitrant countries.

With regards to the global economic slowdown, market conditions have been extremely favourable over the past five years, with high liquidity and low perception of risk amongst investors in both developed and developing countries, making the IMF seem less relevant for emerging market countries. However, the recent turbulence in the US financial markets has already had some impacts on European, Asian and Latin American markets. During past crises, the IMF has acted as a lender of last resort to developing economies, but it is unclear how the global financial markets would behave in a major crisis without the IMF playing a stabilising role.

Diverging positions ahead

The importance of these six factors on the ability of IMF members to agree a substantial change to the quota formula, during either the autumn 2007 meetings scheduled to take place in Washington 20–22 October or in G20 meetings in the following months, are more clearly understood if one illustrates the interactions of the most salient actors. It is possible to imagine the current process of reform as a ‘two-level game,’ adopted from the concept made popular by political scientist Robert Putnam, to better understand how these risk factors change the opportunities for reform and how international economic conditions change the propensity for longer term support of IMF reform.

While the political economy of reform is a popular topic in the academic literature, the majority of work done on the subject has focused on the national

level. International level analysis is much more complex given the number of actors that are involved in achieving reform. Nonetheless two level games are useful in analysing the opportunities and risks to completing reform at the international level. Putnam argued essentially two points: first, that the smaller the international ‘winset’ (the intersection of policy outcomes acceptable to all players), the greater the risk that international negotiations break down; second, that a small winset can be a bargaining advantage when bargaining takes place over two levels, the national and international context. In the current negotiation, US domestic politics acts as a second level to the international game. Therefore the preferences of the US Congress act as an additional opportunity or risk to reform.

How can this literature usefully be applied to the present situation in negotiating changes to IMF quota representation? By illustrating the winsets available in 2007 and 2008, taking into account the conditions above, and comparing them. Figures 1 and 2 map the preferences and ideal points of the three actors – the EU, US and a group of developing countries – under relatively favourable conditions in 2007 and less favourable conditions in 2008.

The actors’ preferences for IMF reform are shown on a uni-dimensional policy space in which one imagines that preference for reform increases as one moves to the right along the line. Rather than mapping the preference of each individual country, the graph instead shows the preferences of three actors: the United States (US), the European Union (EU) and a group of Developing Countries (DC), including large emerging market economies. The figures show reasonable assumptions given that a) these are the three primary groups that will shape the reform package and b) that internal alliance amongst European countries and amongst developing countries is relatively high.⁵

Figures 1 and 2 show a delay in reform from 2007 to 2008 will result in diverging positions. In 2007, there is a small but feasible winset in 2007 (figure 1, shaded area) where reform is possible. But in 2008, this winset diminishes, or indeed, disappears altogether.

On average, developing countries want more reform than do European countries because developing countries have much to gain from a change in representation while EU countries have much to lose. The preference of the US falls between these two groups – and closer to the EU than to developing countries – for two reasons. First, the US does not lose under most proposed formulas because its size and disproportionately large GDP preserve its power in most configurations. Second, the US has stated throughout the negotiation process that it favours reform of the institutions that provide more representation to large emerging market countries to preserve the legitimacy of the IMF.

Each of the three actors has an ‘ideal point,’ or the reform outcome they would most like to achieve, represented by a point on the line. However, the three

actors also have a range of outcomes around this ideal point which they would accept in negotiations. The range is represented by a circle, which has as its centre the ideal point. The area in which all three circles intersect, if at all, is the winset, or the area in which compromise can be found. How is the size of the circle determined? It is determined by the actor’s range of acceptable options. In this example, the EU’s policy circle has the smallest diameter because its members have a relatively homogenous cost / benefit analysis for quota reform and because their positions appear to be the least flexible of member states at present. Developing and large emerging market countries, in contrast, have the largest range of acceptable policy positions because they comprise a highly diverse group and because it is reasonable to assume that developing countries prefer some reform, even if relatively moderate, over no reform and thus have a higher propensity to compromise. The US has a moderate range of policies it would accept – falling between these two extremes.

This illustrative model allows us to consider how the ideal points and acceptance ranges of each of the actors changes between 2007 and 2008. How should the six factors outlined above be reflected in the figures? The first two – the negotiation power of the Managing Director and the current G20 chair, South Africa – have an impact on the range of acceptable options for the EU and developing countries respectively because these leaders have the possibility to help persuade constituencies to cooperate. Thus, the ‘circles’ of acceptable policies in 2008 shrink as their influence wanes in 2008. Similarly, general reform fatigue shrinks the sizes of the policy range acceptable to all three actors in 2008 as positions become more entrenched. More is said about the impact of economic downturn below, which is better modelled using formal mathematics.

Finally, the spectre of new PPP data and the US elections move the ideal point for all three actors. The PPP data, which will benefit developing countries to a

Figure 1: A narrow winset remains till the end of 2007

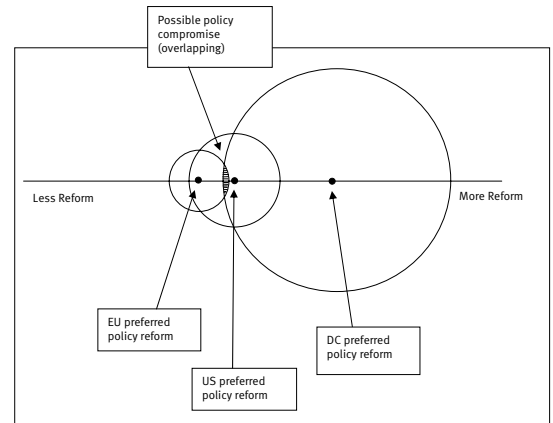
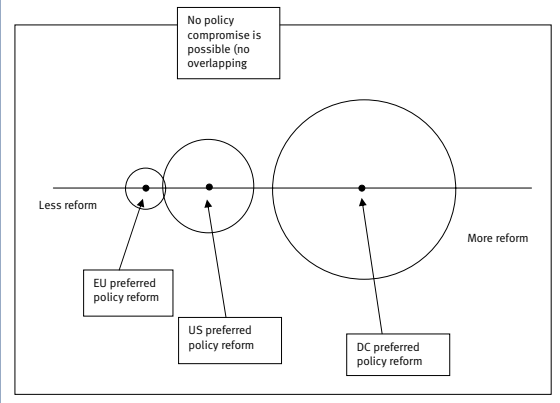


Figure 2: Positions diverge in 2008



greater extent and generate higher losses for the EU, moves the EU ideal point to the left – i.e. reduces their desire for reform – and increases the desire for reform on the part of developing countries, making compromise ever more difficult. The US elections have the same impact on the country’s ideal point – it moves against reform as it becomes less politically palatable with domestic constituencies. More specifically, in the case of the national level of the two level game, the more conservative stance of the US Congress in 2008 moves the domestic ideal point.

Understanding long-term incentives

Graphic representations are useful to illustrate expectations about the impact of cooperative behaviour as the negotiations move into 2008. However, further mathematical formalisation can illuminate the incentives for countries to pursue reform over a longer and more sustained period and therefore how the future risk of a global economic slowdown impacts negotiating positions. A simple mathematical model in which the quota formula is simplified to its two most salient aspects – GDP and trade – suggests that a country will be interested in quota reform that favours GDP if its share of global GDP is greater than its share of global trade. While this result simply helps to confirm intuition, the implications are more interesting if one thinks of the game in a dynamic setting.

The reform proposal recommended for approval by the Executive Board and later approved by the Board of Governors, emphasised that the quota formula will be used in the future in a dynamic manner, to adjust quota representation on an ongoing basis as the relative distribution of power in the global economy changes. Therefore, a single country should inform its negotiating position on the basis of its expectations about the rapidity of its future growth and its share of global trade.

This has interesting implications for the bargaining positions of the three groups of actors modelled above. First, it suggests generally that the possibility for reform of the IMF is greater when countries are experiencing periods of high relative growth, in turn implying that reform is more likely in 2007 than in 2008 if a global economic slowdown is to occur as a

result of the current US credit crisis. More specifically, it yields insights into the conditions under which European states, which have adopted the strongest anti-reform positions, would be likely to shift their preferences towards reform. Stronger growth for any of the EU members, but particularly for larger G7 European countries who wield more power of persuasion in any intra-EU negotiations, will increase their tolerance for reform of the IMF, as their representation is more likely to be based on GDP than trade. This means that a slowdown in European growth, as forecasted in 2008 as a result of global market conditions and export possibilities, would make reform more difficult.

Autumn 2007: Action required

Taking the insights from the graphical and mathematical models, it is possible to understand what is at stake for IMF governance reform. The conditions for immediate change to quota representation are more favourable in 2007 than in 2008 as the winset is larger. In the longer term, the support of member states for reform is likely to increase dependent on positive conditions in the international economy – conditions which might be more favourable in 2007 than in 2008, particularly for European economies which have the most anti-reform positions at present.

2007 represents a unique window of opportunity for finalising the reform package and coming to agreement between developed and developing economies. The new Managing Director, Dominique Strauss-Kahn and the current G20 chair, South Africa, could capitalise on their respective positions to forge a deal while conditions are ripe. However, this window is relatively narrow, and in 2008, a number of new challenges arise for closing the deal.

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- However, the model doesn’t show all the factors. It obscures both the preferences of countries that do not fit easily into one of these three groups (e.g. Japan, Saudi Arabia) and assumes that European countries and developing countries act as two unified blocks.

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