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Task Force 7
Towards Reformed Multilateralism: Transforming Global Institutions and Frameworks

A REFORM PROPOSAL FOR A FIT-FOR-PURPOSE INTERNATIONAL MONETARY FUND

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Abstract

The International Monetary Fund (IMF) is a pillar of the international monetary system, providing multilateral surveillance of countries' economic and financial policies. It also provides short-term funding for countries facing macroeconomic and/or balance of payment stresses. As the needs for its surveillance and lending activities increase, the IMF has become less able to meet those needs. The governance structure of the institution no longer reflects current economic realities and its financial resources have become increasingly inadequate.

These problems are distinct but inter-related and together hinder the IMF's efficiency. A post-COVID-19 global financial system that is fit-for-purpose should envision substantially reforming the IMF's governance structure and bolstering its lending capacity to levels commensurate with the increase in complexity of the financial system and the size of the global economy. This Policy Brief proposes solutions for improving the IMF's governance structure, increasing the resource base, and using those resources more efficiently.

The Challenge

1

The International Monetary Fund (IMF) is the most important institution in the global financial system to help countries manage shocks and crises, but its governance structure and limited resources constrain its ability to respond adequately to systemic shocks as illustrated during the COVID-19 pandemic. While the IMF could resort to existing mechanisms, including emergency ones, to provide support to the most badly hit member countries, this support would be severely constrained if it had to be extended to the bigger emerging market (or even advanced) economies.

Inadequate resource base

Cumulatively, the institution's lending capacity stands at US$952 billion, less than 1 percent of global GDP.[a] This share will continue to decline as global GDP rises. Of the US$952 billion, only US$426 billion or 45 percent represent quota contributions; US$381 billion or 40 percent comprise contributions from the New Arrangements to Borrow (NAB); and the remaining US$146 billion are contributions from the Bilateral Borrowing Agreements (BBA). In other words, non-quota resources account for 55 percent of the IMF's lending capacity. The NAB and bilateral borrowing agreements are temporary and at the discretion of donor countries. The overreliance on these non-quota resources is a source of uncertainty for the institution's resources and is inconsistent with the IMF's basic principle that quota subscriptions should be the main source of resources. As part of the fifteenth general review, the IMF's own policy paper highlighted the resource gap it faces in meeting its members' needs and reiterated that the IMF's current lending capacity should continue to be seen as a minimum.[1]

Archaic governance structures

Multilateral institutions have different governance structures, each with their own advantages and shortcomings. For instance, at the United Nations (UN), each country gets one vote while the UN

a Global foreign exchange reserves amounted to US$11.6 trillion at the end of 2022Q3. The IMF no longer provides a breakdown of foreign exchange reserve holdings into those of developed markets versus emerging market and developing economies. A rough estimate is that the latter group accounts for US$6-7 trillion, highlighting that the level of emerging markets and developing economies demand for safe and liquid assets vastly outstrips IMF resources.

Security Council has 15 members, with five of them holding veto power. The World Trade Organization, meanwhile, largely operates by consensus. The legitimacy and effectiveness of any global institution rests on its responsiveness to the needs of its broad membership, capacity to promote global interests, imperviousness to capture by one or a small group of countries, and the ability to act nimbly at times of urgent need for the institution's services.

A sound governance structure for a multilateral financial institution should ideally take into account the sovereignty of nation-states, as well as the differences not only in economic size and population, but also in capacities and resources.[2] While the IMF's governance structure does a better job at reflecting these principles compared with some other international institutions, it still falls significantly short of a modern structure fit to address the challenges of the 21st century.

IMF quotas are the building blocks of the institution's governance and financial structure. They determine the maximum amount of financial resources each member is obliged to provide to the IMF (and, therefore, the total amount of subscribed resources available to the IMF on a permanent basis), the voting power of each member country, members' access limits to various forms of IMF financing, and members' share in any general allocation of SDRs.

IMF quotas are based on the following formula:

Calculated Quota = (0.50**GDP* + 0.30**Openness* + 0.15**Variability* + 0.05**Reserves*)^*Compression Factor*.

The measure of economic size used in the formula is a blend of GDP based on market exchange rates (60 percent weight) and purchasing power parity (PPP) exchange rates (40 percent weight); *Openness* is the annual average of the sum of current payments and current receipts (goods, services, income, and transfers) for a five-year period; *Variability* is the variability of current receipts and net capital flows (measured as the standard deviation from a centred three-year trend over a 13-year period); and *Reserves* is 12-month averages over one year of official reserves (foreign exchange, SDR holdings, reserve position in the Fund, and monetary gold). The formula also includes a "*compression factor*" that reduces the dispersion in calculated quota shares across members.

The fourteenth general review of quotas was completed in 2010 and became effective in 2016. At that time, the IMF touted the outcome as "a major step toward better reflecting in the institution's governance structure the increasing role of dynamic emerging market and developing countries."[3] The fifteenth general review concluded in 2020 with no increase or redistribution in quotas.[b]

The lack of willingness among key shareholders to use the quota reviews as an opportunity to increase the IMF's resources hampers the institution's effectiveness. Moreover, the decision to not change quotas during the fifteenth review exacerbated existing anomalies as emerging market and developing economies (EMDEs) have registered strong growth performance over the last two decades, especially relative to the advanced economies.

Consider that China's 2022 GDP at market exchange rates was more than the combined GDP of Germany, Japan, and the United Kingdom (UK) in that year, but China's quota is only 6.40 percent while those of the latter three countries sum up to 16.29 percent. Using the full formula mentioned above would only heighten these disparities. Similarly, India's GDP is larger than that of the UK, but their quotas are 2.75 percent and 4.23 percent, respectively. Measured at PPP exchange rates, the divergences between the EMDE economic weights and their quotas would widen further.

In addition to these anomalies, the US voting share of 16.50 percent (which is lower than the US quota of 17.43 percent) gives it effective veto power over major policy decisions that require an 85 percent super-majority. The advanced economies as a group hold more than 50 percent of voting shares, giving them clout over most decisions.[c]

The divergence between the realities of the advanced economies, which are the dominant shareholders,

b These changes must be reviewed and approved by national legislative bodies, which has made the implementation of quota reforms subject to the whims of the US Congress, in particular.

c Voting shares are closely related to quotas but, because every country gets a basic share of votes irrespective of its size, the voting shares of major shareholders are lower than their quotas. During the 2008 reforms, basic votes have been set to 5.5 percent of the total votes.

and those of emerging market and developing economies, which are the main clients, has become increasingly stark and represents a threat to the IMF's legitimacy and efficacy. It also has implications for how effectively the institution's resources are deployed in times of need.

Misdirected resources

The challenge of optimally allocating the COVID-related Special Drawing Rights (SDRs) resources to countries most in need of support illustrates this divergence. Since new SDR allocations are distributed in proportion to quotas, a vast majority of the new SDRs went to the advanced economies or to well-resourced large EMDEs rather than the more vulnerable low-income EMDEs that needed support to deal with domestic and external financing shortfalls. The relatively low quota shares of the group of lower middle-income and low-income economies that stand to benefit the most from the creation of new international liquidity implies that the benefits that this group accrues even from large overall SDR allocations is marginal. Advanced economies could of course on-lend their SDR allocations to EMDEs, but such ad-hoc mechanisms cannot be counted on during crises.

In a statement in April 2022, the G-24 countries have highlighted the implications for their economies of the IMF's inadequate resource base and also the way those resources are allocated.[4]

G20's Role

2

It is in the common interest of all G20 members to have a well-functioning international monetary system, which in turn could be underpinned by an IMF that has bigger resources and is more effective. The membership of the G20 includes the major shareholders of the institution and, collectively, has the power to make the necessary changes. Indeed, the G20 played a pivotal role during the global financial crisis when G20 leaders collectively agreed to triple the IMF's resources (to US$ 750 billion) and also approved a $250-billion SDR allocation to support the world economy and financial system.[5]

The sixteenth general quota review scheduled for this year will be a crucial opportunity to concomitantly increase the IMF's resources, reduce or eliminate the reliance on non-quota resources, and reform its quota allocation mechanism to put the institution on stronger footing to fulfil its mission. The G20 could use the opportunity to institute these reforms and thereby make a significant contribution to the stability of the international monetary system.

Recommendations to the G20

3

This Policy Brief proposes a series of reforms that are essential not only to change the IMF's governance structure but also to increase its resource base and the effectiveness with which those resources are used.

Improve quota formula: In light of their importance in multiple respects, getting the distribution of quotas to be properly aligned with the realities of the world economy is essential. It is laudable that the IMF has created a simple and transparent formula, but this formula can be improved in some respects. This brief makes the following suggestions (which are illustrative, pending further research that might help identify an optimal formula):

- Increase the weight of PPP-based GDP in the blended GDP measure to 50 percent. This change will also help capture differences in population.

- Drop the variability variable. It has close to perfect correlation with openness (0.98), and there is no link between this measure of variability and either actual or potential external vulnerabilities. The IMF's own research has failed to identify a superior measure for variability.[6]

- Replace the *openness* variable with a set of *vulnerability* variables that capture financial and trade integration into the global economy, thus reflecting vulnerability to shocks that emanate on either (or both) the current account and financial accounts of the balance of payments. A separate variable that captures vulnerability to climate shocks would also be desirable to reflect the exposure of some countries to (global) climate shocks even if they are not integrated into the world economy through more traditional linkages.

- We suggest the following alternative formula: **(0.55*GDP + 0.40*Vulnerability + 0.05* Reserves)^Compression factor**. This formula would assign 0.275

weights each to PPP and market-based GDP, 0.30 to a composite measure of trade and financial integration, and 0.10 to a measure of climate vulnerability, while leaving the weight on reserves at 0.05.

- Maintain the compression factor and cap, as appropriate, the contribution of the vulnerability variable to a country's overall quota (to limit the increase in quotas simply on account of a country's greater vulnerability to external and climate shocks).

Realign actual and calculated quotas: At present, there are significant ad-hoc adjustments to calculated quotas and voting power. These should be minimised, or eliminated altogether, to reflect the formula more accurately, although there is a case for some adjustments to maintain the relevance of low-income economies in the voting structure. Eliminate veto power which exposes IMF to US politics but subject some important decisions to a supermajority approval. It is possible that the actual and calculated quota realignment will automatically eliminate the veto power that any nation can have.

Double the size of permanent IMF resources: It is time to increase the IMF's permanent resource base through a doubling of the quotas. This would not by itself increase the IMF's resource envelope if it was accompanied by a phasing out over time of temporary arrangements such as the NABs and BBAs. Nevertheless, this increase in permanent resources that would not be subject to the uncertainty of rollovers of temporary arrangements would give the IMF more certainty and flexibility in deploying those resources. This would leave the overall resource envelope unchanged, of course, so—as noted in the next point, these changes should be supplemented by new resources.

New resources: The IMF charter could be enhanced through a provision allowing the institution to systematically create SDRs at a time of severe global financial stress. Some of these allocations could be of a temporary nature in the case of large, systemic liquidity shortages. New SDR allocations should ideally go into an IMF account, with their distribution across countries determined by an agreed-upon criteria and subject to the nature of shocks (global versus country-specific). Lending programs are subject to IMF Executive Board approval anyway, so oversight on creation and use of SDRs could occur at that stage.

Delink quotas and resources contributions from lending: Linking quotas and lending is inherently contradictory to the mission of the IMF. It substantially reduces the IMF's ability to meet the balance of payments needs of its most vulnerable members at their times of need (even though the access limits can be expanded under exceptional circumstances, subject to the approval of the IMF board). These reforms will *de facto* delink the allocation of new SDRs from quotas and provide the IMF with more flexibility to respond to the varying needs of its members.

Conclusion

4

The reforms outlined in this Policy Brief would help make the IMF a more effective institution that can meet the needs of its membership during times of economic difficulty and, by promoting global financial stability, benefit the entire membership. These reforms are not technically complicated but require political will.

The G20, under the presidency of India, should initiate a substantive and comprehensive reform of the IMF.

Attribution: Brahima S. Coulibaly and Eswar Prasad, “A Reform Proposal for a Fit-For-Purpose International Monetary Fund,” *T20 Policy Brief*, May 2023.

Endnotes

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