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WHAT LIES BEHIND THE IMPASSE AT THE IMF AND WHAT CAN BE DONE ABOUT IT?

Robert H. Wade and Jakob Vestergaard *

Introduction

The years since 2008 have seen a big increase in the stock of dollar-denominated debt in emerging markets and developing countries (EMDCs). Now, as US growth picks up and the US central bank withdraws its stimulus and may start to raise its interest rate, money is flowing back into the dollar, causing its price to soar. The combination of higher dollar and higher interest rates questions the profitability of investments made on the assumption of a low dollar and low interest rates, and causes debt servicing problems around the world. Bank for International Settlement officials say that many EMDCs are now as vulnerable as East Asian countries in the mid-1990s. Meanwhile, the Eurozone crisis is resurfacing, with the possibility of contagion from Greece to Portugal, Italy, Ireland and some other countries with high debt burdens facing rising debt repayments.

Even for today's crises, let alone the ones to come, the IMF is acutely short of secure lending resources -- secure in the sense of not depending on the willingness of non-crisis countries to lend to it short term. The key reason is that the US Congress is blocking ratification of an agreement by all member states that would almost double the Fund's permanent or guaranteed lending resources. The world should be worried that the Fund is currently relying on the good will of countries to sustain its fire-power in an ad hoc way. This is not a solid foundation for the world's main lender-of-last- resort to governments.

To perform effectively the Fund needs a substantial increase in its permanent resources, which means a substantial increase in its total quota. The quota is akin to a credit union deposit, and the amount of a country's quota determines its financial commitments to the Fund, the amount it can borrow, and its share of votes.

The following account of obstructed governance reform in the Fund highlights the sheer oddity of the US and Europe still, in 2015, controlling an organization for the whole world. But on second thoughts, perhaps it is not so surprising, for two reasons.[i]

First, it is part of a much broader hegemonic cycle, in the phase where the US's hegemonic position is eroding; and hegemonic cycles operate over several to many decades. It took from before World War I to the end of World War II for global hegemony to shift decisively from Britain to the US. At the Bretton Woods Summit in 1944, Britain was represented by the patrician, John Maynard Keynes, the most famous economist of his day, who dominated the proceedings intellectually and physically (he stood six foot six inches tall). The United States was represented by

Harry Dexter White, stocky (one foot shorter than Keynes), pugnacious, brought up on the wrong side of the tracks in Boston, unknown to the intellectual world but close advisor to the US Treasury Secretary. White won at almost every turn, signifying the turn of the cycle. We are now in the midst of another major power shift propelled by some emerging market economies reaching shares of world GPD which surpass those of many advanced countries, for the first time in more than two centuries.

Second, the IMF carries out functions – including surveillance, standards-setting, and conditional lending to sovereign governments at times of crisis – which gain from uniform global (rather than regional or bilateral) provision, and which pose high entry barriers to rival providers of these functions. The low probability that discontented IMF members might create *effective* "by-pass" organizations to serve the same functions means that the states dominant at the founding of the organization, which gave themselves a built-in governance advantage, have little incentive to adjust governance in response to their relative loss of economic weight compared to "emerging" states. The founders find it easier to retain their first-mover advantage in the Fund as compared to founders in other kinds of interstate organizations where rival sources of supply are easier to establish (such as development banks, see below).

US blockage of quota increase

In the wake of the North Atlantic financial crash of 2008-09 the G20 meeting in Seoul in November 2010 reached agreement that the Fund's quota should be almost doubled, in order to substantially strengthen the multilateral safety net system.[ii] The US administration took the lead in the G20 process in persuading reluctant Europeans to agree. The G20 agreement was of course only advisory, and the Board of Governors of the Fund, and the Executive Board of Directors, duly negotiated the Fourteenth Review of the Fund's quota in line with G20 instruction.

However, the 2010 agreement or Fourteenth Review did not raise the Fund's total lending resources. What it did is greatly to raise the ratio of the Fund's *secure* resources to the resources it has to borrow from member governments, whose availability must be renewed by the Board of Executive Directors – or not – every six months. Borrowed resources are unreliable resources.

The 2010 agreement was not only to almost double the quota but also to allocate the new quota shares mostly to EMDCs, boosting their share of votes and reducing the current concentration in the hands of advanced economies – whereby France and Germany hold a combined share of 10 percent as against the combined share of China and Brazil of a little more than 5 percent. To make this reallocation towards EMDCs the quota increase was a necessary condition, because Fund rules say that a country cannot have its quota reduced absolutely (and reallocated to others) without its consent.

The 2010 agreement was subject to ratification in capitals.[iii] Here the process broke down, because the US Congress declined to ratify what the US executive branch agreed to – even though the US contribution would carry little extra budgetary cost, because it would merely move funds already committed to be lent to the Fund to another budget head covering the US quota contribution. Congress's refusal reflects the Republicans' substitution of dyspepsia for deliberation as the organizing principle of their relations with the Obama administration. And in any case most Republicans are hostile to multilateral organizations in general and the Fund in particular, seeing it as a vaguely socialist institution which protects governments from holy market discipline by "bailing them out" in the event of crisis. Worse, the additional Fund resources currently would mainly assist European countries, and Congress asks why US taxpayers' money should be used to help Europeans.[iv]

The current low US value on multilateral organizations is caught in the fact that the US had no Executive Director in place at the IMF, the World Bank, or the Interamerican Development Bank (all Washington based) during most of 2014 and into early 2015, because Congress has not acted to approve the administration's nominees. The top US government appointee in each organization has operated in the lower status of "acting" or "alternate". This is unprecedented.

Blame does not rest solely on Congress. The executive (mainly Treasury) also seems not to give the future of the IMF much priority. The executive did not even bring the 2010 agreement to Congress for approval till 2013. Treasury Secretaries Geithner and Lew have not spoken of the issue in public. The executive has not tried to mobilize non-partisan groupings of the Great and Good (from former Treasury Secretary and now co-chair of the Council on Foreign Relations Robert Rubin to Senator John McCain) to build momentum. So the rest of the world has little sense of how the US executive thinks about the IMF issue, beyond mollifying words in private.

This is just one manifestation of a larger pattern of US detachment from international economic organizations. President Obama has used his State of the Union speeches to lay down plenty of challenges which he knows Congress opposes. But he has conveyed no message along the lines of, "The global economic crisis shows our need for strong international organizations. Yet US leadership in these organizations has been slipping. My administration believes it is important to strengthen US global leadership." One might think that both Democrats and Republicans would support action to do so.

Reform of the Board of Executive Directors

The quota reform is complicated by the fact that it was one of two components in the 2010 agreement. The other was a change in the composition of the Board of Executive Directors. The Articles of Agreement say that the top five shareholders shall "appoint" their executive directors, while the other 19 executive directors are "elected". Appointed executive directors can represent only their own country; elected ones can – most do – represent more than one country. The 2010 agreement called for the appointed chairs (US, Japan, UK, Germany and France) to be converted into elected chairs.

Why? Not because of substantive differences in the "heft" of appointed and elected chairs; for there are none. The reason was to facilitate the long-standing US and EMDC objective of reducing the number of chairs held by western European countries (which are seen as overrepresented, with 8, sometimes 9 out of the 24 chairs effectively controlled by western European states). Giving more shares of chairs to EMDCs would bring representation at the Board of Executive Directors into closer alignment with the present distribution of economic weight between countries. The understanding in the 2010 agreement was that "advanced Europe" would give up two seats to EMDCs.

Also, a diplomatic standoff between Britain and France pushed in the same direction. They have occupied two of the five appointed chairs authorized by the Articles of Agreement. But now China has shot to number three shareholder, and one or other of Britain or France must go down to number six – and loose its appointed chair. Britain and France have maintained parity in their shareholding, and neither intends to let the other get ahead. To break the impasse the solution is to abolish appointed chairs. So moving to all-elected chairs could hit two birds with one stone, so to speak: streamline European chairs and save face between Britain and France.

However, this change to an all-elected Board requires change in the Articles of Agreement, and change in the Articles requires approval from shareholders holding at least 85% of the total quota.

US linkage of quota increase with Board reform

The US share is more than 15%, which gives it – either the administration or Congress -- veto power on issues requiring an 85% majority. It is the only state with a veto. The US insisted in 2010 that the two components – the quota increase (which does not require 85%) and the Board reform – be legally linked, making the quota increase also hostage to the US veto. The US insisted on the link because if the quota increase went into effect before the US had ratified it (in which case the US quota would not increase), the US share of the new, much higher total quota would fall below the veto threshold. This would be unacceptable; therefore the quota increase must not go ahead until Congress approves the Board reform.

Also, the US insisted on the link to keep the Europeans on the hook: if the Europeans dragged their heels in giving up two chairs, the US could hit back by vetoing the quota increase, damaging the Fund just when the Europeans needed it for the eurozone crisis. This tactic has worked, up to a point. The advanced Europeans have given up one and two thirds chairs to "emerging market countries". (Fractions of chairs can be given up by allocating more time in the Executive Director position to EMDCs in a given constituency. The European chairs which made this adjustment were all "elected", not "appointed" chairs.) But contrary to what the rest of the membership expected, the gainers were eastern European countries ones conveniently classed as "emerging markets", like Poland, Hungary and the Czech Republic [CHECK]. Which means that the transfer is mostly "within Europe", protecting "Europe's" power position. Also and importantly, Turkey gains; it is now alternating an executive directorship with Austria (whereas before it had a permanently subordinate position in the same constituency). The upshot is that all the European "elected" chairs now represent "mixed" constituencies, including (eastern European) EMDCs, with the exception of the Nordic-Baltic chair (the Baltics do not wish to be classed as "emerging"). This is progress, but one third of a chair remains to go from advanced Europe and the finger points at Spain, which resists. Beyond the current reallocations, there is support from some European countries, the European Commission and the US for Europe to be slimmed down to just two chairs in the longer term, one for the Eurozone and one for the rest of the EU. But powerful European states say: over my dead body.

Can the two components be delinked?

The IMF has prepared an "options" paper to explore how to move some way towards the governance reforms of the 2010 agreement without congressional approval. The paper is top secret (it exists only in a small number of numbered copies), and clearly surrounded by tension and agonizing.

The one solution that would serve the interests of almost every one is to delink the two components of the 2010 agreement, so that the quota increase could go into effect independently of the change in Board composition (Batista and Torres 2015). The Board could assure the US that no issue would be brought to it which required an 85% majority during the period when the US quota fell below 15% -- so it would continue to have a de facto though not de jure veto (until the Congress agreed to raise the US quota by enough to restore it to more than 15% of the higher total). However, such a delinking requires a Board Resolution, and a Board Resolution requires an 85% majority; so again is hostage to a US veto. Many Executive Directors and IMF staff say: the US will never agree to give up its de jure veto and trust to a gentlemen's agreement, especially when the BRICS (Brazil, Russia, India, China, South Africa) have almost 15% of the total quota between themselves. The gentlemen's agreement could be voided by a 50 percent Board vote. Then the BRICS and allies could vote to change the Articles of Agreement and the US, having lost its de jure veto, could not stop them. Imagine how the US giving up its de jure veto even for a minute would play on Fox News: "Obama gives up US power and once again proves he does not love America".[v]

The US administration and the US Executive Director have remained silent on the delinking issue, leaving it to other Executive Directors and IMF staff to articulate likely American refusal. They do not want to say anything that might jeopardize their difficult negotiations with Congress about ratifying the 2010 agreement, which is merely one of many issues on which the administration is trying to cut deals with Congress (sometimes by promising to fund projects wanted by prominent members of Congress, entailing budgetary cost). The IMF has zero salience in US domestic politics, and congressional representatives can extract a high price from Treasury in return for support on the IMF. Treasury therefore has to balance this budgetary price against the administration's repeated embarrassment in international forums (such as the G20) to be admonished by China, Russia, Brazil, India and others to shoulder their collective responsibilities, rather than the other way around, as has long been the norm. When will the embarrassment and loss of legitimacy exceed the price? It is anyone's guess. For now, the bottom line is that any route to doubling the secure resources of the Fund – whether through ratification of the 2010 agreement or by delinking its two constitutive components – requires compromise across bipartisan lines in US Congress, which seems unlikely any time soon.

Looming deadlines

The 2010 agreement envisioned a sequence whereby first the Fourteenth Review would be implemented (the quota almost doubled, etc.), then the quota *formula* would be revised by end of 2013, then the Fifteenth Review would be negotiated by January 2014, bringing it forward two years from its prescheduled December 2015 deadline. (The Fund is obliged by its Articles of Agreement to review its quotas every five years.) The failure to put the Fourteenth Review into effect throws all this out. Where would the Fifteenth Review start from? The answer is entirely unclear.

And what quota formula would the 2015 Fifteenth Review use? (The formula produces the first approximation of what each country's actual quota will be, around which starts the often protracted "life or death" negotiations even down to the second decimal point.) There are fierce differences within the Executive Board on how -- if at all -- the formula should be changed. Broadly speaking, the countries with large GDPs say the formula should give "share of global GDP" much more weight than at present (50%); then they debate whether GDP should be measured at market exchange rates or at purchasing power parity exchange rates or some blend. Countries with relatively small GDPs say that moving to GDP shares would make the Board look as unrepresentative as the G20; and that "economic openness" (as indicated by share of trade in GDP) should continue to receive substantial weight (at present 30%), among other reasons because the very rationale of the Fund is to protect the openness of the world economy. There is wide agreement that the "variability" variable in the formula (weighted at 15%) should be taken out, but disagreement on where its weight should be allocated, to GDP or to openness. In response to these complexities some governments say that the current formula, itself the result of protracted negotiations, should remain unchanged.

How to proceed with governance reforms -- including the stalled Fourteenth Review, the Fifteenth Review and the quota formula -- will be the subject of heated debate at the Annual Meetings in October 2015. But it will be a miracle if agreement is reached by December 2015, as required by the Articles. If agreement is not reached, an extension beyond December would require a Board Resolution (which requires an 85% majority). If the BRICS and allies decide not to agree to an extension beyond December they could block the extension, creating a constitutional crisis. But the BRICS are being cautious to press their case, balancing their pressure for more representation against the need to keep the Fund effective and credible.

The same applies to another main weapon in the hands of BRICS and other EMDCs – to threaten to discontinue their participation in the Fund's New Arrangements to Borrow whereby countries lend to the Fund to preserve its short-term resources, which, as noted, the Board has to approve, or not, every six months. Some of the BRICS wanted to use this weapon to play hard-ball. But China, in particular, has cautioned against. China is playing a long game, knowing that time is on its side.

The way forward: ending the US veto?

The secret options paper mentioned earlier discusses both the delinking option and also some "ad hoc" solutions, ways of getting a small quota increase (maybe a 20 percent increase rather than doubling) which would still keep the US share above the 15 percent veto threshold, and then an allocation of the small increase towards some dynamic emerging market countries. Here the multitude of possible trade-offs make a negotiator's nightmare; and in any case, executive directors have substantially different views as to the wisdom of even embarking on the "ad hoc" or "interim steps" route. Many worry that a small "ad hoc" agreement might prompt the US administration and Congress to say that ratifying the 2010 Fourteenth Review is not so important afterall. No one knows.

The story of the current gridlock shows how the Fund is trapped by its history. The US veto, inscribed at the Fund's creation, is seriously damaging the organization. Even if the US Congress agrees to ratify the 2010 agreement and even if the Fifteenth Review is completed by the end of 2015, the problem of the US veto remains. It gives the US the built-in top leadership position; but the US uses this position to block more than to lead, due to the stalemates between the executive and legislative branches and the powerful current of "Island America". The US can veto any move which would end its veto, and is unlikely to agree to make such a symbolic statement of its own relative economic decline. Yet if it does not agree, the Fund may become a shadow of its former self, hostage to the US executive and legislature and without the resources to act as an effective instrument even just of US foreign policy.

From the outside the situation looks completely paradoxical. The US pushed the Europeans to agree to the Fourteenth Review measures in 2010. The US stands to loose little if the 2010 agreement is implemented, either in its quota share or in budgetary resources. The US stands to loose a lot if the 2010 agreement is not implemented – including good will and the possibility of regional or bilateral safety nets in other parts of the world, undercutting the power of the IMF and the US veto in the global multilateral order. Yet the US is still not willing to ratify. Perhaps the US administration, for all its private assurances to the Fund, is hiding behind the US Congress, content to let Congress take the blame for what it in any case does not have much enthusiasm, fearing that 2010 will be a mere "downpayment" on much bigger quota increases and reallocations to come. Perhaps the other G7 countries are hiding behind the US, content to let the US take the blame, knowing that most of them will suffer big cuts in voting shares if 2010 acts as a downpayment.

Some fresh thinking might be induced by the prospect that, absent changes in the supermajority rules, China on current trends could have a veto in twenty years time, and the US could have lost so much relative economic weight as to loose its veto. This scenario might induce the US to give up its veto as part of a negotiation to change the supermajority rules so as to prevent any one country having a blocking minority. Another idea championed by some Europeans is to lower the supermajority threshold from 85 percent to 70 percent. Not coincidentally, this would give "coordinated Europe" alone the veto. "Coordinated Europe" having the sole veto is a prospect the non-Europeans do not view favorably.

Conclusion

The governing committee of the International Monetary Fund said in its communique after last week's Spring Meetings that it was "deeply disappointed" at the lack of progress in doubling the Fund's secure lending resources.[vi]

At stake is the Fund's ability to provide emergency loans to countries in financial or balance of payments trouble. With the global economy mired in a "stop and go" recovery "at risk of stalling again", according to the latest Brookings Institution-Financial Times tracking index, the demand for such loans is likely to rise and global financial stability is at risk if the Fund cannot provide them.

Currently the Fund's ability to lend depends too much on the willingness of member governments to lend to it short-term. Without change to supermajority rules, the danger is that the stability of the world economy will continue to depend on ad hoc short-term increases in the Fund's resources and on a spaghetti ball of bilateral and regional safety net agreements, their aggregate stabilizing effects unknown when the multi-country crises come. That is a prospect devoutly to avoid.

All the more so because institutionalizing a reliable safety net system outside the Fund is far more difficult than institutionalizing a development bank, for example. The World Bank's functions can easily be mimicked by whoever has sufficient resources (as by the Brazilian development bank, the Chinese development bank, and maybe the New Development Bank created by the BRICS). The IMF's functions cannot easily be mimicked, for reasons given earlier. Its functions require a big balance sheet of secure funding and a lot of learning-by-doing in program surveillance and program design (for example, distinguishing a liquidity from a solvency crisis) which cannot be simply imported from the private sector or national banks. A case in point is the Chiang Mai Initiative Multilateralization, established as a regional safety net system in 1999 after the East Asian crisis, which has barely functioned over its 15 year history. When member countries needed emergency loans they have gone directly to strong central banks (South Korea to the US central bank in 2008, Indonesia to the Bank of Japan in 2009).

Since the IMF's functions cannot be readily replicated, it is important to solve one of its major weaknesses: the low level of its secure lending resources. In the end, all roads lead back to the US veto. The prospect of the Fund in constitutional crisis, short of secure loanable funds, operating in a world of fragmenting safety net arrangements, with the near certainty of more multi-country financial crises in the next decade, should build momentum for ending the US veto in one way or another.

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[i] Quota and governance reform in the IMF, a topic too boring to make it "to the front page of any newspaper" (Johnson 2014b), has received more academic attention in the past year or two, than for a decade or more before that. Examples include Bergsten and Truman (2014); Edwards (2014); El-Erian (2014); Johnson (2014a); Lesage et al (2013) Patrick (2014); Truman (2014, 2015). While many realize that the blockage in the US Congress is the key problem now, few note the deeper problem that its Articles of Agreement make the IMF vulnerable to blocking minorities. For literature on IMF governance reform which discuss in some detail the quota and voting share system of the IMF, see Benassay-Quere and Bereau (2011); Leech and Leech (2005); Rapkin and Strand (2006); Stiglitz (2003); Woods and Lombardi (2006); and Woodward (2007). See also IEO (2008); CIGI (2013); Centre for Research on Globalization (2014) and Congressional Research Service (2014).

[ii] The key document laying down the terms of the 2010 agreement is IMF (2010a, 2010b). For the latest developments, see the Board communiqué from January 2015 (IMF 2015a) and the official IMFC communiqué from the Spring Meetings in April (IMFC 2015).

[iii] The 2010 agreement has been ratified by 147 member countries, constituting an aggregate voting share of 77,24 % (IMF 2015b). For entering into force, a majority of three-fifths of the Fund's member countries (113) and 85 % of its shareholding is required.

[iv] As of 31 March 2015, almost 80 % of IMF lending was for European countries, notably Greece and Ukraine. For details, see IMF (2015c).

[v] As we did our second round of interviews in Washington, the headline story in American media was accusations made by Rudy Guiliana, former mayor of New York, at a dinner for Republicans and business executives: "I do not believe, and I know this is a horrible thing to say, but I do not believe that the president loves America. He doesn't love you. And he doesn't love me. He wasn't brought up the way you were brought up and I was brought up through love of this country (Samuelsohn 2015).

[vi] The full phrase of the IMFC on governance reform reads as follows: "We remain deeply disappointed with the continued delay in progressing the 2010 IMF Quota and Governance Reforms. Recognizing the importance of these reforms for the credibility, legitimacy, and effectiveness of the IMF, we reaffirm that their earliest implementation remains our highest priority. We continue to urge the United States to ratify the 2010 reforms as soon as possible. Mindful of the aims of the 2010 reforms, we call on the IMF Executive Board to pursue an interim solution that will meaningfully converge quota shares as soon as and to the extent possible to the levels agreed under the 14th Review. We will use the 14th Review as a basis for work on the 15th Review of Quotas, including a new quota formula. We reaffirm our commitment to maintaining a strong, well-resourced, and quota-based IMF".