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A Southern perspective on the reform of international financial institutions

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>> Since the onset of the financial crisis, the G20 has moved to centre stage concerning global economic governance in general, and reform of international finance regulation in particular. This ascendance culminated in the G20 Pittsburgh Summit declaration to the effect that the G20 is now 'the' forum of choice for international economic coordination.

As the focal point of any deliberations on the international financial architecture, the G20 offers an important opportunity for developing countries in particular to make a contribution to reform of international financial institutions (IFIs), particularly the International Monetary Fund (IMF) and the World Bank. IFIs matter to developing countries, especially those in Africa, for a number of reasons. Prominent among these is the fact that capital and foreign exchange are in short supply in many developing countries, and therefore cost-effective external sources are often critical supplements. Therefore developing countries, particularly the poorest, are *demandeurs* of the IFIs financial resources. Furthermore, as the global financial crisis has shown, the IMF plays a critical global role as the lender of last resort in times of liquidity and foreign exchange shortages. Both organisations are also key knowledge resources concerning economic management and development policy.

Of course, all this finance comes at a price in the form of policy conditions on IMF and World Bank concessional lending. Depending on one's perspective, these can serve as useful external props to support domestic reform in the recipient country, or externally imposed 'neo-imperialist' instruments of the developed world, which dominates governance of the IFIs. Clearly those who pay the piper call the tune, so it would be surprising if developed countries did not insist on some conditions being observed so that loans will be repaid and the IFIs thereby sustained. How-

FKI THE FEDERATION OF KOREAN INDUSTRIES

G | M | F The German Marshall Fund of the United States

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Presidential Council on Nation Branding



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한국국제교류재단

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»»»»» ever, there is a risk that the IFIs go too far in imposing conditions and thereby alienate their 'clients' thus obviating the need for IFI funding and undermining the *raison d'être* of the institutions.

These problems were particularly evident during the Asian financial crisis of the late 1990s, leading directly to the Chiang Mai currency swap initiative and foreign exchange reserve accumulation by Asian countries in an effort to avoid resorting to IMF funding – a phenomenon referred to as 'self-insurance'. The Chiang Mai initiative reduces the need for East Asian countries to resort to IMF funding in conditions of macroeconomic crisis in the future. Forex accumulation, on the other hand, results in reserves being recycled into US and European financial markets which contributed in substantial measure to the surplus liquidity that underpinned the global financial crisis.

In this light, reform of the IMF needs to be seen as part of the broader discussion about the legitimacy of the global lender of last resort. Consequently, reform of the IMF's governance structures should give the institutions more legitimacy through the improvement of their responsiveness to developing country needs, as well as increasing its accountability and effectiveness.

CURRENT PROBLEMS WITH IFI GOVERNANCE

The major issue dominating the discourse on IFI reform concerns the 'legitimacy' of these institutions. Most of these concerns centre on the IMF given that it has been the major 'winner' in the post financial crisis world, returning to centre stage after a period of stagnation and seemingly growing irrelevance.

There appears to be a consensus among developing countries that major governance reforms are needed, translating in particular to changes in quotas, voting rights, executive board representation and transparency in the management selection process. Lack of voting power means that developing countries do not have an effective

'voice' in the institutions, therefore there is not enough incentive for them to engage meaningfully in the deliberations and in the decisions taken. Concomitantly, there is no incentive for developed countries to listen if they control the voting process. This disjuncture reinforces the notion that developed countries use the IMF as instruments of neo-imperial policy.

Ngairé Woods identifies three reasons why governance deficits have contributed to an ineffective IMF in the developing world. Firstly, the responsiveness of the IMF is limited. This is because developing countries have no voice in the institution and thus cannot express their concerns, interests and priorities and as a result the institution cannot implement programmes and instruments that address developing country concerns and priorities. Secondly, the governance structure limits the effectiveness of the IMF in developing countries. This is because there isn't sufficient 'buy in' from developing countries to give effect to IMF programmes and initiatives. Thirdly, the governance structure of the IMF affects its accountability. The priorities of the IMF are set by its Board, which is not representative of the majority of its members. As such, the Board needs to be appropriately accountable to developing countries, which serve as its major clients but are not represented in the governance structures.

The key problem is that voting weights in the IMF primarily reflect historical prerogatives and weight in the global economy. The former ensures European overrepresentation and its downside – a strong unwillingness to yield prerogatives. From an African perspective, the latter raises the obvious difficulty that African economies are small, and if GDP is to be the most important yardstick for representation, then African economies will lose out in any redistribution.

GOVERNANCE REFORMS SO FAR

Both the IMF and the World Bank have made modest reforms to their governance structures and procedures to enable improved developing country participation. In April 2008, the IMF adopted re-

forms that included a tripling of basic votes; a mechanism to keep the ratio of basic votes to voting power constant; and allowances for each of the two Executive Directors representing African constituencies to appoint an additional Alternate Director. The increase in basic votes is a significant development as it has amplified, although modestly, the political influence of smaller IMF members. The IMF has also undertaken to shift the quota share by at least 5 per cent to give greater voice to emerging markets and developing countries. A January 2011 deadline has been set to achieve the shift.

However, these reforms have met with criticism on the basis that they preserve the dominance of developed countries. Within the IMF, discussion of the composition and selection of the Executive Board seems to have been kept off the table entirely. Western Europe has eight representatives on the Board, while sub-Saharan Africa has just two. The dent made in the voting power of the developed countries through the trebling of the basic vote is quite marginal. European countries still enjoy major weight in the IMF: approximately double the voting power of the United States even though their accumulated GDP is roughly the same as US GDP. Major questions remain as to why this is the case given that most are members of a single currency area. Indeed, the US remains relatively under-represented in the IMF, although it does retain a veto Belgium currently has more votes than Brazil.

WHAT FURTHER REFORMS ARE NEEDED?

A number of proposals have been made:

1 A redistribution of quotas in the IMF to reflect changes in the global political economy while maintaining the quota shares of over-represented developing country members. This is particularly important in light of the recent increase in voting shares to developing countries in the World Bank, which resulted in the loss of voting shares for some developing countries such as Nigeria and South

Africa: the shares of over-represented developing countries are the ones distributed to the countries whose shares are being increased. Consequently, the effects of the vote reshuffle are not that significant for developed countries. The initial voting powers and quota allocations in these institutions were based on the financial contributions of the members as well as their economic importance. This has changed significantly over the years with developing countries contributing significantly more through their loan repayments. Also, as the primary users of IFI services, developing countries deserve an equal voice in the institutions.

2 The IMF Board decides the priorities of the institution. As a result, equitable representation of developing countries on the Board is needed if such priorities are to reflect developing country needs. This could be done by consolidating some European chairs into a single Eurozone seat, since Europe is overrepresented. Such changes in the Board's structure would need to reflect changes in voting weights.

3 A reconfiguration of the 'heads' and staff selection procedures. The selection of the head of the World Bank and the Managing Director of the IMF is based on the voting and quota structures, and is thus based upon nationality – either US or EU. Appointment to such positions should be made through an open, transparent and merit-based process, without regard to nationality or gender. To its credit, the G20 has pledged to move on this issue. Staff selection should also be diverse and reflective of regional representation in the institutions. This would allow for greater accountability. This is very important given that the make-up of the senior staff creates a structure of accountability for the whole body of staff of each organisation, which decides the countries that hold the institutions to account. Opening up accountability of the senior staff to the whole membership would also enhance developing countries' voice in these institutions and help their effective representation.



»»»»» **WHAT ROLE FOR THE G20?**

The question of the reform of IFIs has long been on the agenda. However, a new issue is that the G20 has the necessary clout to drive the reform process and can provide the necessary impetus to put the changes in motion. The latest report of the G20 working group on the reform of the IMF mentions reform aimed at increasing the voice and representation of emerging markets and developing economies as a reflection of the changing economic weights in the world economy. Similarly, G20 communiqués have also underscored the importance of such reform in the IFIs. The challenge is to transform these proposals into concrete action.

This of course raises questions of the effectiveness of developing country participation in the G20 as well as the matter of the G20's legitimacy. A small group formulating key decisions to guide the global economy will always face charges of a lack of legitimacy. South Africa is the sole African 'representative', which raises issues about why it was selected, by whom and how and if it can most effectively 'represent' Africa, the continent with arguably the most severe development challenges. South Africa has, however, attempted to mobilise African positions through its engagements with the so-called Committee of 10, which enables the South African government better to reflect Africa's interests in these issues.

Nonetheless, the G20 seems to be driven by the G7 agenda, raising questions about the reform process of the IFIs and its transparency. These

questions need to be addressed in order for the reform process to be more reflective of developing country concerns. This need is sharpened by the fact that the major consumers of IMF and World Bank services are those countries which are excluded from the G20 process.

This leads into the question of the representation of developing countries in the G20 itself. Many argue that while the global political economy is currently undergoing a significant power shift, the emerging powers do not yet have sufficient clout to command these reforms. As such, it would be far-fetched to expect immediate reforms in the short run. It could also be argued that the focus should be less on governance and representation and more on financial capacity and crisis prevention and response.

Nonetheless, the core of the argument above is that without the necessary reforms regarding the governance and representation of these institutions, the greater objectives such as crisis prevention and increasing financial resources for developing countries will not be adequately achieved and will not reflect developing country priorities. If governance issues are resolved, it would pave the way for more comprehensive reforms.

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