A suggestion for the IMF: Embrace regionalism

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It is no secret that the governance of the International Monetary Fund (IMF) does not match economic reality and that the vote shares of emerging market countries do not reflect their economic strength. If the IMF does not make its governance more inclusive, it will (continue to) lose the support of emerging market countries. But if the power of the United States and Western Europe is diluted, they may be less inclined to support the IMF with additional funding in the future. Perhaps this is the signature of a multipolar world, where no one is strong enough to dominate at the international level – and regional hegemons emerge. If this is so, one potential solution for the Fund is to recognise the growing strength of regional organisations and find ways to engage and work with them.

Note that the need for change in IMF governance is recognised by those who dominate its Executive Board of Directors, but acceptable solutions have evaded them for years. The United States wants smaller Western European countries to accept smaller vote shares and to give up their Executive Directorships. Western Europe has called for the United States to give up *de facto* veto power over major decisions by reducing its vote share below the 15 percent threshold (major decisions at the IMF require an 85 percent majority). Yet the US Congress would not likely approve increased contributions to an IMF in which the United States has less say over the use of such funding. Western European countries would likely be in a similar bind. Would Belgium, the Netherlands, and Switzerland be able to generate domestic financial support for an IMF where they did not have seats on the Executive Board?

Any reduction in Western political and financial support would have to be met by an increase from the emerging market world. Certainly, emerging market countries have the foreign currency reserves to meet the task. But do they have the political will – or even the political interest to do so?

Emerging market countries have lamented for years the fact that they are underrepresented in voting power at the IMF – and rightfully so. China – the second largest economy in the world (having overtaken Japan) – has a smaller vote share than France (3.65 percent vs. 4.85 percent).[3] Belgium (GDP = US$ 470 billion) has 2.08 percent of the votes, while Brazil (GDP = US$ 1.6 trillion) has only 1.38 percent of the votes and India (GDP = US$ 1.2 trillion) has only 1.88 percent of the votes. Other factors beyond GDP definitely matter when it comes to "economic weight," but there is no realistic weighting that could support vote share apportionments in which France is stronger than China, and Belgium stronger than both Brazil and India – at least not without political machinations. But because an 85 percent majority of the current votes is required for any change to the voting structure, ma-

3 Small shifts in the vote shares that are occurring as we write notwithstanding.

jor shifts have been easily thwarted. Still, there have been incremental changes throughout the past decade. Slowly, the vote shares are coming into line with economic realities (see Vreeland 2007).

But are these changes too little too late? Do emerging market countries really even care about having a greater say in the IMF? Let us consider their actions when it comes to competing in the Executive Board elections, and contrast them with the actions of Western European countries. Every two years, the 187 member-countries elect the 24-member Executive Board of Directors. There is a kind of free market for Directorships.

By teaming up with other countries, Italy, which has 3.2 percent of the votes at the IMF by itself, ends up controlling 4.1 percent of the votes on the IMF Executive Board. This is more than China, which teams up with *no one*, and controls only 3.7 percent.

Belgium, which has 2.1 votes at the IMF by itself, teams up with several countries and ends up controlling 5.1 percent of the votes on the Executive Board, more than either the United Kingdom or France (which have 4.9 percent each). Up until this weekend, Belgium represented Austria, Belarus, the Czech Republic, Hungary, Kazakhstan, Luxembourg, Slovak Republic, Slovenia, and Turkey.

The Netherlands bloc includes a group of non-obvious partners: Armenia, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Georgia, Israel, Macedonia, Moldova, Montenegro, Romania and Ukraine.

And then there is Switzerland. Since joining the institution in 1992, Switzerland has put together a coalition of states from Central Asia, Western Asia, Eastern Europe, and Southern Europe. This turns out to be important for global representation, since no Director comes from Central Asia or Eastern Europe.

Countries like China, which claim to want a stronger voice at the IMF, could have competed for the support of smaller countries – like Kazakhstan, for example. But what happened? Well, Kazakhstan's votes were up for grabs – Belgium lost them. But they were not picked up by a bloc led by an emerging market country. Rather, Kazakhstan joined the Swiss bloc. Instead of giving up its seat, as urged by the United States, Switzerland solidified its position.

How does Switzerland do it? Research indicates that foreign aid might be helping (Vreeland 2010), allowing money to be traded for political influence. Rich countries provide foreign aid to developing countries that offer political support at the IMF.

Why do the emerging market countries remain aloof from this game? We suspect that they simply do not care. Recent changes in vote shares may partially address the question of emerging-market representation, but not of the loss of confidence in the institution. In fact, since the global financial turmoil of the late 1990s and early 2000s, emerging markets have largely avoided IMF borrowing – partly due to collective memories of economic contractions and growing inequality during the periods of heavy borrowing in the 1980s and 1990s, and partly because most of these middle-income countries have been able to borrow from private capital markets. Since 2007, the IMF has concentrated the bulk of its lending on

European countries in distress. Of the US$ 90 billion in IMF current standby arrangements, over-three quarters of the money is committed to six countries: Greece, Hungary, Iceland, Latvia, Romania, and Ukraine.

Meanwhile, emerging market countries have been exploring regional alternatives to the IMF (and World Bank).[4] Last year, for example, Prime Minister Vladimir Putin called for concerted action to break the stranglehold of the US dollar and create a new global structure of regional powers (see Desai / Vreeland 2010). In East Asia, the Chiang Mai Initiative of the ASEAN+3 (the Association of Southeast Asian Nations plus China, Japan, and South Korea) may be a precursor to an Asian Monetary Union. Although much newer, the Union of South American Nations (UNASUR) – born from the convergence of MERCOSUR and the Andean Community, as well as President Hugo Chavez's proposed Banco del Sur and the Latin American Reserve Fund (FLAR) – are considered by many in the region to be necessary counterweights to the Bretton Woods Institutions. More recently, the African Union has proposed the establishment of an African Monetary Fund.

These regional options, however, still leave a constructive role for the IMF. Consider the European Union (EU), by far the most advanced regional organisation. Faced with issues of debt, the governments of the EU have turned to the IMF. They do not need the money – they need the institutionalised mechanism whereby liquidity is provided in return for policy reforms.

Similarly, the Chiang Mai Initiative does not obviate the need for the IMF: if a country needs to borrow more than 20 percent of the available swaps, it must submit to IMF guidelines on economic reform – a *de facto* "conditionality" intended to deter lax economic policies (see, e.g., Woo 2007). Unlike the Chiang Mai Initiative, the Banco del Sur designers insisted on a "no conditionality" clause, indicating that the Banco del Sur will determine the capacity of its members to borrow and will not place any restrictions on repayment beyond the established terms of the loan (McElhinny 2007). We are not convinced, however, that creditor-states, like Brazil, are going to be willing to contribute to a pool of funds that can be lent with absolutely no strings attached. If they do, they will be inviting moral hazard and inflationary pressures.

How will regional organisations navigate between providing liquidity and avoiding moral hazard? One avenue is to work explicitly with the IMF. There are various arrangements that one can imagine. One possibility would be for regional funds to set lending terms and conditions, while leaving monitoring and enforcement to the IMF. Alternatively a two-tiered system could be developed, where countries turn first to their regional organisations for short-term liquidity, and subsequently submit to IMF conditionality for longer-term lending (Johnson 2009; Subramanian 2010). Regional organisations are likely to have greater local knowledge of the financial and fiscal constraints and prospects of regional economies, yet

4 For a more thorough review of regional monetary funds, see Desai / Vreeland (s. a.). Also see McKay / Volz / Wölfinger (2010).

may be less willing to impose strict conditionality on their regional partners under stress than the IMF.[5] Ultimately, it may be incumbent upon regional monetary regimes to acquire the capacity to devise their own stabilisation programmes, conduct their own monetary co-ordination and surveillance, and to impose their own system of sanctions. The record of such regional arrangements – even in the most advanced case of the EU and its monetary arrangements – has been disappointing. But the regionalisation of the financial architecture is inevitable, both because financial regionalisation is demanded by emerging market economies, and because of the diminished relevance of global institutions such as the IMF to fast-growing regional economies.

In a multipolar world, current institutions of global governance are losing ground to regional organisations. A potential path for the old institutions is to recognise the growing strength of regionalism and find ways to engage with these regional counterparts.

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5 Particularly those that are politically important. See Kilby (2006) and Lim / Vreeland (2010).