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January 22, 2002

To: Members of the Executive Board

From: The Secretary

Subject: **Twelfth General Review of Quotas—Preliminary Considerations and Next Steps**

Attached for consideration by the Executive Directors is a paper on preliminary considerations and next steps relating to the twelfth general review of quotas, which is proposed to be brought for discussion in a seminar on Friday, February 8, 2002. Issues for discussion appear on pages 20 and 21.

Questions may be referred to Mr. Trines (ext. 35639) and Mr. P. Ross (ext. 38973).

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INTERNATIONAL MONETARY FUND

Twelfth General Review of Quotas—Preliminary Considerations and Next Steps

Prepared by the Treasurer's Department

In consultation with other departments

Approved by Eduard Brau

January 22, 2002

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I. INTRODUCTION

1. The Articles of Agreement (Article III, Section 2 (a)) provide that the Board of Governors shall at intervals of not more than five years conduct a general review of the quotas of members.[1] In this regard, the upcoming Twelfth General Review of Quotas is to be completed not later than January 30, 2003. **This paper considers conceptual issues related to the size of Fund quotas** in light of developments in the world economy and the evolving role of the Fund, particularly its financing policies but does not provide a quantification of the appropriate level of quotas.[2] A subsequent paper in the proposed work program on quota issues will consider a number of indicators that could be used in assessing the adequacy of Fund quotas taking into account the Executive Board's discussion of the conceptual issues. In response to requests from Executive Directors, the paper also examines two ancillary issues in annexes: the **distribution of non-equiproportional quota increases** and **basic votes.**

2. **The remainder of the paper is organized as follows.** Section II considers the implications of globalization on the evolving role of the Fund and its financing policies. Section III discusses the impact of these developments on the Fund's resource base. Section IV sets out a program of further work on quotas and raises issues for Executive Board discussion.

II. THE CHANGING WORLD ECONOMY AND THE EVOLVING ROLE OF THE FUND

3. **The globalization of the world economy continued during the past decade as a growing number of countries adopted private market based economic systems and barriers to international trade and capital movements were reduced.** The growing economic interdependence of countries is reflected in the increasing volume and variety of cross-border transactions in goods, services, and capital flows. The changes in the global financial system have enabled more countries to use private capital markets to help meet their external financing needs and have altered the role of the official sector, particularly of the

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[1] The period for completing the quota review begins on the date the previous review was completed or scheduled to be completed, whichever is earlier. The Eleventh Review was concluded on January 30, 1998. The rules and regulations of the Fund (Rule D–3) provide that at least one year prior to the time when a general review of quotas must be undertaken, the Executive Board shall appoint a Committee of the Whole (COW). A draft decision proposing the formation of a COW (EDB/01/118, 12/18/01) was circulated to the Executive Board and adopted on a lapse of time basis on December 27, 2001.

[2] The paper considers only issues relating to the Fund's activities in the General Resources Account (GRA) and not the role of the Fund in providing unconditional liquidity through the SDR Department or concessional financing and debt relief through the PRGF and HIPC Trust Accounts. For a recent discussion of the SDR, see *SDR Allocation in the Eighth Basic Period—Basic Considerations* (SM/01/347, 11/16/01).

Fund. This section briefly reviews the key features of globalization and the steps taken by the Fund to adapt to the challenges posed by greater financial integration.[3]

4. **The continued liberalization of trade and payments has contributed to the rapid growth of international transactions in goods and services**. The volume of world trade flows has increased by 6 percent annually over the past two decades, twice as fast as world real GDP, thereby contributing to a deepening of economic integration.[4] As a result, import and export shares of GDP have generally grown in both the advanced and developing economies. Furthermore, developing countries as a group achieved the fastest expansion of trade and now account for one third of world trade, up from one quarter in the early 1970s. The growth in developing country trade has also been marked by a rapid rise in trade among developing countries, which now accounts for nearly 40 percent of the total, and a rising share of manufactures in developing countries' exports, which has risen threefold to more than 80 percent. In particular, emerging market countries have experienced the strongest growth in trade volumes as they have participated in the geographic dispersion of production processes and intra-industry trade. A strong multilateral framework has supported the trend toward greater trade liberalization—with the WTO at its center—that has facilitated general reductions in tariff and non-tariff trade barriers. Trade liberalization has also encouraged an easing of restrictions on current payments, with acceptance of the obligations of Article VIII—the elimination of restrictions on current international payments—increasing from less than one third of the membership in 1970 to four fifths today.[5] [6]

5. **The liberalization of capital transactions and the integration of financial markets have resulted in a significant expansion in the volume and variety of international capital flows.** Liberalization of domestic capital markets and of international capital flows since the early 1970s, coupled with rapid gains in information technology have been a catalyst for financial innovation and the growth of cross-border capital flows. The integration of national financial systems toward a single global financial system is indicated by: more diversified investment portfolios; the larger number of firms tapping foreign sources of funds; and the growth of sophisticated asset managers. As a result, there has been

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[3] See Chapters III-V in *World Economic Outlook*, May 1997 for a comprehensive discussion of globalization, and Masson, Paul, *Globalization: Facts* and *Figures*, Policy Discussion Paper 01/4, October 2001, for a recent concise summary of its economic dimensions.

[4] See Chapter II in *World Economic Outlook*, October 2001 on increased international linkages.

[5] *Trends in Trade Liberalization,* FO/DIS/01/137 (11/8/01).

[6] See *A New Trade Round for a Better World*, Statement by the Managing Director at the WTO Ministerial Conference, Doha, Qatar, November 10, 2001; and *Global Trade Liberalization and the Developing Countries*, Issues Brief 01/08, November 2001, both of which are available on the Fund's website: www.imf.org.

substantial growth in gross portfolio flows and cross-border securities' transactions that exceeded the growth of trade flows.[7]

6. **A notable feature during the 1990's has been the changing composition of international capital flows from a heavy concentration on bank lending and official flows to private flows, especially foreign direct investment (FDI) and portfolio investment.** Inward FDI for all countries grew at an annual average rate of 21 percent between 1990 and 2000 reaching some $1.4 trillion, as enterprises diversified production internationally in order to reap the benefits of comparative advantages in different countries. Private portfolio flows and other capital flows to developing countries increased but have followed a more volatile pattern than FDI.[8] In the past decade, annual net private capital flows to developing countries have fluctuated between a net inflow of $190 billion and an outflow of $6 billion.

7. The welfare benefits of globalization are clear, with increasing economic efficiency contributing to higher productivity and rising income and employment. **However, the risks and challenges have also increased, most notably the greater vulnerability to external shocks and financial crises for many countries.** Global trade integration may lead to increased vulnerability to external real shocks, particularly for economies that are not diversified, including foreign demand shocks and terms of trade fluctuations. Integration can also increase the synchronicity of business cycles among countries with output fluctuations in developing countries positively correlated with output fluctuations in the G-7 countries for most of the 1971–2000 period (except between the late-1980s and the mid-1990s). Furthermore, macroeconomic, particularly financial, disturbances are being transmitted more rapidly via financial channels to other countries due to the interdependencies in creditors' portfolios, a re-evaluation of fundamentals of countries not directly affected by a shock, and by "herding" by investors driven by asymmetric information or from incentives faced by fund managers.[9] However, creditors have recently shown greater discrimination in their evaluations of credit risks in borrowing countries, which should reduce contagion.

8. **Greater openness, integration, and interdependence have important implications for individual members and the integrity of the international financial system.** Broadly, financial market participants now attach a greater premium to prudent borrower policies, crisis prevention, flexibility to adapt policies quickly to unforeseen events, and to a transparent policy stance that is communicated accurately to the world.[10] Countries that fall

[7] For example, the volume of foreign exchange trading increased six fold between 1986 and 1995 and cross-border transactions in bonds and equities burgeoned in the major advanced economies from less than 10 percent of GDP in 1980 to generally well over 100 percent of GDP in 1995.

[8] See Table 33 of the *World Economic Outlook*, October 2001.

[9] See "International Financial Contagion," Chapter III in *World Economic Outlook*, May 1999.

[10] There are clear indications of investors' discrimination between credits and countries in recent months. See *Emerging Market Financing in the Third Quarter of 2001—Developments and Prospects*, (SM/01/327, 11/2/01).

short of these expectations risk either provoking a crisis or succumbing to one through contagion. Recent evidence suggests that crises have become more frequent in the last decade relative to earlier periods (i.e., twice as frequent in the 1990s),[11] that the vulnerability of emerging markets has increased, and that the origins of financial crises have become widely dispersed.[12] Moreover, the costs of these crises have been substantial in terms of output losses, reduced employment, higher borrowing costs, and capital outflows.

9. **The Fund has adapted its policies and instruments to place greater emphasis on crisis prevention and crisis resolution in order to enable members to reap the benefits of globalization and deal more effectively with the downside risks.**

- **Fund surveillance has been strengthened and expanded to enhance crisis prevention.** It now includes: assessing external vulnerability; increasing transparency of members' policies, and of the activities and assessments of the Fund; the adoption and assessment (in cooperation with other agencies) of international standards and codes of good practice; in-depth financial sector surveillance including Financial Sector Assessment Programs (FSAPs); and work on capital account issues and liberalization. These activities help the Fund give early advice to countries on policies that may help avoid economic difficulties. They also aim to create an environment that will enable private market participants to form better judgments and to reduce irrational behavior or overreactions.[13]

- **There have been a number of important recent changes in Fund financing policies(see Box 1 for details).**[14]

    - **To improve the Fund's capacity to resolve crises**, the Supplemental Reserve Facility (SRF) was created in 1997 to provide financial assistance to members experiencing liquidity crises that require large, front-loaded, and short-term financial support.

[11] See "International Financial Contagion" op. cit.

[12] See "Financial Crises: Characteristics and Indicators of Vulnerability," Chapter IV in *World Economic Outlook*, May 1998; Chapters I–II in *World Economic Outlook*, October 1998; and *International Capital Markets—Developments, Prospects, and Policy Issues*, September 1998.

[13] See *Report of the Managing Director to the International Monetary and Financial Committee on the Fund's Crisis Prevention Initiatives* (IMFC/Doc/4/01/10, 11/14/01).

[14] This paper deals solely with the Fund's activities involving the General Resources Account (GRA) and thus primarily the use of members' quota subscriptions.

Box 1. Changes in Fund Facilities

The Fund has responded to changes in the world economy and its role by adding new financial facilities and changing the financial terms of existing facilities to place greater emphasis on crisis prevention and crisis resolution in order to enable members to reap the benefits of globalization and deal more effectively with the downside risks. This box describes the principal changes.

- **Contingent Credit Lines (CCL) facility was established in 1999 to promote crisis prevention,** in order to help prevent the spread of capital account driven crises by providing members pursuing policies favorably assessed by the Fund a safeguard with a precautionary line of defense against balance of payments problems arising from international financial contagion. The CCL is designed to promote policies to bolster a country's ability to resist contagion. The access and terms of financing recognize that current crises can require substantial Fund support[1] on short notice and that quick responses by the country and international community can lead to a rapid turnaround. The procedures for activating a CCL in the event of a balance of payments crisis involve greater automaticity than traditional Fund financing and large upfront disbursements are envisaged.

- **The Supplemental Reserve Facility (SRF) was created in 1997 to help improve the Fund's capacity to assist members resolve crises.** The SRF is designed to provide financial assistance to members experiencing liquidity crises that require large, front-loaded, and short-term financial support to address exceptional balance of payments difficulties following a sudden and disruptive loss of market confidence, reflected in pressure on the capital account and the member's foreign reserves. The SRF (in common with the CCL) does not have explicit limits on access to Fund resources. However, as the financing need is expected to be short-lived, the borrower is expected to repay sooner than for use of Fund resources under other facilities and a substantial interest surcharge is levied to encourage early repayment.

- **In 2000, time-based early repurchase expectations have been introduced with respect to *purchases in the credit tranches and under the EFF in recognition of the fact that a* borrower's balance of payments position can improve faster than initially programmed and interest surcharges are imposed to discourage large and prolonged use of Fund resources.**[2] At the same time, the possibility for member countries to request an extension of the repurchase expectations makes the timing of repurchases less predictable, and adds to the volatility of re-flows of Fund resources.

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[1] While the CCL does not have an explicit limit, there is an indicative range for access (300–500 percent of quota).

[2] In the credit tranches countries are expected to repay within 2¼-4 years under the expectations schedule, and within a maximum of 5 years under the obligations schedule. Under EFFs countries are expected to repay within 4½–7 years under the expectations schedule, and within a maximum of 10 years under the obligations schedule. Under the SRF and the CCL purchases are expected to be repaid in 1–1½ years but the period may be extended by one year.

- **To promote crisis prevention**, the Contingent Credit Lines (CCL) facility was established in 1999 to help prevent the spread of international financial contagion to countries with sound policies.

- **Time-based repurchase expectations have been introduced** in 2000 in recognition of the fact that a borrower's balance of payments position can improve faster than initially programmed[15] and interest surcharges are imposed to discourage large and prolonged use of Fund resources.

10. **The changes in the Fund's financing policies have enabled the institution to respond more effectively and flexibly to both prevent and resolve crises.**[16]

- The number and size of Fund-supported programs have increased (Figure 1). In the period 1995–2001, 82 arrangements[17] were approved involving commitments averaging SDR 1,036 million and annual average access of 62 percent of quota. Moreover, exceptional access to Fund resources increased, accounting for 12 percent of the number of arrangements (i.e., 10 commitments), and with access averaging about 583 percent of quota (Table 1).

- The number of arrangements treated as precautionary has also increased; almost one half of all arrangements approved since 1996 were treated as precautionary, compared to one fifth in 1990–95.[18]

- The level and variability of Fund credit outstanding has increased during the 1995–2001 period, from SDR 36 billion at the start of the period reaching a peak of SDR 60 billion in 1998 before declining to SDR 53 billion at the end of 2001. This compares with average annual credit outstanding at SDR 24 billion in the first half of the 1990's (Table 2).

- The concentration of Fund commitments has also increased with 3 countries accounting for 96 percent of the total in 2001 rising from an average of 80 percent in 1995–2000 and 57 percent in 1990–94.

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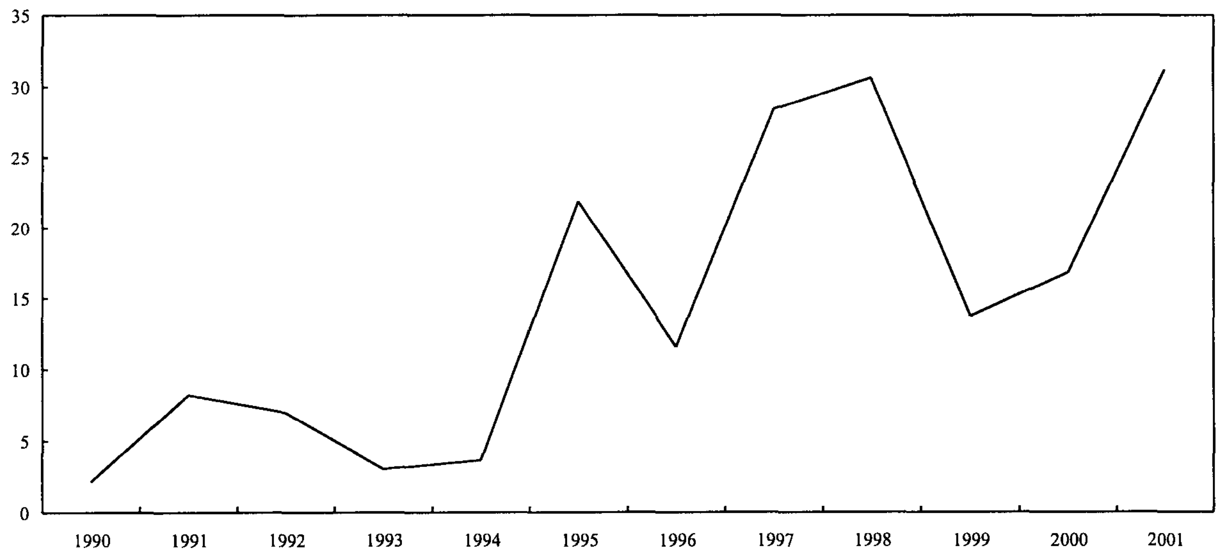
[15] This is in addition to the already existing policy on early repurchases.

[16] See papers prepared for *Review of Fund Facilities,* EBS/00/37 (3/2/00), EBS/00/131 (7/10/00), and Supp. 1 (7/18/00), EBS/00/187 (8/31/00), and Supp. 1 (9/13/00), EBS/00/216 (11/3/00), and Supp. 1 (11/21/00); staff statements Buff/00/169 (11/15/00), Buff/00/170 (11/16/00), and the Summing-Up Buff/00/175 (11/27/00).

[17] Including augmentations.

[18] For purposes of this paper, references to "precautionary" arrangements should be understood to mean arrangements where the member has stated in its Letter of Intent that is does not intend to make purchases.

Figure 1. Annual New Financial Commitments in the General Resources Account During Calendar Year 1990-2001
(In billions of SDRs)



11. **The role of the Fund as a source of official financing has been affected by the lack of availability of official bilateral support to deal with balance of payments crises.** In a number of cases, the share of the Fund in financing packages has been large (23–70 percent of the total).[19] This reflected, in part, difficulties in mobilizing other sources of official financing—including second lines of defense—as pledged financing was not fully implemented, coordination issues emerged, and conditions were attached to bilateral financing that proved to be excessively restrictive.[20] In the most recent cases of Argentina and Turkey, financing packages did not include substantive bilateral official financing. Consequently, there is an increased apparent preference by the international community for the Fund to take the lead in mobilizing and providing the official component in resolving balance of payments problems.

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[19] See Box 3.3 in *IMF-Supported Programs in Capital Account Crises—Design and Experience* (SM/01/245, 8/3/01).

[20] Furthermore, in some cases where bilateral financing was pledged, these funds were never disbursed (e.g., Korea and Indonesia), contributing to market anxieties that may have influenced the decisions of private creditors to continue to exit. (SM/01/245, op. cit.)

Table 1. GRA Commitments, 1990-2001 1/

	1995	1996	1997	1998	1999	2000	2001
				(In billions of SDRs)			
Total number of new commitments during calendar year	26	21	17	12	15	14	11
Total amount of new financial commitments during calendar year	21.9	11.6	28.4	30.6	13.7	16.8	31.2
Of which: large commitments 2/							
Total number of new commitments	1	0	3	2	1	1	3
Total amount of new commitments	12.1	0.0	25.7	18.7	2.9	5.8	30.0
				(In percent)			
Share of new large commitments in total Commitments	55	...	91	61	21	34	96

1/ Includes augmentations.

2/ Defined either as a new arrangement with access of 300 percent or more of quota or an augmentation under which access is increased by 300 percent or more of quota.

Table 2. The Fund's General Resources Account – Commitments, Total Purchases and Fund Credit Outstanding, 1990–2001

	Average 1990-94	1995	1996	1997	1998	1999	2000	2001
New Financial Commitments (SDR billion) 1/	**4.8**	**21.9**	**11.6**	**28.4**	**30.6**	**13.7**	**16.8**	**31.2**
Percent to 3 largest borrowers	57.1	82.0	74.0	90.7	81.7	67.6	88.1	96.3
Percent to 5 largest borrowers	73.1	91.9	82.6	93.7	93.9	87.1	95.5	97.9
Total Purchases (SDR billion) 1/ 2/	**5.3**	**17.0**	**5.3**	**16.1**	**20.6**	**10.0**	**7.2**	**23.8**
Percent to 3 largest borrowers	56.2	82.0	69.7	75.7	71.4	64.9	71.3	94.0
Percent to 5 largest borrowers	70.8	90.5	86.0	88.0	90.7	75.4	86.4	96.6
Total Fund Credit Outstanding (SDR billion) 3/	**23.8**	**35.9**	**36.1**	**46.6**	**60.5**	**51.1**	**43.0**	**53.5**
Percent to 3 largest borrowers	39.1	59.1	61.7	53.1	53.2	49.0	50.5	55.4
Percent to 5 largest borrowers	51.9	68.8	70.3	67.2	69.5	64.1	66.9	78.8

1/ Within period (during calendar year).

2/ Includes SDR 2.9 billion financed by NAB and SDR 1.4 billion financed by GAB in 1998.

3/ End of period.

12. **The resort to large-scale official financing packages has led to increased interest in greater involvement of the private sector (PSI) in crisis resolution.** An initial framework endorsed in 2000 by the International Monetary and Financial Committee (IMFC) at its Prague meeting is premised on the recognition that official financing is limited, that debtors and their creditors must take responsibility for their decisions to borrow and lend, and that contracts must be honored to the fullest extent possible. The framework identified four broad categories of country cases to delineate the financing and other roles the Fund could play based on an assessment of a member's underlying payment capacity and the prospects for regaining market access (Box 2). In each category, the Fund's involvement depends critically on judgments regarding the prospects for regaining external medium-term sustainability and the pace at which the combination of strong policies and official financing will allow members to regain spontaneous market access. These judgments are likely to be particularly difficult in crises in which there is a marked divergence of views between market participants, on the one hand, and the Fund and the official community, more generally, on the other hand.

III. The Implications for the Fund's Resource Base

13. **The Fund's efforts to adapt its financing policies to help prevent crises will have important implications for assessments of the adequacy of the institution's resource base. A key change has been the creation of the CCL, which provides for substantial commitment of resources in the absence of an immediate balance of payments financing need for disbursement, as a means of providing enhanced insurance.** While there have been no requests for a CCL as yet, the Fund has taken steps to make the CCL more attractive and is encouraging eligible members to apply for it.[21] To the extent that the Fund is successful in encouraging participation in the CCL, it will need to commit substantial resources and be in a position to make large up-front disbursements in the event a crisis materializes; however, to the extent that CCLs prevent crises from requiring even larger financing, the potential call on the Fund's resources would be diminished.

14. **The establishment of the SRF with its potentially high access to Fund resources and recourse to the exceptional circumstances mechanism under credit tranches and EFF arrangements have also contributed to an increase in the size and volatility in the use of Fund resources**. The Fund can expect a continuing demand for financing from countries with no or little market access. The Fund also needs to be ready to respond to sudden and possibly quite large financing needs arising from impairments in market access. Moreover, while continued improvement in market participants' ability to discriminate among borrowers should help reduce contagion, renewed bouts of crisis affecting several countries cannot be ruled out.

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[21] At its meeting in Ottawa in November 2001, the IMFC stated that the CCL is an important signal of the strength of countries' policies and a safeguard against contagion in financial markets, and encouraged eligible countries to consider applying for it.

Box 2. Private Sector Involvement (PSI)

The international community is working to develop a sound framework for PSI in crisis resolution. An initial framework was endorsed by the IMFC in 2000 at its Prague meeting. The framework is underpinned by several principles, including the recognition that official financing is limited. It included a categorization that identified four broad categories that may pertain to country cases and described the financing and other roles the Fund could play in each category.

- In the first category, policy adjustment and official financing should allow the member to regain market access fairly quickly. In some cases, extraordinary access to Fund resources may be warranted albeit on terms and conditions that reflect the early resumption of market access and thus ability to make early repayment to the Fund. In other cases, markets will only get the assurances they need if the Fund's financing (and other official financing) is of sufficient maturity to reduce concerns about potential near-term liquidity shortages. In such cases, Fund assistance may have to be on credit tranche rather than SRF terms, yet ensure Fund credit is not a substitute for medium-term private sector credit.

- The second category requires that official financing and policy adjustment be combined with encouragement to creditors to reach voluntary agreements to overcome coordination problems.

- The third category reflects a judgment that early restoration of full market access on terms consistent with medium-term external sustainability is unrealistic and a broader spectrum of actions by private creditors, possibly including comprehensive debt restructuring, may be warranted in the context of a Fund-supported program to provide for an adequately financed program and a viable medium-term balance of payments profile.

- The fourth category involves extreme cases where the member may have to resort to a temporary payments suspension or standstill pending sufficient action by creditors to support restoration of viability. In such cases the Fund would be prepared to continue providing financial support for a member's adjustment program despite arrears to private creditors, provided the country is seeking to work cooperatively and in good faith with other creditors and is meeting other program requirements

15. **Member countries have also taken increasing recourse to precautionary arrangements as a form of crisis prevention, which may continue.** While annual access under precautionary arrangements in general has been relatively low or in line with access under active arrangements, there have been occasions when large commitments and disbursements have occurred (e.g., Brazil's 2001 stand-by arrangement).

16. **On the other hand, there are several important efforts in the Fund which could reduce the demand for Fund resources and help improve the predictability of demand.**

- **The effective application of robust strategies for private sector involvement (PSI) should mean less need for Fund financing as the private sector plays a larger role in crisis resolution.** However, there will be a continuing need for the Fund to play a leading role in dealing with liquidity problems where official support is critical to restoring market access at an early date and such support could in certain cases require the commitment of substantial resources. Moreover, the Fund will also have an obligation to come to the assistance of members in those circumstances where PSI is uncertain, although the size and timing of its support will depend importantly on the need for and scope of concerted action to obtain the appropriate participation by the private sector. Fund financial support is also likely to be required in situations involving sovereign debt restructuring to assist members during the workout effort, as a catalyst for a successful resolution and during the period before full market access is restored, and possibly in the wake of an unsuccessful and disorderly resolution.

- **The increased emphasis on effective surveillance, including on FSAPs and standards and codes, will enhance the Fund's crisis prevention efforts and reduce the need for financing for crisis resolution.** Moreover, work on early warning indicators may help to project better demand in the near term, as vulnerabilities are brought to light earlier together with their potential impact on financing needs. The introduction of time-based repurchase expectations for purchases in the credit tranches and under the EFF and interest surcharges are expected to reduce the effective maturity of disbursements, which should increase the revolving character of the Fund's resources and enable it to make larger financial commitments from a given resource base.

17. **The recent changes in the world economy may also affect the available supply of usable Fund resources, for a given resource base.** While the overall size of quotas determines the theoretical limit of the Fund's financing capacity, only a portion of total Fund quotas (uncommitted usable resources) are available at any point of time to finance new commitments, because of prior commitments and because the Fund only uses currencies of members considered strong enough to be included in the Financial Transactions Plan (FTP). The number of member countries that participate on the creditor side of the Financial Transactions Plan (FTP) has increased to 40 members, the highest level in 20 years, and the quota share of creditor countries is at a record level of more than 70 percent of total quotas. However, the heightened volatility of external conditions and financing availability has increased uncertainty regarding member countries' participation over an extended period.[22]

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[22] In this context, it is of interest to note that several large scale changes in the Fund's liquidity position, such as those which occurred in the late 1970s, have in fact occurred mainly in connection with a reduction in the total usable currency holdings because of balance of payments difficulties in one or more of the creditor countries whose currencies had been sufficiently strong for the creditor side of the FTP.

Similarly, the ability of the Fund to supplement its liquidity by mobilizing the NAB could be affected as potential lenders may no longer be eligible to participate in the FTP and their credit lines could not be drawn.[23]

18. **In view of the increased uncertainties regarding the prospective magnitude of the Fund's commitments and the volatility in its credit outstanding, it is important that the resources of the institution be replenished in a timely and forward-looking manner.** The Articles of Agreement provide for regular five-year reviews of Fund quotas and possible Fund quota increases. Experience shows that the negotiation and implementation of a quota increase often is time consuming and can leave the Fund with uncomfortably low levels of liquidity before resources are replenished. This suggests that consideration of a possible increase in quotas should occur well before an actual need arises. The Fund has borrowing arrangements in place to supplement its quota resources when needed. The membership has concluded that primary reliance should be placed on the Fund's owned resources in the form of quotas and that borrowing should be limited and temporary (see Box 3).

19. **There is a possibility that any given size of the Fund's resource base could be "too large" or "too small."** Concern has been expressed, in particular, that a large quota base could result in excessive Fund-led financing packages that could create moral hazard by permitting countries to delay needed economic adjustments and/or encouraging private creditors to take unwarranted risks and over lend in anticipation of an official bail-out. While some moral hazard is present in any insurance arrangement such as Fund financing, the central question is whether it is large and whether the costs exceed the social benefits for the countries in crisis and the world economy. Recent evidence suggests some creditor moral hazard but its magnitude is unclear.[24]

20. **A Fund whose resource base is "too small" in order to minimize any moral hazard could prevent it from fulfilling its critical responsibilities.** Further, the financial cost to members of providing resources to the Fund is low.[25] In these circumstances, more flexible means of addressing moral hazard concerns would be preferable, including the recent efforts to better focus Fund conditionality, enhance crisis prevention, adjust the terms of Fund financing to promote sound economic policies and speed the revolving character of Fund resources, and develop robust arrangements for private sector involvement in crisis resolution.

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[23] The NAB was last activated in 1998 with a call for commitments totaling SDR 9.1 billion, although drawings amounted to SDR 2.9 billion.

[24] For a discussion of the empirical evidence regarding Fund financing and moral hazard issues, see *IMF-Supported Programs in Capital Account Crises-Design and Experience*, SM/01/245, 8/3/01, especially Box 3.4 and Annex II.

[25] The interest paid on Fund reserve positions is market based and compares favorably with the yield on alternative reserve assets.

Box 3. The Resource Base of the Fund—The Role of Owned and Borrowed Resources

The financial structure of the Fund reflects its role as a cooperative monetary institution. Quota subscriptions provide the basic source of financing and each member is obligated to provide the Fund with reserve assets up to the full amount of its quota and on short notice to help meet the balance of payments financing needs of another member experiencing difficulties. The Fund has implemented financial and operational policies to ensure the uniform treatment of members in the use of their quota subscriptions and to preserve adequate liquidity to be able to respond promptly to members requests to encash reserve claims on the Fund and to support balance of payments adjustment efforts.

The Fund is also authorized under the Articles of Agreement (Article VII, Section 1) to borrow to supplement its quota resources. The Fund maintains two standing borrowing arrangements, has borrowed on an ad hoc basis from official sources, and may borrow from private markets.

- **New Arrangements to Borrow (NAB)/General Arrangements to Borrow (GAB)**: Under these standing arrangements, the Fund may borrow up to SDR 34 billion from a group of members and official institutions to supplement existing resources to forestall or cope with an impairment of the international monetary system.

- **Ad hoc arrangements**: The Fund borrowed extensively from small groups of members and official institutions in the early 1970s and mid-1980s when payments imbalances were particularly large and/or skewed to finance special facilities and policies (e.g., the Oil Facility of 1974/75 and the Supplementary Financing Facility in 1979/81).

- **Private market**: The Fund can borrow from private markets but has never done so because of concerns about the consistency with the cooperative character of the institution, uncertain availability in times of greatest need, and potential cost.

The Fund has adopted guidelines on borrowing,[1] which state that quota subscriptions are and should remain the basic source of the Fund's financing but that borrowing on a limited basis can provide an important supplement to its resources. Borrowing provides the Fund a useful degree of flexibility, especially at times when the Fund's liquidity is under strain, by enabling the institution to call on those members or institutions that are financially strong to provide resources in excess of the amounts that could be mobilized from their quota subscriptions. However, the use of borrowed resources is limited to specific purposes and often entail consultation and approval requirements which may prevent timely activation and applicability to the broad range of circumstances that may confront the Fund. Moreover, under the NAB the cost of borrowing has exceeded the cost of using owned resources. Finally, excessive reliance on borrowing from a relatively small group of members to finance Fund activities could raise fundamental issues about the cooperative character and thus the governance of the institution.

A judgment regarding the appropriate balance between owned and borrowed resources will need to consider the nature of the payments imbalances likely to confront Fund members in the future. As discussed in this paper, the globalization of the world economy and integration of capital markets represent a significant structural change, which has resulted in larger and more volatile capital flows. Consequently, the magnitude and timing of demands for Fund resources have become more uncertain. In these circumstances, reliance on permanent owned resources in the form of quota subscriptions may be more consistent with the institution's financing needs although borrowing in certain circumstances remains a useful supplement.

[1] *Selected Decisions*, Twenty-Fifth Issue, December 31, 2000, page 419.

21. **Judgments regarding the adequacy of Fund resources and the need for and size of a quota increase will need to reach a balance between these competing considerations in a manner that commands the wide support necessary for implementation.** The adequacy of the Fund's resource base and the possible need for a quota increase have traditionally taken into account several indicators. These indicators are premised on reasonably stable relationships between aggregate quotas relative to certain scale factors and the demand for Fund resources which may no longer be appropriate in view of the greater volatility in Fund financing. Consideration may need to be given to more forward-looking measures that can take account of the increased uncertainties that exist, including a higher level and greater volatility in commitments and disbursements as well as an increased divergence between commitments and disbursements.

22. **Traditionally, the size of aggregate quotas has been assessed in relation to the key economic indicators that are included in the quota formulas.** The quota formula variables (GDP, current payments and receipts, reserves and variability of current receipts) seek to provide a measure of the potential demand for and supply of Fund resources by members. As such, the evolution of the aggregate actual quotas in relation to the sum of the members' calculated quotas, or in relation to the aggregates of the quota formula variables, has been used to provide some indication of the relative size of the Fund. These indicators have continued to grow rapidly while the increases in quotas have not kept pace, resulting in a decline over time in the ratio of actual quotas to calculated quotas (Figure 2 and Table 3).

Figure 2. Ratios of Agreed Size of the Fund to Calculated Quota and Current Payments, 1978-1999

(In percent)

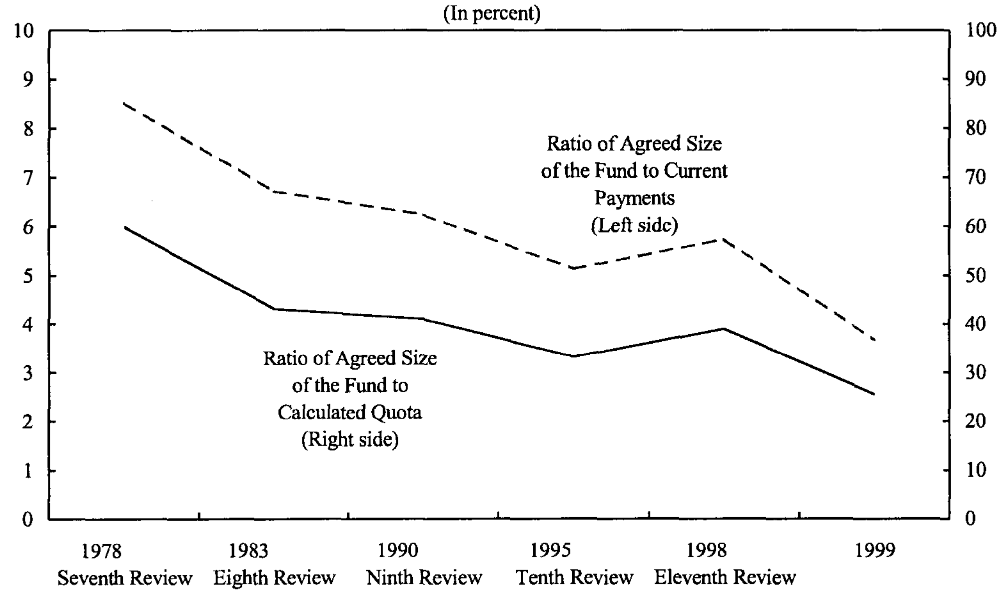

Table 3. Actual and Calculated Size of the Fund
(In billions of SDRs or in percent)

	Seventh Review 1978 1/ (1)	Eighth Review 1983 1/ (2)	Ninth Review 1990 1/ (3)	Tenth Review 1995 1/ (4)	Eleventh Review 1998 1/ (5)	1999 2/ (6)
1. Agreed size of the Fund	61.1 3/	90.0	135.2	146.1	212.0	212.0
2. Quantitative economic indicators	1972-76	1976-80	1981-85	1986-90	1990-94	1995-99
a. Calculated quotas	102	209	330	441	545	832
b. Current payments	718	1,341	2,168	2,852	3,700	5,785
c. GDP	4,253	7,588	11,083	15,744	17,884	22,442
d. Reserves	185	333	391	594	768	1,150
e. Variability of current receipts	43	67	112	159	173	264
3. Ratio of line 1 to line 2, in percent						
a. Calculated quotas	59.9	43.1	41.0	33.1	38.9	25.5
b. Current payments	8.5	6.7	6.2	5.1	5.7	3.7
c. GDP	1.4	1.2	1.2	0.9	1.2	0.9
d. Reserves	33.0	27.0	34.6	24.6	27.6	18.4
c. Variability of current receipts	142.1	134.3	120.7	91.9	122.4	80.4

1/ Year in which the quota review was completed, i.e., when the Board of Governors' Resolution on quota increases was approved. Quota agreed in 1976 under the Sixth Review came into effect in 1978, following the coming into effect of the second Amendment of the articles. The Tenth Review did not provide for an increase in quotas, and the increase in actual quotas relative to the Ninth Review is due to the increase in the number of members.
2/ This does not include China's ad hoc quota increase of 1.682 billion SDRs in 2001.
3/ Including special quota increases for China and Saudi Arabia in 1980 and 1981.

23. **The size of the Fund has also been assessed in relation to members' projected gross financing needs** (GFNs).[26] GFN has been used in the recent access review and is an element in countries' vulnerability assessments. It was also used in the Eleventh General review. The GFN concept is a useful tool but remains subject to a number of limitations.[27] The WEO projections which are used in estimating GFN are based on policies currently in place, which may overstate the need for financing if programs are adopted later; and there are problems in aggregating individual

[26] GFN consists of the projected current account excluding grants, amortization of medium- and long-term debts and repurchases due to the Fund, repayments of arrears, and gross reserve accumulation. The concept was further expanded by including short-term debt to reflect a further potential source of financing need (Augmented GFN or AGFN).

[27] See EBS/01/133, pp. 23–25.

countries' GFNs to obtain a global total. In addition, as with other indicators, use of GFN or AGFN assumes that the Fund would finance a (relatively) fixed share of the financing need. Experience to date shows this has not been the case and it is possible to envisage that the Fund's share in some financing packages could change in the future. Between 1994 and 2000, Fund financing ranged between 9 and 14 percent of GFN for "ordinary" access cases, yet was considerably higher in some SRF, SRF-type and exceptional circumstances arrangements, ranging up to almost 40 percent.[28] Furthermore, in an environment in which the demand for Fund resources has become increasingly driven by sudden sharp and unpredictable shifts in capital flows, the GFN concept may not be fully adequate.

24. **A final indicator considered in the context of past quota increases has been the liquidity ratio.**[29] The liquidity ratio (115 percent in mid-January 2002) attempts to capture the Fund's net available resources in relation to its liabilities. The ratio fluctuates over time depending on the level of commitments and actual credit outstanding, as well as the resources available through participation in the FTP. During the Eleventh General Review, it was argued that a decline of the liquidity ratio below the historical average of 70 percent indicated the possible need for an increase in quotas and that the increase should be large enough (in light of estimated demand for Fund resources) to offer a reasonable assurance that the liquidity ratio would not drop below 70 percent on a sustained basis during the subsequent five-year period. However, the usefulness of the liquidity ratio as a measure of the adequacy of Fund resources has been subject to considerable debate, in part due to the large adjustments made to uncommitted usable resources and working balances.[30] Finally, the liquidity ratio is subject to significant volatility as precautionary arrangements are activated, a problem that could increase with greater recourse to CCLs and the impact of CCL activation on a creditor country's participation in the FTP.[31]

25. **In order to better capture the importance of capital account crises, additional indicators may be needed**. Potential instability of capital flows has clearly become a more important factor in assessing the potential demand for Fund resources. Therefore, one might consider analyzing how the demand for Fund resources has evolved in relation to various measures of capital account variability. As noted in a recent staff paper on quota formulas,[32] finding the most appropriate measure of capital flows for this purpose is not straightforward, but the volatility of these flows is clear and could be expected to continue. The volatility of these flows increased during

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[28] See Table 1 of *Review of Access Policy in the Credit Tranches and under the Extended Fund Facility* (EBS/01/133, 8/9/01) and Table 13 of *Review of Access Policy in the Credit Tranches and under the Extended Fund Facility—Background Paper* (EBS/01/134, 8/9/01).

[29] This is the ratio of net uncommitted usable resources to liquid liabilities.

[30] See Box 1 of *The Fund's Liquidity Position—Review and Outlook* (SM/01/171,10/4/01).

[31] This is because activation of precautionary arrangements would affect both the numerator and denominator of this ratio. The purchase reduces net uncommitted usable resources (the numerator) and increases liquid liabilities (the denominator).

[32] *Alternative Quota Formulas—Considerations*, (SM/01/293, 9/27/01).

the 1990s by some 30 percent.[33] The variable used in the quota formula paper,[34] however, may be of limited use for the Fund membership in aggregate, as a decline in capital flows to one group of members may be offset by an increase in flows to other members. Nonetheless, for large Fund borrowers in recent years, the volatility of private capital flows has been apparent, large, and important in determining their demand for Fund resources. In the future the countries affected by volatile capital flows may be different, but this volatility is likely to remain important. An approach which examines the volatility of capital flows experienced by large borrowers from the Fund in recent years, may be a useful supplementary gauge of the potential impact on the demand for Fund resources.

26. **Finally, forward capacity to make financial commitments[35] could be seen as a more robust indicator of the Fund's ability to support good policies and thus prevent or resolve crises.** This forward capacity concept takes account of all existing commitments and uses prudent assumptions on the timing of repurchases.[36] It provides a transparent indicator of the financial commitments that the Fund can make to its members for crises prevention, resolution and on-going balance of payments financing. As of end-2001 and relative to total quota resources of SDR 212.4 billion and total usable resources of SDR 102.5 billion, the Fund's one-year forward capacity to make new financial commitments from owned resources amounted to SDR 42 billion and SDR 72 billion with NAB/GAB activation; and the Fund's two-year forward capacity to make new financial commitments from owned resources amounted to SDR 58 billion and SDR 88 billion with NAB/GAB activation.[37] The adequacy of the forward capacity could be assessed in light of scenarios that would draw on recent patterns of demand for Fund commitments and credit and the recent vulnerabilities exercises.

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[33] This is measured by comparing the standard deviations of the three-year moving average of net private capital inflows to all member countries for 1990-94 and 1995-99.

[34] The variability of the sum of current receipts and net capital flows measured as the standard deviation of a three-year moving average, using annual data for 1987–99.

[35] Defined as: Uncommitted Usable Resources including undrawn amounts under activated NAB/GAB (at a given point of time) plus Projected Repurchases (over the relevant time horizon) minus Minimum Acceptable Level of Uncommitted Usable Resources. See *The Fund's Liquidity Position—Review and Outlook* op. cit.

[36] The assumptions used are that all scheduled purchases under already approved precautionary and non-precautionary arrangements are made; all repurchases are extended from the expectations to the obligations schedule; all commitments made after end-December 2001 will be fully drawn by December 2002 in the one-year forward capacity and by December 2003 in the two-year forward capacity; and that uncommitted usable resources would not be allowed to fall below SDR 40 billion.

[37] Assumes SDR 30 billion would be available under the NAB/GAB (of total commitments of SDR 34 billion).

IV. Work Program and Issues for Discussion

A. Work Program

27. **The current paper is the latest in a series of background papers on issues related to the Twelfth General Review of Quotas.** The Executive Board has held several discussions on the quota formulas, including seminars on the report of the external panel of experts and a staff paper on possible alternative quota formulas.[38] A further discussion on quota formulas is planned for early 2002 to consider a staff paper quantifying alternative formulas that takes account of suggestions by Executive Directors at the October 2001 seminar.

28. **A further discussion on the size of the Fund's resource base could be considered after the Spring IMFC Meetings** based on a paper that sets out alternative quantitative scenarios on the size of the Fund's resource base in light of the conceptual considerations discussed in the current paper and the guidance from Executive Directors at the meeting.

B. Issues for Discussion

29. **The change in the Fund's financing policies toward increased deployment of financial resources for crisis prevention suggests that the overall level of Fund commitments could be substantial even in good times and that such commitments would not normally be associated with a concomitant rise in disbursements**. Moreover, the availability of the SRF and exceptional access policies as well as the introduction of repurchase expectations and surcharges are likely to mean that the amounts of disbursements and level of credit outstanding could be subject to sharp spikes, both up and down, in the wake of a crisis. Do Directors concur with these assessments? What are Directors' views on the implications of these trends in assessing the adequacy of Fund resources?

30. **Concern that the Fund's financing packages may have become too large has led to continuing efforts to expand the role of the private sector in crisis prevention and resolution.** Nevertheless, the framework for private sector involvement that is being developed at present envisages a continued important role for the Fund in dealing with pure liquidity problems of members, as a catalyst for both voluntary and concerted private sector involvement, and in facilitating sovereign debt restructuring. Do Directors agree that there may be significant Fund financing involvement even after further development of PSI? At this stage, how do Directors view the evolving policies concerning private sector involvement in influencing the adequate size of the Fund's resources?

31. **The economic indicators that have been used in the past to assess the adequacy of Fund resources appear to be less relevant in the current, more volatile economic and financial environment**. The staff has discussed use of possible new indicators related to capital account variability and forward capacity to make new financial commitments. What are Directors' views

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[38] SEM/01/08, 10/15/01.

regarding the role that the traditional and possible new indicators should play in assessing potential demand for Fund resources?

32. **The provisions in the Articles of Agreement provide for regular reviews of Fund quotas**. In the past, assessments regarding the adequacy of quotas have focused on the Fund's liquidity position, taking into account prospective disbursements. The analysis provided in this paper suggests that the Fund's crisis prevention efforts are, in part, involving greater possible use of contingent or precautionary commitments, which may not be associated with disbursements, and that the timing and magnitude of any disbursements under such commitments are uncertain. In this light, what are Directors' views on the implications of these changes in the Fund's policies on decisions on the timing of possible increases in quotas?

THE DISTRIBUTION OF SELECTIVE QUOTA INCREASES

33. **As background information for further steps in the quota review process, this Annex considers the distribution of selective quota increases**. In all of the nine general increases in quotas approved to date, part or all of the increase in quotas has been distributed to members selectively based on criteria established by the Executive Board. This approach has often been used to increase or preserve the quota shares of a particular subset of the membership in the context of a general increase in quotas. The focus of this Appendix is on the recent past.[39]

34. **General increases in Fund quotas comprise two elements**. One element is an increase in the quota of each member by a uniform amount in proportion to its existing quota. This *equiproportional* element has the effect of preserving the prevailing structure of quotas, in the sense that the quota share of each member remains unchanged. The other element is a *selective* increase in quotas of some or all members, which generally aims to effect change in the structure of quotas through an adjustment in quota shares.

35. **All recent general increases in quota have included a selective element**. The size of the selective element has varied considerably, from 2 percent of the overall increase under the Seventh General Review in 1978 to 60 percent under the Eighth General Review in 1983. The relative weight of the selective element in an overall quota increase is a matter of judgment for the Executive Board, reflecting among other things the desired restructuring of quotas.

36. **The selective element has taken a variety of forms**. Several techniques have been used in past quota reviews to adjust the quota shares of individual members or groups of members. The most common technique, which has been applied in one form or another in all but the first general increase in 1958/59, is to use the results of the quota formulas as an allocative key. Calculated quotas have been used by allocating some or all of the selective element on the basis of calculated quota shares, and by taking into account differences between calculated and actual quotas. Other techniques include rounding conventions that benefit members with very small quotas, and voluntary agreements among groups of members to facilitate a realignment of their quotas without affecting the total quotas of the group

37. **The Eighth General Review represented a shift in approach from absolute amounts to shares**. It featured a selective element that uniformly adjusted members' quota shares (positively and negatively) toward their calculated quota shares. This was accomplished

[39] The use of selective increases is discussed in detail in the numerous papers prepared at the time of each general review of quotas. For a recent summary, see Appendix I in *The Evolution of the Shares in Fund Quotas of Developing Countries*, SM/95/152 (6/22/95) and *External Review of the Quota Formulas* (the Cooper Report), EBAP/00/52 (5/1/00), pages 23–32.

by distributing the selective element to all members in proportion to their shares in calculated quotas.[40] Earlier general increases in quota had provided for selective increases to be distributed among only a *subset* of the membership, usually on the basis of differences between calculated and actual quotas. This change in approach reflected the view of the Executive Board that the quotas of *all* members should be brought more in line with their relative positions in the world economy, as proxied by their shares in calculated quotas. A similar approach was followed under the Ninth and Eleventh Reviews.

38. **The most recent selective increase had several dimensions**. The equiproportional element under the Eleventh General Review accounted for 75 percent of the overall increase in quotas. The 25 percent selective element was split into three components:

- 15 percent was distributed to all members based on their shares in calculated quotas.
- 9 percent was distributed among members whose calculated quota shares were greater than their actual quota shares. The Executive Board determined that when this ratio was greater than unity, the member's existing quota was "out of line." The increase for each member was determined in a manner that uniformly reduced the initial disparity between the ratio of calculated quota shares to actual quota shares and the predetermined cutoff ratio of unity.
- 1 percent was distributed to five members whose quotas were considered far out of line with their relative economic positions and which were in a position to contribute to the liquidity of the Fund over the medium-term.[41] Increases were allocated in the same manner as for the 9 percent share above.

39. **More direct approaches have also been used to effect change in quota shares**. Under the Sixth General Review in 1976, the overall increase in quotas was based on an understanding that the combined quota share of the major oil-exporting countries would be doubled, while the aggregate quota share of other developing countries would be left unchanged. This was achieved by providing for a corresponding decline in the quota share of industrial countries as a group. Within each country group, individual quota adjustments were made primarily on the basis of differences between calculated and actual quotas.

40. **A similar approach was used to restructure the largest quotas**. Under the Ninth General Review in 1990, a realignment of quotas was agreed among G-7 countries to accommodate an ad hoc quota increase for Japan. This resulted in the equalization of quotas

[40] The size of the selective element, relative to existing quotas and the total quota increase, determines the speed of adjustment of quota shares (see Box 6 in *Alternative Quota Formulas—Considerations,* SM/01/293 (9/27/01)).

[41] Korea, Luxembourg, Malaysia, Singapore, and Thailand, which were also participants in the NAB.

for Germany and Japan with the second largest quotas, and for France and the United Kingdom with the next largest quotas. Voluntary adjustments to the quotas for Canada, Italy, and the United States ensured that the quota share of the G-7 countries as a group was left unchanged.

41. **The effect of selective increases has been limited**. The extent to which a selective increase effects change in the structure of quotas depends first and foremost on the absolute size of the overall increase in quotas and the relative size of the selective element. The selective increase was 42 percent of the overall increase on average for the last three quota increases. The effective contribution of the selective element to the overall structure of quotas has been much smaller, however, averaging only 13 percent over the same period. This is because a large portion of the overall increase has been distributed on the basis of actual quotas and the selective element has been distributed to all members. In general, distributing the selective increase among all members (as done in recent reviews) tends to mute the distributional effects; more focused distribution (as under earlier reviews) sharpens the effect. The specific technique used to distribute the selective element is less important but can make a difference for individual members at the margin.

Basic Votes

42. Since the conclusion of the Eleventh Review of Quotas, questions have been raised about the distribution of voting shares amongst the Fund's members. As a background to further discussions, and in response to Executive Directors' requests, this annex considers aspects of members' basic votes.

43. **The provision for voting power in the Fund that was adopted at the Bretton Woods conference in 1944 was a compromise between two alternative bases for determining voting power**, i.e., voting power related solely to member (quota) contributions, and voting power based on the principle of equality of members. The resulting compromise is enshrined in the Articles of Agreement (Article XII, Section 5(a)) which provides that:

> *Each member shall have two hundred and fifty votes plus one additional vote for each part of its quota equivalent to one hundred thousand special drawing rights.*

In 1981 and at the time of subsequent quota reviews[42] Executive Directors had extensive discussions on the participation of developing countries in the decision-making process in the Fund and suggestions were made to increase the number of basic votes. This would require an amendment of the Articles and, thus far, there has been insufficient support in the Board for amending the Articles for this purpose.

44. **The effect of an increase in basic votes is to increase the voting power of those members whose voting power is below the average voting power for Fund membership as a whole, and thereby to allow the smallest members to have an increased measure of influence in the Fund's decision-making process.**[43] The distribution of voting power is of particular significance because many important decisions may be taken only by special majorities (70 or 85 percent) of the total voting power as determined by the Articles of Agreement.

45. **The relative importance of basic votes increased substantially from the inception of the Fund in 1944 until the late 1950s as a result of the rapid growth in the number of new Fund members with smaller-than-average quotas, but it has declined very**

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[42] *Participation of Developing Countries in the Decision Making of the Fund: Questions Regarding Basic Votes,* SM/80/235, 10/17/80 and *The Acting Chairman's Summing Up at the Conclusion of the Discussion on Participation of the Developing Countries in the Decision Making of the Fund—Questions Regarding Basic Votes,* Buff/81/2, 1/6/81. See also *Ninth General Review of Quotas—Further Consideration of the Shares of Developing Countries in the Fund,* EB/CQuota/88/7, 8/9/88, and *Eleventh General Review of Quotas—Issues Relating to the Size of Basic Votes,* EB/CQuota/96/3, 2/13/96.

[43] In general, the effect of basic votes, in comparison with a voting system solely based on quotas, is to increase the voting power of those members whose quotas are below the average quota, which at present is SDR 1,160.7 million. Out of 183 Fund members, 157 have smaller-than-average quotas.

substantially since then (Table 1). Basic votes represented 11.3 percent of total voting power in 1945 (if all original participants at Bretton Woods had joined the Fund at the outset), and this proportion had risen to 15.6 percent in 1958. At present, basic votes represent about 2 percent of the total voting power in the Fund. The decline in the relative importance of basic votes reflects, in part, the effects of regular quota increases since 1965, and more recently, the marked slowdown in new membership of relatively small countries. As the Fund's membership is now almost universal, the relative importance of basic votes as determined under the present Articles would continue to decline with future quota increases.

46. **For member countries with very small quotas, basic votes remain a significant determinant of the voting power, despite the overall decline in the share of basic votes**. For example, at present there are 25 members for whom basic votes comprise more than half of the member's individual voting power and 61 members, or one third of the membership, were this share exceeds 20 percent.

47. **There are two alternative approaches to changing members' relative shares in votes, namely either a modification of the provisions that determine a member's voting power, which could entail either changing the basic votes or the relationship between the size of the quota and votes, or changes in members' quota shares**. As regards changing basic votes, different proposals have been made in the past, including:

- Increasing the number of basic votes by the same fixed amount for all members. Under this approach, the smaller a member's quota relative to the Fund-wide average, the larger would be the proportionate increase in that member's voting power.
- Increasing the number of basic votes by a fixed amount, but only for members that belong to the category of small or developing country members.
- Establishing the total number of basic votes as a fixed percentage of total quotas.
- Provision for the equal distribution among all members of a specified percentage of the sum of the basic and quota related votes for all members. This method would prevent the erosion of the share of the basic votes over time.[44]

48. **Discrete increases in the number of votes would raise the relative importance of basic votes in voting power, but would impact differently on the voting shares of groups of countries**. Table 2 demonstrates the impact on member aggregate groupings of two hypothetical increases in basic votes, equiproportionally distributed. One example shows a doubling of basic votes, the other an increase that would restore the 1945 share of basic votes at 11.3 percent of the total. As noted above, the smaller the quota of a member relative to the

[44] A similar, "floating" basic vote approach is used by the Asian Development Bank whose voting provisions are such as to maintain the share of basic votes at 20 percent of total votes at all times.

Fund's average quota, the larger the increase of a member's relative voting share. Thus, the impact would be particularly significant for the voting share of African countries, many of which have small quotas.

49. **Without amending the Articles, the voting power of individual members or a particular groups of members could be increased (or maintained at a certain level with future increases in quotas) by providing a "compensating" increase in the quotas of such members, in addition to equiproportional and selective increases that are normally considered at the time of general reviews.**[45] This approach would result in a nonuniform adjustment of quotas and would also have important implications for members' access to Fund resources and the allocation of SDRs. It would also involve (difficult) judgments about eligibility for the compensating increase. Like proposals that would involve amendments of the Articles, this type of approach has, in general, not received much support.

50. **At the time of the Ninth General Review, further consideration was given to schemes that could mitigate, in part, the decline in voting share of members with relatively small quotas, without using predetermined constraints based on a given country specification and without fundamentally changing the general parameters of the quota review**. These schemes involved an additional quota increase for certain countries, over and above the equiproportional and selective components calculated on the basis of uniform techniques. In general, they involved provision of a fixed absolute amount of quota increase to each member and minimizing the distortions between members with relatively small quotas and others by relating the mitigation factor to the smallest quota. These proposals were not accepted, but as a compromise, a further alternative mitigation technique, which had been adopted in past quota reviews, was used. This technique consisted of rounding up the final agreed quotas in a manner that tended to benefit the very smallest quotas.[46] In addition, the quota shares of four very small countries[47] were set equal to their calculated quota shares, which also helped improve the aggregate quota and voting share of the members with quotas that at that time were less than SDR 10 million.

51. **Increasing quota shares of countries and subsequently their voting power could be achieved, in theory, by including a constant in the formula(s) that generate the quotas**. In effect this would be equivalent to separating a certain share of the total quotas that would not be affected by economic variables in the quota formulas but would be distributed equiproportionally to all member countries. The constant would have to be set at such level

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[45] E.g., under the Sixth Review, it was agreed that the distribution of quota increases would be such as to double the aggregate of the quota share of the major oil exporting countries while maintaining unchanged the share of the non-oil developing countries in total quotas.

[46] Quotas smaller than SDR 10 million were rounded up to the next higher multiple of SDR 0.5 million (other quotas were rounded up to the next higher multiple of SDR 0.1 million.)

[47] Antigua and Barbuda, Bhutan, Maldives, and Seychelles.

(in terms of the share of quotas or size of the constant component) as to be meaningful for small countries.

52. **Given that countries already have existing quotas, inclusion of a constant in the formulas that would achieve the same effect as an increase in basic votes would require an increase in quotas and thus would affect individual countries' access to Fund resources**. As with any quota increase, the smaller a member's quota, the larger the effect of a given constant. Inclusion of a constant can be demonstrated with a small example. E.g., to achieve the effect of a doubling of the basic votes (i.e. an increase by 250 votes) requires an increase, ceteris paribus, of member countries' quotas by SDR 25 million from the present level. Assuming the same relationship between the economic variables in the formulas as before, this means that the constant would need to be equivalent to SDR 25 million. For the 25 members with quotas presently smaller than SDR 20 million this would signify a quota increase ranging from just over 800 to 133 percent.[48] A quadrupling would require more than doubling the quotas of 49 member countries, with increases ranging from 399 to 2,419 percent.

[48] Based on actual quotas as of November 2001.

Table 1. Relative Importance of Basic Votes, 1945-Present

	Number of Members	Total Votes	Basic Votes Number	Basic Votes Percent of Total
Schedule A 1/	45	99,390	11,250	11.3
1958	68	108,930	17,000	15.6
1965	101	179,928	25,250	14.0
1970	115	236,835	28,750	12.1
1976	132	319,714	33,000	10.3
1978	140	432,415	35,000	8.1
1983	145	646,415	36,250	5.6
1988	150	937,126	37,500	4.0
1993	178	1,492,497	44,500	3.0
19952/	181	1,498,438	45,250	3.0
Present2/, 3/	183	2,166,739	45,750	2.1

1/ Schedule A refers to schedule A in the Articles of Agreement, as agreed at the Bretton Woods Conference in July 1944, which entered into force on December 27, 1945. Includes the votes of Denmark, whose initial quota was not specified in Schedule A and the former Soviet Union, which did not become a member of the Fund.

2/ Including countries whose voting power was/is suspended.

3/ Based on actual quotas as of November 2001.

Table 2: Illustrative Voting Shares 1/

		With 250 Basic Votes		With 500 Basic Votes		With 1497 Basic Votes 2/	
	Actual Quota Shares	Voting Share	Basic votes as percent of Total	Voting Share	Basic Votes as Percent of Total	Voting Share	Basic votes as Percent of Total
Advanced economies 3/	61.97	60.96	0.5	60.00	1.0	56.57	2.8
Major advanced economies	46.31	45.42	0.2	44.56	0.4	41.51	1.0
Other advanced economies	15.66	15.54	1.4	15.44	2.8	15.06	7.8
Developing countries	30.44	31.28	4.8	32.09	9.1	34.97	22.8
Africa	5.30	5.77	10.2	6.23	18.5	7.85	40.1
Asia	10.30	10.43	3.3	10.55	6.4	10.99	16.9
Middle east, Malta, Turkey	7.35	7.38	2.5	7.41	4.9	7.51	13.2
Western Hemisphere	7.49	7.70	4.8	7.90	9.1	8.62	22.9
Transition economies	7.59	7.75	4.2	7.91	8.0	8.46	20.4
Total	100.00	100.00	2.1	100.00	4.1	100.00	11.3

1/ Based on present actual quotas.

2/ Basic votes required to bring basic votes to 11.3 percent of total.

3/ WEO breakdown of country groups, except for Korea and Singapore, which are included under Asia.