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IMF Executive Board Discusses Further Considerations in the Twelfth General Review of Quotas

On August 30, 2002 the Executive Board of the International Monetary Fund (IMF) held further discussions on conceptual issues involved in assessing the adequacy of the IMF's resource base as part of the Twelfth General Review of Quotas.

Background

The discussion provided an opportunity for an exchange of views on issues raised in a staff paper entitled "Twelfth General Review of Quotas – Further Considerations," which provided quantitative indicators to help inform judgments regarding the possible need for an increase in quotas. The Executive Board's discussion was the latest in a series of discussions to consider issues related to the size and distribution of quotas and possible reform of the quota formulas (see PIN No. 02/12 and No. 02/59). During the latest discussions, Directors expressed a range of views on the implications of the evolving role of the Fund in crisis prevention and resolution in making an assessment of the adequacy of the Fund's resource base in a more integrated world economy.

Executive Board Assessment

Managing Director and Chairman, Horst Köhler, summarized the discussion as follows:

Our discussion has provided a useful opportunity for a further exchange of views on the conceptual issues relating to the role and size of the Fund, and for consideration of quantitative approaches for assessing the adequacy of the Fund's resource base and the possible need for a quota increase. While Executive Directors are not close to coming to a consensus regarding an increase in quotas, they agreed progress has been made in clarifying issues and the considerations that could form the basis for a decision.

Directors had a further exchange of views on the implications for the size of the Fund of globalization, integration of financial markets, and the Fund's efforts to strengthen its capacity to prevent and resolve financial crises. There is broad recognition that greater reliance on private market financing by many countries has contributed to increased vulnerability to capital account shocks, and that such shocks could be quite large in absolute amounts and relative to the size of an economy. There is also recognition that global economic and financial integration may entail the risk of financial contagion. Directors generally agreed that the Fund's crisis prevention efforts will contribute to a reduction in the frequency and severity of financial crises, through improved surveillance that promotes sound economic policies and strengthens the functioning of domestic and international capital markets. At the same time, Directors accepted that future crises would occur, and that the Fund will need to continue to play a central role in crisis resolution and therefore should have adequate resources at hand. However, views differed on the extent to which the Fund's response to these developments would or should result in large financing that could require additional Fund resources.

Directors noted that the Fund is continuing to adapt its financial policies to strengthen its catalytic role, including by improving the conditionality associated with Fund financing, encouraging use of the Contingent Credit Line (CCL), clarifying policies on access to Fund resources in capital account crises, and developing new approaches for involving the private sector in crisis resolution. While resolution of these issues will have implications for the Fund's financing role, Directors considered that, especially in view of the increased uncertainties and volatilities, decisions on the size of the Fund should be made in a forward-looking medium-term context.

Directors had a further discussion of the moral hazard implications of Fund financial support. A number of Directors argued that increasing the size of the Fund and of Fund financing could aggravate moral hazard concerns and reduce incentives to strengthen crisis prevention by creating undesirable incentives for excessive official and private financing, and would send a mixed signal about the Fund's effort to increase the role of the private sector in crisis resolution. However, other Directors felt that moral hazard concerns must be weighed against the potential cost of disorderly adjustment to the member and to the international community. These Directors considered that there is little evidence from past experience that moral hazard is a significant problem. They believed that Fund conditionality and the private sector involvement and sovereign debt restructuring mechanism initiatives should remain the principal means of dealing with potential moral hazard and safeguarding Fund resources, and that seeking to deal with moral hazard by leaving the Fund with inadequate resources would be counterproductive, especially as the cost of a Fund that is too small to fulfill its responsibilities exceeds the cost of providing resources that may not need to be utilized. Several Directors remarked that effective and prudent use of Fund resources would place the Fund in a good position vis-à-vis its members to obtain a swift decision for an augmentation of Fund resources should the need arise. These Directors also encouraged countries in favorable economic positions to make early repurchases to further strengthen the Fund's liquidity position.

Directors welcomed the opportunity to consider several quantitative approaches for assessing the adequacy of Fund resources and the need for a quota increase. In the discussions, many Directors noted that the size of the Fund has declined relative to the traditional indicators of the global economy in which the Fund functions, and expressed concern that a further decline in the relative size of the Fund would send the wrong signals about the Fund's ability to continue to fulfill its important responsibilities. Many other Directors, however, suggested that, based on alternative measures, the relative size of the Fund has not declined and that, moreover, it is not necessarily the case that Fund size should keep pace with world output or other macroeconomic variables, including international capital flows, as this would tend to diminish the catalytic role of Fund resources. They noted that the historical decline of the Fund's quota base in relation to the traditional indicators has not impacted adversely on the IMF's central role, and that it needs to be considered in the context of ongoing changes in Fund polices and the evolving situation in the world economy and financial markets.

Directors also considered projections of future Fund financing based on the Fund's share of the gross financing needs (GFN) of members that have recently used Fund resources. The discussion suggested that it is difficult to draw conclusions from the GFN variable, because in the last few years several countries have experienced particularly large reversals in capital flows that might not be repeated in the future. Moreover, projections based on recent GFN did not take account of possible changes in policies, both by the borrower and the Fund, and any conclusions for the size of the Fund would have to be interpreted with caution. Directors, therefore, concluded that this variable would need to be complemented by other indicators.

In response to an earlier request by Directors, the staff provided several measures of variability of capital flows, which confirm that capital flows have increased significantly and become more volatile, with large reversals occurring in recent cases of financial crises. Many Directors saw the size of these reversals and measures of capital variability in the second half of the 1990s as useful additional indicators that should be taken into account when assessing the adequacy of Fund resources. Other Directors were more skeptical that definitive conclusions could be reached due to the difficulty of interpreting the significance of recent experience as a predictor of future trends, particularly given the ongoing efforts to reduce market volatility and country vulnerability.

Directors also discussed the implications of several illustrative scenarios presented by the staff for the assessment of the adequacy of the Fund's resources. They noted that the Fund's ability to meet the substantial demand for financing in recent cases was attributable in part to the rapid turnaround of some of the larger cases which facilitated early repayments; the ability to utilize the General Arrangements to Borrow and the New Arrangements to Borrow to supplement the Fund's quota resources; and the increase in quotas that became effective in 1999. In considering possible scenarios of future demand for Fund financing, it was agreed that it is very difficult to foresee either the size or timing of future crises and therefore the scenarios presented by the staff should be considered purely illustrative. In this connection, a range of views was expressed on the plausibility of the scenarios. On the one hand, the scenarios were considered plausible or even too optimistic with regard to possible future demands on Fund resources. Recent developments were viewed as consistent with the worst

case scenario described by the staff, with Fund credit outstanding reaching a historically high level and the proposed arrangement for Brazil representing the largest single commitment of Fund resources. As a result, Fund liquidity has fallen sharply, at a time when bilateral official financing has diminished, which points to the need for an early quota increase to enable the Fund to support members' adjustment efforts and to avert renewed contagion. Conversely, the scenarios were also viewed as overly pessimistic, as the projected use of the CCL seemed large in the absence of current interest in the facility, and that the base period of 1996-2001 reflected an unusually high demand for IMF financing. Moreover, even the most pessimistic scenario did not indicate a clear need for a quota increase, as uncommitted usable resources would remain substantial even with the latest commitments, while the estimates of forward lending capacity were based on conservative assumptions regarding the required prudential minimum (for which the appropriate level has not yet been decided), and the Fund's borrowing arrangements remain fully available at the present stage.

In conclusion, I believe that we are continuing to make progress on the conceptual and quantitative issues that need to be addressed to inform judgments regarding the adequacy of Fund resources. Although differences of view on the need for a quota increase remain, there is also broad recognition of the importance of the Fund having adequate resources to fulfill its critical responsibilities. Many Directors viewed progress on a number of related issues as important to reaching a decision on a quota increase. On steps forward, I realize that the Board is not close to the 85 percent majority vote required for a quota increase, and that some of you would not wish to pursue this issue further. Nonetheless, I believe the continued discussion of the size of the Fund is integral to a broader consideration of the role of the Fund in an integrated global economy, and that financial prudence requires that the IMF should attempt to make further progress on these issues in the period ahead. Therefore, I would propose that the staff prepare a status report to the International Monetary and Financial Committee on the Twelfth General Review of Quotas based on today's discussion as well as the earlier discussion on the distribution of quotas. We could return to these issues for further discussion following the IMFC meeting and to prepare a report to the IMF's Board of Governors on the Twelfth General Review of Quotas by January 2003.