

**FOR
AGENDA**

SM/02/355

November 18, 2002

To: Members of the Executive Board

From: The Secretary

Subject: **Twelfth General Review of Quotas—Draft Report of Executive Directors to the Board of Governors**

Attached for consideration by the Executive Directors is a paper on twelfth general review of quotas—draft report of Executive Directors to the Board of Governors, which is tentatively scheduled for discussion on **Monday, December 9, 2002**. A draft decision appears on pages 7 and 8.

The staff proposes the publication of this paper after the Executive Board completes its discussion.

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

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

**Twelfth General Review of Quotas—
Draft Report of Executive Directors to the Board of Governors**

Prepared by the Treasurer's Department

(In consultation with other departments)

Approved by Eduard Brau

November 18, 2002

I. INTRODUCTION

1. **The Articles of Agreement provide for General Reviews of quotas by the Board of Governors at intervals of not more than five years.**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, before its scheduled completion date of March 31, 1998, and the Twelfth Review is scheduled to be concluded by January 30, 2003. As provided by the rules and regulations of the Fund (Rule D-3) a Committee of the Whole (COW) was established by a decision of the Executive Board adopted on December 27, 2001.² The General Review would be concluded by a Resolution approved by the Board of Governors, based on a report by the Executive Board.

2. This paper reviews the work of the Executive Board relating to the Twelfth General Review of Quotas, discusses the principal considerations relating to the Executive Board's report to the Board of Governors, and proposes a draft report and resolution for the Board of Governors.

II. STATUS OF KEY ISSUES IN THE TWELFTH GENERAL REVIEW

3. **The Executive Board has held a number of discussions over the past two years on quota-related issues.**³ These discussions have resulted in considerable progress having

¹ Article III, Section 2(a).

² Decision No. A11673-(02/1), adopted December 27, 2001.

³ Executive Board Seminars 01/4 (8/31/00), 01/08 (10/15/01) and 02/01 (2/8/02) and Executive Board Meetings 02/55 (6/3/02) and 02/90 (8/28/02).

been made in clarifying key issues on:

- the role and size of the Fund;
- the adequacy of Fund resources and the need for a possible quota increase;
- the distribution of quotas including possible changes to the quota formulas; and
- governance and representation.

However, the broad support necessary for a quota increase does not yet exist to warrant making specific proposals at the present time.

A. Role and Size of the Fund

4. **The Twelfth General Review of Quotas is taking place in an environment marked by uneven economic growth and progress in adjustment among economic regions and countries, large volatile capital flows and continued vulnerability of certain countries to financial crises.** The impact of global integration and the Fund's response to members' balance of payments financing needs continues to be subject to ongoing debate and reform.

5. **There is broad agreement that the Fund must have sufficient resources to fulfill its central role in the international monetary system.** However, differences of view among members remain on the current and prospective adequacy of the Fund's resource base, and the possible need for a quota increase.⁴

6. **Discussions of the conceptual issues involved in reaching a judgment regarding the adequacy of the Fund's resource base** have considered the implications of the continued globalization and financial integration which has resulted in greater reliance on private sources of capital for many members. Globalization and integration have brought welfare benefits with increased economic efficiency contributing to higher productivity and rising income and employment; but it has also contributed to increased external vulnerability and potential for financial contagion.

7. **The Fund has responded to these changes by adapting its surveillance policies to strengthen the Fund's capacity to prevent financial crises.** They now include greater focus on: assessing external vulnerability, increasing the 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

⁴ See *Concluding Remarks by the Chairman Twelfth General Review of Quotas—Further Considerations* (BUFF/02/143, 9/10/02) and *Concluding Remarks by the Acting Chair Twelfth General Review of Quotas—Preliminary Considerations and Next Steps* (BUFF/02/18, 2/13/02).

good practice; in-depth financial sector review including Financial Sector Assessment Programs; and work on capital account issues and liberalization.

8. **The Fund has also bolstered its crisis resolution instruments.** To this end, it has streamlined and focused the conditionality attached to use of Fund resources, undertaken a review of Fund facilities, clarified access policies in capital account crises, and is developing new approaches for involving the private sector in crisis resolution, including consideration of a sovereign debt restructuring mechanism (SDRM). Some of these initiatives remain works in progress and views differ on their likely impact on future demand for Fund financing.

9. **Views differ on the implications of an increase in the size of the Fund for the extent and significance of moral hazard in the system.** There is concern by some that an increase in the size of the Fund at this time could aggravate moral hazard by creating incentives for excessive financing and undercutting the Fund's efforts to expand private sector involvement (PSI) in crisis resolution. However, others perceive no major moral hazard concerns and consider that any concerns must be weighed against the potential cost of disorderly adjustment in the absence of the Fund having adequate resources to assist members to meet their balance of payments financing needs; in any case, more targeted measures are available for addressing any perceived risk, e.g., conditionality, strengthened role of debt sustainability analyses, and a possible SDRM.

B. Adequacy of Fund Resources and Need for Possible Quota Increase

10. **Several quantitative approaches for assessing the adequacy of Fund resources over the next five years have been considered in light of the policies and financial instruments the Fund has adopted.** The Executive Board examined the size of the Fund relative to: various measures of the world economy; members' gross financing needs and the volatility of capital flows; and illustrative scenarios of possible demand for Fund resources. Views, though, still differ on the appropriate size of the Fund relative to the world economy and on future demand for Fund financing in light of the difficulty in foreseeing either the size or timing of future crises, and thus, the plausibility of the various scenarios.

C. Quota Distribution and Formulas

11. **The Executive Board has held extensive discussions on quota formulas in response to the understanding reached as part of the Eleventh General Review.**⁵ The Report of the Executive Board to the Board of Governors on the increase in quotas under the Eleventh General Review recommended "that the formulas used to calculate quotas be reviewed promptly after the completion of the Eleventh General Review." Executive Directors recognized that the quota formulas have had only a limited impact in changing the actual distribution of quotas, because the effective weight given to calculated quota shares is reduced by existing quota shares and equi-proportional quota increases.

⁵ See paragraph 4 of *Report of the Executive Board to the Board of Governors: Increase in Quotas of Fund Members—Eleventh General Review* (SM/97/289, 12/22/97).

12. **The Executive Board has examined possible changes in the formulas used to calculate members' quotas that would help achieve a quota distribution that better reflects the relative economic positions of member countries and recent developments in the world economy.**^{6,7} Progress has been made in developing a formula(s) that would be simpler and more transparent than the current formulas. Work in this area has been based on an updating of the traditional variables (GDP, openness, reserves, and variability) in the formulas, including the introduction of a measure that takes account of the variability of capital flows. There is broad but not universal support for a new approach, but differences remain in a number of critical areas, including the exact specification of the variables to be included in a new quota formula and the number and form of formulas that could be used in making quota calculations.

13. **There is increased recognition that changes in quota distribution that enhance the representation of developing countries cannot be achieved solely through revised formulas that reflect economic variables relating primarily to the financial functions of quotas.** Therefore, the Executive Board has also considered other means that may be required to achieve a distribution that would better reflect the relative economic position of members and to improve the governance structure of the Fund.

14. **A number of countries have actual quota shares that are considerably lower than calculated quota shares, almost regardless of the specific formulas used.** Moreover, based on additional indicators of relative economic position, some other countries could also be considered out-of-line. There was support for considering possible adjustments in quotas for countries in these categories, either in the context of a general quota review or as a separate ad hoc increase. However, Executive Directors also expressed caution that decisions on ad hoc increases for some countries would need to consider carefully the effect of those increases on others.

15. **An increase in the number of basic votes as a means of enhancing the representation of developing countries, especially the poorer members, in the Fund's decision making** has been considered, although some have cautioned that care should be exercised to ensure voting power is sufficiently linked to member countries' relative economic and financial importance. There is broad interest in further consideration of an increase in basic votes, but the consensus required for a needed amendment of the Articles of Agreement does not presently exist.

⁶ See *Report to the IMF Executive Board of the Quota Formula Review Group* (EBAP/00/52, 5/01/00 and Supplements 1, 2, and 3, all 5/01/00), *Staff Commentary on the External Review of the Quota Formulas* (EBAP/00/66, 6/07/00), and *External Review of Quota Formulas—Quantification* (EBAP/01/29, 4/13/01).

⁷ For further information, see *The Acting Chair's Summing Up—Alternative Quota Formulas—Further Considerations* (BUFF/02/77, 6/11/02) and *Concluding Remarks by the Acting Chair—Alternative Quota Formulas* (BUFF/01/171, 11/5/01).

D. The Fund's Current Liquidity Position

16. **The Fund's current liquidity position remains adequate by historical standards, despite the significant weakening experienced during 2002.**⁸ At end-October 2002, the level of the one-year forward commitment capacity (FCC) was SDR 52 billion from own resources.⁹ Based on the current WEO baseline scenario, these resources appear adequate for the period immediately ahead, barring unforeseen developments that could result in large new demands for Fund resources. However, as noted, the demand for Fund resources is increasingly difficult to predict and a deterioration in the global economy could result in potential spikes in new commitments and credit outstanding that could exhaust the FCC from own resources and require possible activation of the borrowing arrangements.¹⁰ In view of the considerable uncertainties, it will be important to continue to monitor the Fund's liquidity closely.

III. REPORT TO THE BOARD OF GOVERNORS

17. **There is broad agreement on the need for the Fund to have adequate resources for the forthcoming five-year period; however, the necessary broad support for a decision to increase quotas at this time does not exist.** This section considers whether to conclude the Twelfth General Review in January 2003 with no increase in quotas or to extend the period of the Twelfth General Review.

18. **The timing of the scheduled completion of the Thirteenth Review would not be affected by a decision to conclude or extend the Twelfth Review.** 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 Fund can initiate a new Review and the Board of Governors conclude it at any time prior to the expiration date of the five-year period. The Thirteenth General Review will need to be completed by January 30, 2008 regardless of the date of actual completion of the Twelfth Review.¹¹

19. **The Executive Board could recommend that the Twelfth Review be concluded with no increase in quotas.** A number of earlier quota reviews have been concluded with no

⁸ See *Concluding Remarks by the Acting Chair The Fund's Liquidity Position—Review and Outlook*, (EBM/02/109, 10/25/02).

⁹ Based on the approach agreed by the Executive Board at the recent review of the Fund's liquidity position in EBM/02/109 (10/25/02).

¹⁰ The Executive Board approved the renewal of New Arrangements to Borrow (NAB) and General Arrangements to Borrow (GAB) for a further five years on November 12, 2002.

¹¹ If the Twelfth Review is completed prior to January 30, 2003 the deadline for the next review would be five years from that date.

quota increase, most recently the Tenth Review in 1995. Moreover, it could be argued that concluding the review with no quota increase would serve as a means of sending a signal to official borrowers and private lenders that official resources are limited, thereby helping to reduce potential moral hazard in the system.

20. **An alternative approach would be to recommend an extension of the Twelfth Review period.** Many of the previous review periods have been extended, often more than once in order to provide more time to conclude discussions without losing the momentum that had been achieved. The present review commenced at a time of major financial crises, considerable uncertainty in the world economy, and consideration of changes in Fund policies. Further, at the request of the Interim Committee, the Executive Board embarked on a comprehensive review of the quota formulas, including a report by external experts. In these circumstances, it is not surprising that the many issues that are an inevitable part of any quota review could not be resolved in order to achieve the broad support necessary to propose a change in quotas. It could be argued that in these circumstances, concluding the review would be premature and reflect inadequate consideration of the critical issues confronting the Fund regarding its role in the world economy and send inappropriate signals to financial markets and members at a time of continuing uncertainty.

21. **Staff would recommend an extension of the current review with a view to reaching a final decision on a quota increase during the Twelfth Review immediately after the 2003 Annual Meetings.** Such an extension would allow more time to clarify likely trends in the world economy, particularly prospects for economic recovery, to review developments affecting the current large users of Fund resources and the potential for further financial market instability, and to assess the likely impact of new policies on the Fund's resource base, including possible changes in the Contingent Credit Lines facility (CCL). The specific work program on quotas would need to take account of developments in these areas as well as the prospects for an agreement on a quota increase. This work program could also seek to identify those members with actual quota shares that are seriously out of line with their relative position in the world economy based on approaches that would not rely exclusively on new quota formulas, possibly along the lines noted in an earlier staff paper.¹² Based on this work, the Executive Board could consider whether to recommend possible ad hoc quota increases for a very small group of members even in the absence of an agreement on a general increase in quotas as part of the Twelfth Review.

IV. PROPOSED DECISION

In light of the above considerations, it is proposed that the Executive Board adopt a decision submitting to the Board of Governors:

¹² See pages 26–27 of *Alternative Quota Formulas—Further Considerations* (SM/02/132, 5/06/02).

IV. PROPOSED DECISION

In light of the above considerations, it is proposed that the Executive Board adopt a decision submitting to the Board of Governors:

1. a report on the status of the Twelfth General Review of Quotas; and
2. a draft resolution whereby the Board of Governors would take note of the report of the Executive Board, resolve to continue the Twelfth Review, and request the Executive Board to complete its work and submit a final report by October 31, 2003. The proposed decision would be adopted by the Executive Board by a majority of votes cast and the proposed resolution by the Board of Governors also by a majority of the votes cast.

The following draft decision is proposed for adoption by the Executive Board:

1. The Executive Board approves the report annexed hereto, entitled *Twelfth General Review of Quotas—Report of the Executive Board to the Board of Governors*, for transmission to the Board of Governors.
2. The Board of Governors is requested to vote without meeting, pursuant to Section 13 of the *By-Laws*, on the draft Resolution attached to that report.
3. The Secretary is directed to send each member of the Fund by rapid means of communication on or before December [--], 2002 the Report *Twelfth General Review of Quotas—Report of the Executive Board to the Board of Governors* set forth in the Annex and the draft Resolution attached to that Report.
4. To be valid, votes must be cast by Governors or Alternate Governors by rapid means of communication on or after December [--], 2002 and must be received at the

seat of the Fund on or before January [--], 2003. Votes received after that date will not be counted.

5. The effective date of the Resolution of the Board of Governors shall be January [--], 2003, the last day allowed for voting.

6. All votes cast pursuant to this decision shall be held in the custody of the Secretary until counted, and all proceedings with respect thereto shall be confidential until the Executive Board determines the result of the vote.

7. The Secretary is authorized to take such further action as he shall deem appropriate in order to carry out the purposes of this decision.

**Twelfth General Review of Quotas—
Report of the Executive Board to the Board of Governors**

Article III, Section 2(a) of the Articles of Agreement provides that “the Board of Governors shall at intervals of not more than five years conduct a general review, and if it deems it appropriate propose an adjustment, of quotas of members.” The five-year period for the Twelfth Review will end on January 30, 2003. The Executive Board has established a Committee of the Whole in accordance with Rule D-3. Considerable progress has been made in clarifying the issues that need to be resolved in reaching a judgment regarding the adequacy of the Fund’s resource base and the possible need for a quota increase. In response to the Interim Committee’s request for the Executive Board to review quota formulas after the completion of the Eleventh General Review,¹³ progress has also been made on possible changes to quota formulas that would help achieve a quota distribution that better reflects the relative economic positions of member countries, although other means, e.g., increases in basic votes, have also been discussed to achieve changes in the governance structure of the Fund. However, there is not the necessary broad support among Executive Directors for a recommendation to increase quotas. Relatedly, no agreement has been achieved on changes to quota formulas. In addition, the Fund’s current liquidity position appears adequate, barring unforeseen developments that could result in large new demands for Fund resources.

At the same time, the Executive Board has not completed its work on reviewing certain policies that could affect the adequacy of the Fund’s resource base, including possible changes to the Contingent Credit Lines facility. The Executive Board also intends to continue considering whether countries can be identified that have quotas which may be considered to be most seriously out of line with their relative position in the world economy.

In light of the above, the Executive Board is not in a position to make recommendations in time for the Board of Governors to adopt a resolution completing the Twelfth General Review by January 30, 2003. Therefore the Executive Board proposes that the Board of Governors decide to continue its review under Article III, Section 2(a), to request the Executive Board to complete its work on the matter and submit a report to the Board of Governors together with appropriate proposals by October 31, 2003.

In view of the foregoing considerations, it is recommended that the Board of Governors adopt the resolution set out in the attachment to this report.

¹³ See paragraph 4 of *Report of the Executive Board to the Board of Governors: Increase in Quotas of Fund Members—Eleventh General Review* (SM/97/289, 12/22/97).

Proposed Resolution of the Board of Governors

RESOLVED

That the Board of Governors, having noted the report of the Executive Board entitled *Twelfth General Review of Quotas—Report of the Executive Board to the Board of Governors*, hereby resolves to continue its review under Article III, Section 2(a) and requests the Executive Board to complete its work on this matter and submit an appropriate proposal to the Board of Governors not later than October 31, 2003.