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The Reform of the IMF: Europe's Short-Term Arithmetic and Long-Term Choices

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What role did Europe play in the recent IMF governance reforms?

What implications does the reform have for European representation and coordination at the IMF?

In October 2010, the G20 reached a compromise on a large-scale reform of the IMF. The reform package comprises several elements, including a shift of quotas and a change in the Fund's capital stock. The most contentious item of the reform agenda was the decision to reform the composition of the Executive Board: After much transatlantic haggling in the weeks prior to the summit, the G20 concluded that advanced European countries would give up two of their currently eight seats in favor of large emerging market countries. Over the coming months, Europe will have to make some tough choices on the implementation of the deal. European member states should use this opportunity to consider more generally how the EU could coordinate its international macroeconomic policy and manage its external relations with the IMF better in the future.

The G20 Deal on IMF Reform: Europe Minus Two

At their meeting in Gyeongju (South Korea), the finance ministers of the G20[1] agreed on a far-reaching reform of the International Monetary Fund (IMF). The reform package was subsequently endorsed by the IMF Executive Board. It includes a quota shift by more than 6 percent in favor of emerging market countries. China will now be the third-largest shareholder after the U.S. and Japan. It will relegate Germany—which reduced its quota share to just under 6 percent—to the fourth position among the ten most powerful shareholders that now also include Russia, India, and Brazil. Furthermore, the Fund's capital stock was doubled to $755.7 billion at current exchange rates.[2] Most remarkably, the G20 agreed on reforming the composition of the IMF Executive Board, which was preceded by heated transatlantic negotiations: In the future, advanced European countries will give up two of their currently eight seats. The Board's size was kept at twenty-four seats (in contrast to the U.S.' preference to reduce it to its regular size of twenty members). Furthermore, all twenty-four Executive Directors shall be officially elected—thus ending the practice of the five largest countries appointing their Executive Directors that, up to now, could not be elected by and represent further countries. Some constituencies will also have two rather than one Alternate Director in the future.

In how far the reforms of the IMF's formal governance structures will amount to the "biggest reforms ever in the governance of the institution"[3] remains to be seen: The practical implications for internal decision-making will be modest, given that the IMF has already shifted considerably on several policy issues over the past years, and decisions are generally made by consensus. However, the fact that the G20 countries kept their promise and agreed on a reform—and exceeded expectations with regard to the timing of the compromise—carries immense symbolic importance: not only for the legitimacy of the IMF, but also for the G20's credibility as an effective global forum.

The Run-Up to the Deal: Europe between a Rock and a Hard Place

When the G20 was upgraded to the level of the heads of state and government in the wake of the financial crisis,[4] one of the Group's main objectives was to reform international financial institutions—in particular the IMF—to acknowledge and reflect the change in the international economic balance of power in favor of emerging countries. A first round of quota reforms was initiated in 2008. With a procedural ploy to block the election of the new Executive Board, the U.S. administration jump-started the reform discussions in August 2010:

The U.S. maintained that if there was no compromise on reshuffling seats in favor of emerging countries, the practice of having twenty-four members on the IMF Executive Board—four more than provided for in the IMF's Articles of Agreement—would be discontinued, which would hurt precisely some of the big emerging countries such as Brazil or Argentina whose presence and influence should be strengthened within the framework of multilateral financial institutions.

The number of European seats on the Executive Board varies depending on the rotating chairmanship of some country groupings—so-called constituencies. Germany, France, and the United Kingdom have individual appointed Executive Directors; other European Executive Directors represent a constituency on a permanent basis; and some rotate (see Table 1). Currently holding eight seats at the Executive Board, Europe was seen as grossly overrepresented.[5] It was argued that by holding on to all of its seats, Europe was denying emerging countries the opportunity to play a bigger role in the IMF. Having been close to political exodus before the financial crisis, fundamental governance reform was seen as vital for the Fund's effectiveness and legitimacy, as it would help ensure that emerging countries—especially China—would not abandon the Fund for alternative regional or national arrangements in the future. In addition, the U.S. hoped that by supporting emerging countries' demands, it would receive greater support on several vital policy issues in the future. Thus, advanced European countries were confronted with an alliance of policymakers from the U.S., emerging countries, and the IMF itself to reduce their presence at the Executive Board. And while European member states did not fully embrace the reform process for fear of losing influence, they eventually acknowledged the changing tides and agreed to the institutional reforms.

Short-Term Implications: European Musical Chairs

Having reached a deal at the highest political level, the details of the reform package will be decided and implemented step-by-step over the next two years. For the changes to take place at the Executive Board, it will be first necessary to carry out the envisaged quota reforms. Even if the required majorities for a change of the IMF Articles of Agreements (two-thirds of the organization's members with at least 85 percent of the vote) will be found in all likelihood, the implementation of the reform of the Executive Board will take time—possibly even beyond the target date of 2012.

The single largest open question following the deal is how Europe will implement the reduction by two seats. Over the coming months it will be up to European countries to divvy up the remaining six advanced European Executive Board positions. The internal negotiations will have ripple effects for the composition of constituencies and thus for non-European countries who are currently in "mixed constituencies" with advanced European countries.[6] Three broad analytical scenarios are conceivable that vary in their extent of reshuffling and their level of necessary political will among European member states for substantial reforms.

Shifting Small European States

The first scenario foresees the reshuffling of some of the small European states who would have to take turns in holding a seat at the Executive Board. The goal of reducing European seats by two would be reached by adding up fractions of chairs: Options include Belgium and Switzerland rotating or even giving up their constituencies' Executive Directorship in favor of Turkey and Poland, respectively. As Poland is not included in the deal's definition of advanced European countries, this would free up two half-seats; the Netherlands could join the Nordic chair or merge their constituency with the Belgian one; and Spain could leave the Latin American constituency and join a European constituency—for instance as Italy's rotating Alternate—thereby freeing up a third of a chair.

Such an additive approach of shifting around small European states is a very probable scenario. Although it would dismantle some long-grown constituencies, it requires only minor changes to the current system and mirrors the internal economic weights—and bargaining power—among European member states: Germany, the United Kingdom, France, and Italy, as the largest European shareholders, have already announced that they will hold on to their seats at the Executive Board. However, the reduction would have to be borne entirely by small European countries that would have to rotate more at the Executive Board than before. Furthermore, by not giving up entire seats but rather arriving at the two-seat goal in a piecemeal fashion would not send a strong signal of conviction by the European member states to reform the Board's structures.

Table 1: Current European Representation at the IMF Executive Board

Executive Director of Constituency or Seat **[Alternate Director]**	**EU Constituency Members** ***Euro-Area Members***	**Non-EU Constituency Members**	**Overall Share of Constituency or Seat (in %)**
Germany (appointed seat) [Germany]	*Germany*	-	5.87
France (appointed seat) [France]	*France*	-	4.85
United Kingdom (appointed seat) [United Kingdom]	United Kingdom	-	4.85
Belgium (elected permanent chair) [Austria]	*Austria*, *Belgium*, Czech Republic, Hungary, *Luxembourg*, *Slovak Republic*, *Slovenia*	Belarus, Kazakhstan, Turkey	5.13
Netherlands (elected permanent chair) [Ukraine]	Bulgaria, *Cyprus*, *Netherlands*, Romania	Armenia, Bosnia and Herzegovina, Croatia, Georgia, Israel, FYR Macedonia, Moldova, Montenegro, Ukraine	4.77
Currently vacant (elected chair rotating between Spain, Mexico, and Venezuela) [Mexico]	*Spain*	Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Venezuela, Bolivia	4.44
Italy (elected permanent chair) [Greece]	*Greece*, *Italy*, *Malta*, *Portugal*	Albania, San Marino, Timor-Leste	4.10
Canada (elected permanent chair) [Ireland]	*Ireland*	Antigua and Barbuda, Bahamas, Barbados, Belize, Canada, Dominica, Grenada, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines	3.63
Denmark (elected chair rotating between Denmark, Finland, Sweden, and Norway) [Norway]	Denmark, Estonia*, *Finland*, Latvia, Lithuania, Sweden	Iceland, Norway	3.43
Switzerland** (elected permanent chair) [Poland]	Poland	Azerbaijan, Kyrgyz Republic, Serbia, Switzerland, Tajikistan, Turkmenistan, Uzbekistan	2.78

*Source: IMF (as of 1 November 2010). *Estonia will adopt the euro in 2011. **Switzerland is also included into the total number of seats that are held by advanced European countries despite not being an EU member.*

Opening up European Single-Country Seats

With the move to an all-elected Executive Board, it becomes legally possible for Executive Directors of formerly appointed single-seat countries like France, Germany, and the United Kingdom to be elected by and represent other member states in the future. This option allows the creation of new constituencies out of single seats and would entail a much broader reshuffling of constituencies. For example, Switzerland, the Netherlands, and/or Austria could join the German seat, freeing up up to two seats; France could take on board Spain and/or open up a “Mediterranean chair,” including some—or all—European members of the current Italian constituency; the reform would also allow two big countries to form a constituency, such as the previously-discussed proposal of a German-Franco chair.[7]

At this stage, a joint chair for Germany and France is very unlikely given the countries' disagreements over several strategic questions of IMF policy—e.g., the role of the Fund in development policy or the pertinence of financial safety nets—and the big member states' announcements to hold on to their seats. Moreover, the three large European member states will still have enough votes to be able to elect a chair on their own even after the envisaged quota reform. However, while this scenario is less likely to occur than the first, the option of having single-seat Directors representing some of the smaller European member states and waiving their claim on the Alternate Director has the benefit of large member states contributing to an overall European solution: Small EU member states had complained after the G20 meeting that they had not been part of the overall deal but had to bear the main burden of Europe's reduction in seats.

Going Beyond the G20 Deal—Toward European Chairs

The previous two scenarios keep entrenched the idea that European countries are scattered across mixed constituencies even if they reduce some of the split. The third scenario of moving toward European chairs would require more political will than the previous two options. Yet, the current G20 compromise does not prevent European member states from going beyond the immediate demands of the deal given the principle of voluntary constituency formation. Under the third scenario, European member states would agree to re-align in European chairs that would be comprised solely of European (or euro-area) countries. Such a move would entail a major reshuffling that would involve all EU member states—even those that are not directly affected by the reduction of two advanced European seats, such as Ireland and Poland—as well as non-European countries who are currently part of mixed constituencies (e.g., in the current Belgian and Dutch constituencies). A number of European subgroups are conceivable, including a Benelux chair, an emerging market European chair, a Mediterranean chair, or a euro-area chair.

Mixed constituencies have been identified as one (though not the only) reason why coordination among European member states in the Fund proves difficult at times, as it hinders the direct translation of European compromises into Executive Directors' positions at the Board. Over the years, several proposals to create all-European chairs—or move toward two or three European chairs with the according voting power—have been made.[8] The current reform negotiations provide a window of opportunity for a major reshuffle toward greater European consolidation at the Fund—a window that has been recognized by the European Commission who will most likely table another proposal to that end over the coming months. So far, however, the large EU member states—but also many of the smaller member states—have lacked the political will to undergo such major reforms at the Fund: Large EU member states with individual seats defend their right to a chair at the Board in accordance to their relative global economic weight. Some smaller member states, on the other hand, fear that by agreeing to an intermediate step of European consolidation without the involvement of the bigger member states will make them relatively worse off than holding on to chairs of mixed constituencies.

Despite its merits, the prospect for a major overhaul of the European constituencies in the wake of the current reform is therefore dim.

A Long-Term European Strategy Toward the Fund

Beyond the immediate requirement to deliver on the promise to give up two seats at the Board, the recent IMF reform points to the larger question of how Europe will manage—and coordinate—its international macroeconomic and financial policies at the IMF more generally. The Fund has grown dramatically in importance for many European countries and the Monetary Union as a whole: The Irish bailout plan is only the latest example.

The current changes should be seen as the beginning of a reform path rather than the end, and even big member states such as Germany will not be able to go it alone in the future. Advanced European countries will in all likelihood have to further reduce their shares and chairs as a reflection of their relative decline in global economic power, given the new built-in review of IMF Board composition every eight years in addition to regular quota reviews. What role Europe and the EU will play in the Fund in the long run does, therefore, not only depend on the number of seats EU countries hold, but whether the European capitals will be able—and willing—to reach substantive agreements "at home" in the future. Any decision taken over the coming months should be conformant with Europe's longer-term objectives for the Fund: European policymakers—especially large member states like Germany and France—should use the current negotiations to revive the internal debate on how the members of the European Union (and especially the euro-area) should coordinate their stances toward the IMF and its representation more coherently and strategically in the future.

NOTES

1 The G20 members are: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, the United States, as well as the European Union. Representatives of the World Bank, the IMF, the Financial Stability Board, OECD, ILO, WTO, and the UN and other countries are invited on a regular basis.

2 Each IMF member country is assigned a quota, based broadly on its relative position in the world economy. The quota determines its maximum financial commitment to the IMF, its access to IMF financing, and its voting power in the Fund. See also Meeting of Finance Ministers and Central Bank Governors, Communiqué, Gyeongju, 23 October 2010, <http://www.g20.utoronto.ca/2010/g20finance101023.pdf> (25 October 2010); “IMF Executive Board Approves Major Overhaul of Quotas and Governance,” *IMF Press Release* No. 10/418, 5 November 2010, <http://www.imf.org/external/np/sec/pr/2010/pr10418.htm> (9 November 2010).

3 At the same time, other special funds—the New Arrangements to Borrow (NAB)— will be reduced so that the overall national contributions to the IMF will not change. Dominique Strauss-Kahn, cited in: “Strauss-Kahn says Officials at G-20 Agreed on ‘Biggest Reform Ever’ of IMF,” *Bloomberg*, 23 October 2010, <http://www.bloomberg.com/news/2010-10-23/strauss-kahn-says-officials-at-g-20-agreed-on-biggest-reform-ever-of-imf.html> (28 October 2010).

4 The G20 was originally founded in 1999 by the G8 against the backdrop of the Asian financial crisis. For the first decade, it met in the public shadow of the G7/G8 at the level of finance ministers and central bank governors. In 2008, President Bush invited the leaders of the G20 to a “Summit on Financial Markets and the World Economy.” The group has met several times since, establishing itself as the “premier forum for international economic cooperation.” See Pittsburgh Summit Declaration, Leaders’ Statement, 24 and 25 September 2009, <http://www.pittsburghsummit.gov/mediacenter/129639.htm> (accessed 28 October 2010).

5 On the criticism see, e.g., Paulo Nogueira Batista , “Europe must make way for a modern IMF,” *Financial Times*, 23 September 2010, <http://www.ft.com/cms/s/0/8b57a684-c744-11df-aeb1-00144feab49a.html> (1 October 2010); Dominique Strauss-Kahn cited in: Edwin M. Truman, “The G-20 and International Financial Institution Governance,” *Working Paper* 10-13, Peterson Institute for International Economics: 25, <http://www.iie.com/publications/wp/wp10-13.pdf> (1 November 2010). The view was supported by a number of scholars and commentators, e.g., Amar Bhattacharya, Colin I. Bradford, and Johannes F. Linn, *Europe’s Governance Stalemate Causes Gridlock for Global Governance Reform*, 23 April 2010, The Brookings Institution, <http://www.brookings.edu/opinions/2010/0424_governance_linn.aspx> (29 October 2010); *Open Letter to IMF Governors*, 28 September 2010, <http://www.new-rules.org/news/program-updates/296-open-letter-to-imf-governors> (27 October 2010).

6 While there is no formal definition of mixed constituencies, the term generally stands for country groupings within the IMF that have a heterogeneous membership, e.g., including creditor and debtor countries, or EU and non-EU countries.

7 In 1998, Dominique Strauss-Kahn, then-Finance Minister of France, suggested to form a common chair with Germany at the IMF. See, e.g., Alan Ahearne and Barry Eichengreen, “External monetary and financial policy: A review and a proposal,” in: André Sapir (ed.), *Fragmented Power: Europe and the Global Economy* (Bruegel Books, 2007): 128-155.

8 Suggestions include inter alia a single chair for all euro-area countries; two chairs—one for the euro-area and one for the non-euro-area EU members; or three chairs, adding one for non-EU European countries. See, e.g., European Commission, “EMU@10: Successes and Challenges after 10 Years of Economic and Monetary Union,” *European Economy* 2/2008, <http://ec.europa.eu/economy_finance/publications/publication12682_en.pdf> (17 November 2010); Paul van den Nord et al., “The Evolution of Economic Governance in EMU,” *Economic Papers* No. 328, June 2008, <http://ec.europa.eu/economy_finance/publications/publication12746_en.pdf> (2 November 2010). See also Lorenzo Bini Smaghi, “Why the Euro Area is still a political dwarf?,” *International Finance* 9 (2006) 2:261-279; for an overview of proposals see, e.g. Alan Ahearne and Barry Eichengreen, “External monetary and financial policy: A review and a proposal,” in: André Sapir (ed.), *Fragmented Power: Europe and the Global Economy* (Bruegel Books, 2007): 128-155; Eurodad, “European coordination at the World Bank and the IMF: A question of Harmony?,” *ADS insight*, January 2006, <http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Eurodad%20EUIFIgovernance.pdf> (2 November 2010).

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