

Working Paper 282

Closing the deal:  
Assessing the opportunities and risks for Bretton  
Woods governance reform in 2007

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# Contents

Abstract	v
Acknowledgements	v
<b>1 Introduction</b>	<b>1</b>
<b>2 Rationale for reform</b>	<b>2</b>
2.1 Voice, representation and equity	2
2.2 Legitimacy and the changing global political economy	5
<b>3 Progress to date</b>	<b>6</b>
3.1 Quota votes	6
3.2 Representation for low-income countries	6
3.3 Bretton Woods leadership	7
<b>4 Risks and opportunities for the reform process</b>	<b>7</b>
4.1 The ‘honeymoon’ of Dominique Strauss-Kahn	8
4.2 Leadership of the G20	8
4.3 Publication of new PPP data	8
4.4 US domestic politics	9
4.5 Reform fatigue	9
4.6 Risk of financial market volatility or global downturn	10
<b>5 Modelling the political economy of reform</b>	<b>10</b>
5.1 Literature on two level games	10
5.2 Model over two periods	12
5.3 Further formalisation	14
<b>6 Conclusions</b>	<b>16</b>
References	17

## Acronyms

ADB	Asia Development Bank
ASEAN	Association of South-East Asian Nations
BIS	Bank of International Settlements
DC	Developing Countries
EU	European Union
G7	Group of seven leading industrialised countries (Canada, France, Germany, Italy, Japan, United Kingdom and United States)
G20	Group of twenty comprising nineteen of the worlds largest economies (Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, United Kingdom, United States) plus the European Union
G24	Also known as Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development the Group of twenty four is a subset of the G77 (Group of 77) and consists of the following countries: Algeria, Argentina, Brazil, Colombia, Côte d'Ivoire, Democratic Republic of the Congo, Egypt, Ethiopia, Gabon, Ghana, Guatemala, India, Iran, Lebanon, Mexico, Nigeria, Pakistan, Peru, Philippines, South Africa, Sri Lanka, Syria, Trinidad and Tobago and Venezuela
GDP	Gross Domestic Product
ICP	International Comparison Programme
IFI	International Financial Institution
IMF	International Monetary Fund
IMFC	International Monetary and Finance Committee
NGO	Non Governmental Organisation
UK	United Kingdom
US	United States

## Abstract

This paper details the efforts that have been made since 2006 to reform the governance structure of the International Monetary Fund and the World Bank. It focuses, in particular, on efforts to re-evaluate how emerging market economies are represented in the quota formula. It reviews the rationale for reform and how it came to be supported by some of the IMF's largest members including the United States and the United Kingdom. It goes on to assess the progress made toward reform and the likelihood of completing the process by 2008 – the date set by the Fund's Board of Governors for revising the quota formula and amending the voting structure. The paper argues that while there remain substantial differences in the ‘first best’ options for reform advanced by developed and developing countries, the climate for reform has rarely looked more favourable. Delaying a decision on reform until 2008 undermines the potential for compromise that currently exists and presents a host of new dangers. These opportunities and risks are formally modelled in a ‘two level game’, where developing and developed countries bargain over ideal-type reforms, bearing in mind the constant constraints placed on them by underlying factors such as domestic politics, particularly those in the US. Using further mathematical formalisation, it assesses the prospects for longer term support of reform and finds that this is more likely under conditions of strong and sustained economic growth in Europe and other developed regions. These conclusions suggest that all parties – whether developed or developing – have an incentive to forge a deal in the coming months.

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# 1 Introduction

2006 was a watershed year for global governance reform. Following a series of public statements by the US Treasury outlining support for an overhaul of the International Monetary Fund's voting structure at the end of 2005,<sup>1</sup> and clear warnings from the Governor of the Bank of England in early 2006 that '...membership of the top table must change with circumstances – the group of big players is no longer an exclusive group of rich countries'<sup>2</sup> a process aimed at reforming the Bretton Woods institutions was actively undertaken. At the spring meetings in April 2006, the International Monetary and Finance Committee (IMFC) of the International Monetary Fund declared that: 'the IMF's effectiveness and credibility as a cooperative institution must be safeguarded and its governance further enhanced, emphasizing the importance of fair voice and representation for all members. We underscore the role an ad hoc increase in quotas would play in improving the distribution of quotas to reflect important changes in the weight and role of countries in the world economy.'<sup>3</sup> It went on to ask for the preparation of further concrete reform proposals ahead of the Annual Meetings of the IMF and World Bank, which were due to take place in the September of that year.

The case for reform had been made. The IMFC adopted a package of reforms, aimed at modifying quotas and voice within the institution, which were due to be completed by the Annual meetings of 2008, at the latest. The communiqué from the meetings stated that: 'Starting with initial quota increases for China, Korea, Mexico, and Turkey, this package of reforms, when implemented, would make significant progress in realigning quota shares with members' relative positions in the world economy and, equally important, in enhancing the participation and voice of low-income countries in the IMF as set out in the resolution'.<sup>4</sup> Thus, the scene was set for the most radical shake-up of the global economic governance regime in decades – something which even just a few years ago had seemed virtually impossible.

However slim the prospects for reaching an acceptable compromise appear at present (given that any agreement entails both winners and losers), it is worth noting that as time progresses and 2008 approaches, the number of potential obstacles to a deal multiply exponentially. The current situation is one in which there are a number of advantages associated with negotiation, which ought ideally to be taken into account by all parties to the process, thereby providing added incentives for a speedy conclusion. Among the myriad incentives are (i) the recent resignation of Managing Director Rodrigo de Rato and the subsequent appointment of former French finance minister Dominique Strauss-Kahn; (ii) the difficulty in gaining support from certain sections of the US government for wide-ranging reform of the IMF given next year's US presidential elections; (iii) the impending change of the G20 chair, South Africa, and the planned release of new data at the end of the year which may strengthen the case against the use of purchasing power parity (PPP) metrics.

How did this reform process come about, and what progress has been made in the 12 months since the programme began in earnest? What are the prospects for completing the reforms ahead of this year's annual meetings, which are only weeks away? And what are the risks of deferring completion to 2008? These are the questions that this paper sets out to answer. It argues that completion of the reform process ahead of this year's annual meetings would be highly desirable given the inflated number of risks associated with the process in late 2007/early 2008. The political economy for reform is currently

<sup>1</sup> A speech by the Under Secretary for International Affairs in the US Treasury in 2005 stressed that '....the governance of the IMF should evolve along with the world economy, so that countries have a rightful stake in the institution. The world economy has evolved considerably, as some countries have grown more quickly than others.' *Timothy D. Adams, US Department of the Treasury: Speech at the Institute for International Economics, 23 September 2005: Washington DC.*

<sup>2</sup> Mervin King, Governor of the Bank of England: *Speech at the Indian Council for Research on International Economic Relations (ICRIER), 20 February 2006: New Delhi, India.*

<sup>3</sup> Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund: April 22, 2006. <http://www.imf.org/external/np/cm/2006/042206.htm>

<sup>4</sup> Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund: September 17, 2006. <http://www.imf.org/external/np/cm/2006/091706.htm>

favourable but may well be less so in a year's time. Thus, if members of the IMF and the World Bank are serious about reaching an agreement on an equitable and meaningful reform programme, all efforts must be made to close the remaining gap in negotiating positions between blocks of low, middle and high income countries.

The paper is structured around the questions posed above. The second section investigates the rationale for reform and looks at the various factors which triggered the process in 2006. In particular it considers the role of advocacy organisations and scholars of development and good governance in applying strong and sustained pressure for governance reform. The third section assesses the progress of negotiations to date and highlights areas of consensus and agreement. The fourth section outlines the remaining obstacles to, and opportunities for, meaningful reform in the short to medium term including the negotiating power of the new Managing Director, the role of the G20 chair, the release of new data which will affect the representation of the largest emerging market countries, US domestic politics, reform fatigue and the more generalised risk of an economic downturn. Section five formalises these findings into a model of political reform loosely based on Robert Putnam's concept of two-level games. This formalisation of the situation demonstrates clearly that the 'winset' for an agreement on governance reform is larger this year than next. Further formalisation in this section also illustrates that the likelihood of securing support for IMF reform in the longer term is dependent on global economic growth and in particular on the growth of European economies.

The paper concludes with the argument that quota and voice reform within the Bretton Woods institutions should ideally be completed during this calendar year, which implies a strong push ahead of the autumn meetings in a few weeks time. The timeframe in which to reach an agreement has therefore contracted considerably and time is running out yet there are still major differences between some developed and developing countries about how representation in these institutions should be structured in the coming years.

## 2 Rationale for reform

This section looks at the rationale for reforming governance within the Bretton Woods institutions in two parts. First, the large literature on the necessity of reform is reviewed. Although this body of work has tended to focus on the need to achieve greater parity in the voting rights and voice of developing countries, it is worth bearing in mind that these arguments have been around for almost a decade; they cannot therefore be considered the impetus for reform that has gained momentum in the last year. Rather, the rationale for reform at this particular juncture in the history of the Bretton Woods institutions can be traced back to fears from the US in particular that these institutions are becoming increasingly irrelevant given important changes in the international political economy, especially the increasing importance of Asia. These reasons are explored in sub-section B below.

### 2.1 Voice, representation and equity

As indicated above, the reform of the Bretton Woods institutions has, for some years, been a priority for scholars of development, international relations and global governance. One of the main arguments that crops up more or less consistently is the need for institutional reform because the current governance structure fails to adequately represent developing countries, and therefore lacks legitimacy. Over time, the two voting mechanisms established for governing the Fund's operation (basic and quota votes) have become increasingly unequal. While quota votes were based on each country's contribution to the IMF and therefore on their relative wealth and economic power, basic votes were awarded to all countries on the principle of equality among states. In 1945, basic votes

represented 11.3% of total votes; today, these votes account for just 2.1% of representation<sup>5</sup> due to increased contributions to quota over time. This has of course meant that representation for the smallest/poorest states has declined significantly. The current governance structure has also been criticised for its lack of transparency: devised at the founding of the Bretton Woods institutions, the formula was designed to meet a series of political objectives rather than serve any real practical purpose.<sup>6</sup> As such it was (and remains) highly complex and ambiguous. The IMF also features repeatedly in the academic literature on the ‘democratic deficit’ of international institutions, where such institutions are thought to suffer from a lack of democracy and accessibility at one or more levels. Frequently cited criticisms include the fact that membership is often limited to governments, some of which are not democratic and lack of equality in voting amongst members (Nye, 2001; Moravcsik, 2004).

There are two critical issues worth highlighting here, both of which contribute to a better understanding of the current reform package and its content: firstly, the way that seats on the Executive Board are allocated and secondly, the distribution of quota votes. This has become known as ‘chairs and shares’ in the literature. The discussion on chairs and shares is critical because the largest shareholders dictate the Fund’s mandate, goals and programmes. Redistributing formal representation to emerging market developing countries is therefore likely to change its mandate and ideas. As suggested above, the formula used to determine quota allocations is based on political negotiations which took place at the time of the Fund’s founding in 1944. Its overall effect has been to provide disproportionately large representation to small, open economies, such as those of many European countries.

In terms of chairs, each country is assigned to an ad hoc, non-binding voting constituency; the 24 seats on the Executive Board are then distributed among these constituencies (see Table 1). Although formal votes are rarely taken on the Board, voting power is significant because it is noted informally and all members must be in agreement before a decision is made. One of the major problems with the current situation are the large number of African countries which report to one executive director (creating an enormous work load and, by extension, a capacity constraint which limits work to strategic matters and detracts from country specific, programme related issues). Another is the spread of European Union members across some 10 chairs (some of which contain no other EU members as is the case for Spain, Ireland and Poland). Additionally, many chairs include countries which are both net borrowers and net lenders to the IMF and are therefore likely to have different priorities.

In response to these failings, the literature has suggested a number of potential reforms. Woods, for example, recommends a double-majority voting system which would favour wealthy countries *and* countries with large populations (Woods, 1999), a proposal which has since found favour with the Bretton Woods Project, a UK network of non-governmental organisations (NGOs).<sup>7</sup> Buira has suggested a number of ways in which to make quota votes more equitable, including using GDP measured in Purchasing Power Parity (PPP) terms and including a metric which factors in a country’s vulnerability to volatility (Buira, 2003). The most radical proposals have come from NGOs, which call for one country- or one-person- one-vote systems (Christian Aid, 2003). A series of proposals has also been put forward on the restructuring of European constituency votes, given that a number of small European states enjoy a disproportionately high level of representation on the Executive Board, as noted above (Coeure and Pisani-Ferry, 2003; Bini Smaghi, 2004; Leech and Leech, 2005). Despite the large body of literature on reform and the range of options it covered, from the marginal (rearrangement of constituencies) to the radical (a one country one vote system), the reform process did not get underway until the **Fund’s crisis** of legitimacy began to critically undermine its continued ability to regulate the international economy. This is explored in greater detail below.

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<sup>5</sup> G24 Secretariat Briefing Paper on Reforming the Governance of the IMF, March 2003. Available online at: <http://www.g24.org/r gover.pdf>

<sup>6</sup> Ibid.

<sup>7</sup> See article, 2 February 2007 online at <http://www.brettonwoodsproject.org/art-549743>

Table 1: Current voting power, by constituency<sup>8</sup>

Executive Director	Other members	% of vote
US	N/A	16.79
Japan	N/A	6.02
Germany	N/A	5.88
France	N/A	4.86
UK	N/A	4.86
Belgium	Austria, Belarus, Czech Republic, Hungary, Kazakhstan, Luxembourg, Slovak Republic, Slovenia, Turkey	5.15
Netherlands	Armenia, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Georgia, Israel, Macedonia, Moldova, Romania, Ukraine	4.76
Venezuela	Costa Rica, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Spain	4.45
Italy	Albania, Greece, Malta, Portugal, San Marino, Timor-Leste	4.11
Australia	Kiribati, Korea, Marshall Islands, Micronesia, Mongolia, New Zealand, Palau, Papua New Guinea, Philippines, Samoa, Seychelles, Solomon Islands, Vanuatu	3.85
China	N/A	3.66
Canada	Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Ireland, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines	3.64
Finland	Denmark, Estonia, Iceland, Latvia, Lithuania, Norway, Sweden	3.44
Egypt	Bahrain, Iraq, Jordan, Kuwait, Lebanon, Libya, Jamahiriya, Maldives, Oman, Qatar, Syria, UAE, Yemen	3.20
Saudi Arabia	N/A	3.17
Indonesia	Brunei Darussalam, Cambodia, Fiji, Lao, Malaysia, Myanamar, Nepal, Singapore, Thailand, Tonga and Vietnam	3.12
Kenya	Angola, Botswana, Burundi, Eritrea, Ethiopia, Gambia, Lesotho, Malawi, Mozambique, Namibia, Nigeria, Tanzania, Sierra Leone, South Africa, Sudan, Swaziland, Uganda, Zambia	2.94
Switzerland	Azerbaijan, Kyrgyz Republic, Poland, Serbia and Montenegro, Tajikistan, Turkmenistan, Uzbekistan	2.79
Russia	N/A	2.70
Iran	Afghanistan, Algeria, Ghana, Morocco, Pakistan, Tunisia	2.42
Brazil	Colombia, Dominican Republic, Ecuador, Guyana, Haiti, Panama, Suriname, Trinidad and Tobago	2.42
India	Bangladesh, Bhutan, Sri Lanka	2.35
Peru	Argentina, Bolivia, Chile, Paraguay, Uruguay	1.96
Rwanda	Benin, Burkina Faso, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Congo (DRC), Congo, Cote d'Ivoire, Djibouti, Equatorial Guinea, Gabon, Guinea, Guinea-Bissau, Madagascar, Mali, Mauritania, Mauritius, Niger, Sao Tome and Principe, Senegal, Togo	1.39

Source: IMF.

<sup>8</sup> There are slight variations in the composition of the IMF and World Bank board. The IMF is used here for illustrative purposes. Updated as of ad hoc quota reform, September 2007.

## 2.2 Legitimacy and the changing global political economy

The recent interest in, and support for, institutional reform from some of the Fund's more powerful members is clearly linked to concerns about the viability and ongoing operational legitimacy of the Fund rather than any new found concern with equity – an issue which has dogged the Fund for decades. This paper identifies three major changes to the global political economy which have increasingly cast doubt over the Fund's ability to manage the international economy going forward. These are outlined below.

The first was the gradual accumulation of enormous stores of foreign exchange reserves by Asian and other developing countries which fundamentally altered the balance of power in the IMF. By the end of 2006, the Bank of International Settlements (BIS) estimated that Asia (excluding Japan) held more than \$2 trillion of dollar reserves, with China alone holding a trillion. Latin America and Russia held another \$245 billion each (Mohanty and Turner, 2006). The financial reserves held by the central banks across the developing world has therefore begun to dwarf the Fund's resources and provided a form of 'self-protection' against financial market crises and other economic downturns (Gengberg et al., 2005). The accumulation of foreign exchange reserves has in turn reinforced momentum for regional liquidity arrangements, such as the bilateral swap facility amongst ASEAN + 3 nations, the so-called 'Chiang Mai' initiative, and an 'Asian Monetary Fund' (floated by Japan following the East Asian financial crisis but dismissed by the US and Europe). The threat of reduced participation in the Fund by Asia and other large developing economies would, it was feared, critically undermine the Fund and, limit the US and Europe's leverage in key areas of economic and political interest across the world.

The second major change in the global political economy prompting a push for institutional reform has been the increasingly precarious financial situation of the Fund. Early repayments of large debt tranches by the Fund's largest borrowers – including Argentina, Brazil, Turkey and the Philippines – reduced the Fund's primary source of interest income. This, combined with a lower incentive to borrow given favourable market conditions for both finance and export goods, accumulation of foreign exchange reserves and rejection of the IMF as a source of funding (linked to a growing sense of self-reliance and 'national pride' among many developing countries) suggests that the Fund will experience real difficulty in raising sufficient income from interest payments to fund ongoing operations without a massive increase in quotas – an unpalatable option for most members.

The third major change to unsettle the global political economy has been the increasing number and complexity of market failures and economic crises. The apparent impotence of the Fund in addressing these and other issues, particularly the ongoing problem of international imbalances has strengthened the case for reform. The IMF's mandate has, historically, been strictly bilateral – the Fund interacts with only one member at a time. This effectively prevented the fund from bringing several member states together to discuss imbalances or for that matter any other such issue. During the autumn 2006 meetings, the mandate of the Fund was altered to enable them to undertake so-called multilateral surveillance.

Combined, these changes in the global political economy indicated that the IMF was becoming an increasingly marginal actor in the management of global economic affairs, and that as such, a key foreign policy tool of the US and, to a lesser extent the European Union, was being eroded. The US hoped that by granting large, fast-growing economies a greater say in governing institutions such as the IMF, their legitimacy and indeed existence could be secured. But the opening of discussions on IMF governance reform also brought equity issues to the fore and there was a renewed effort to ensure that of the reforms being tabled, none implied a loss of representation for low-income countries. Thus the communiqués referred to above focus on altering the quota vote structure to ensure that distribution of votes more accurately reflects the current distribution of power in the global economy. They further seek to address the low levels of representation among African constituents in particular. The achievements to date in both of these areas are reviewed in the section below.

### 3 Progress to date

This section briefly reviews the progress made to date on meeting the objectives set out by IMFC members in the 2006 Spring and Autumn communiqués. It also looks at the question of Bretton Woods leadership, which became an issue in the summer of 2007 after the forced resignation of World Bank President Paul Wolfowitz in June and the unexpected resignation of IMF Managing Director Rodrigo Rato the following month.

#### 3.1 Quota votes

The first step in implementing reforms of the quota vote system and representation of developing countries in the IMF was an ad hoc quota increase for four of the fast-growing economies: China, South Korea, Mexico and Turkey, all of whom were grossly underrepresented in the previous formula. Gaining approval at the Autumn meetings, it increased China's representation by 0.72 percentage points from 2.94% to 3.66%. The remaining three countries had to make do with a smaller, though no less significant, increases. As a result, other countries – both developed and developing – lost a small share of their voting power. Overall, the ad hoc increase was equivalent to a 1% increase in total quota.

Despite this ad hoc increase, the debate about how to determine quota votes and, in particular, whether other developing countries should also be granted ad hoc increases continues. The primary forum for negotiation has been the G20 – a group of countries which includes the G7 in addition to large emerging market economies such as Argentina, Brazil, China, India, and South Africa.<sup>9</sup> To date, there have been a number of proposals tabled by the membership on ways to increase representation among developing countries – most of these involve changes to the quota formula that would calculate gross domestic product (GDP) in terms of purchasing power parity (PPP). These proposals have won broad support from developing countries, not least because they imply quite significant gains for almost all emerging economies. These gains, however, come at the expense of developed country economies in general and European economies in particular. Despite a number of meetings, member states have yet to come up with a formula that adequately addresses the representational claims of large developing economies without imposing unacceptably high losses on European and other constituencies.

#### 3.2 Representation for low-income countries

The main problem in increasing the representation of low-income countries in the IMF is that most of the proposals relating to the redistribution of quotas do not benefit the overall voice of low-income countries because their economies are small on a global scale. Reforming the Fund with a view to making it more representative requires, as a first step, an increase in the number of basic votes. Ideally this would be accompanied by a series of other measures given that a three-fold increase in the number of basic votes increases representation among African and other low-income countries only marginally. Such measures could include one or more of the following (i) additional technical support for African countries to better manage the challenges of their large constituencies; (ii) an extra seat on the Executive Board to reduce the overall administrative burden; (iii) more frequent meetings between African executive directors and the IMF management – a suggestion made during the autumn 2006 meetings.

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<sup>9</sup> G20 Members include Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States of America.

### 3.3 Bretton Woods leadership

A third and final opportunity for reform presented itself with last summer's leadership crisis which began with the forced resignation of Paul Wolfowitz at the World Bank, and was followed not long after by the departure of Rodrigo Rato at the IMF. An informal agreement between the founding members of the Bretton Woods institutions ensures that an American always heads the World Bank and a European, the IMF. This long-standing practice goes against the idea of having an open and transparent leadership selection process which would aim to appoint the best qualified candidate, irrespective of nationality. Thus, when the President of the World Bank, Paul Wolfowitz, was forced to resign following allegations of nepotism there were a number of calls to use the opportunity implement a more equitable and transparent leadership selection process.<sup>10</sup> The same calls were repeated when IMF Managing Director Rodrigo de Rato announced his resignation in July, particularly after the Europeans put forward former French Finance Minister Dominique-Strauss Kahn as their preferred candidate.<sup>11</sup> Russia eventually proposed an alternative candidate, Josef Tosovsky, a former prime minister of the Czech Republic, arguing that Strauss-Kahn 'lack[ed] the technical qualifications for the job'.<sup>12</sup> The UK meanwhile announced that it supported an open and transparent selection process for the Managing Director.<sup>13</sup> Nevertheless, in both cases it was the EU/US backed candidate that eventually won out, jettisoning hopes for a more equitable and transparent process and, by extension, a more representative leadership.

Thus, the overall conclusion is that while a significant amount of progress has been made in addressing the under-representation of middle and low-income countries in the governance structures of the IMF, there are still a number of issues that need to be resolved ahead of any deal on quota votes and representation for low-income countries. The recent leadership crisis demonstrates that while the impetus for change exists, the overall scope of change remains relatively limited.

## 4 Risks and opportunities for the reform process

This section argues that there is, at present, a clear window for completing the IMF governance reform process initiated in 2006; as 2007 draws to a close, however, that window is likely to contract. Member states should seek to take advantage of the favourable climate and 'strike while the iron is hot' as there are a number of opportunities for negotiation available now that may not be available in two to three months time. A renewed push to finalise the package of reforms during the Autumn meeting series in October and subsequent follow-up meetings is therefore vital if members are to meet their self-imposed deadline for completing the reform process.

This paper identifies several opportunities for reform, each of which are discussed in more detail in the following sub-sections before being formalised in the penultimate section, Section V, through the adaptation of a model known in the political science literature as a two level game. These opportunities include: the appointment of Dominique Strauss-Kahn as the new Managing Director of the IMF and his commitment to institutional reform; the continuity of leadership associated with reaching an agreement prior to a new chair assuming control of the G20 in 2008; the risk that new data on Purchasing Power Parity due to be published at the end of the year will have negative implications for European and other developed countries and that as such, any proposal based on the new data will be more difficult to push through; and the risk that the United States will lack the capacity and inclination to effectively negotiate and implement a reform package in 2008 given the forthcoming presidential elections. There are two further risks associated with delaying reform to the early part of next year

<sup>10</sup> See for example Callan, E. (2007) 'World Bank managers call for a shake up,' *Financial Times*, 29 May. A series of letters published in the *Financial Times* during May and June 2007 also argued for more transparency in the selection process.

<sup>11</sup> See the strongly worded editorial in the *Financial Times*, 'Europe is wrong to push Strauss-Kahn', 28 August 2007.

<sup>12</sup> Luce, E. (2007) 'Russia says IMF candidate lacks key skills,' *Financial Times*, 25 August.

<sup>13</sup> Guha, K. et al. (2007) 'UK calls to open up IMF chief selection,' *Financial Times*, 9 July 2007.

which are of concern to us here: the risk of reform fatigue given the protracted nature of negotiations to date and the risk of accelerated financial market instability or a generalised economic downturn as a result of the current US credit crisis.

#### **4.1 The ‘honeymoon’ of Dominique Strauss-Kahn**

While the appointment of Dominique Strauss-Kahn as Managing Director of the IMF was not without controversy, as indicated above, his appointment by the Executive Board at the end of September has given the process a renewed sense of purpose and direction, bolstering prospects for timely completion of the governance reforms promised in 2006. Strauss-Kahn has said that he wants to focus his tenure at the IMF on overhauling the institution, announcing: ‘I defined myself as the candidate for reform. Now I’m the designated managing director for reform. What I want to do after November 1 is to really be the managing director for reform.’<sup>14</sup> He also mentioned that new voting structures for the Fund will not diminish the voice of the United States, but would require changes in weighting for Europe and Russia.

An early victory on quota reform would consolidate Strauss-Kahn’s position and demonstrate that he is indeed serious about his pledge to prioritise reform. While closing a deal on reform now may mean that it is not as radical as some developing countries had hoped, Strauss-Kahn could utilise the ‘honeymoon’ period of his leadership to push through initial reforms on quota representation while at the same time reassuring members that this was merely the first step in a long-term vision of reform. If Strauss-Kahn instead agrees to review or revisit the reform options currently on the table, he could unwittingly be inviting a long drawn out process of negotiation in which all sides become increasingly entrenched, delaying reform with no clear advantages in terms of scope or depth of change.

#### **4.2 Leadership of the G20**

A second opportunity for completing the governance reform process in 2007 concerns the G20, which as previously mentioned, has been the primary locus for negotiating quota and governance reforms under the current chair South Africa and the previous chair, Australia. There are three main advantages to negotiating a reform package under the current chair. First, while the G20 utilises a ‘troika’ system to ensure continuity between the past, present and future chairs of the body, the transition to new leadership at the beginning of 2008 may cause delays in the negotiation of an IMF reform package. This is because it will inevitably take time for the new chair, thought to be from the Latin American region, probably Brazil, to become completely familiar with the role and find a niche in its negotiating style. Second, as things stand, South Africa will almost certainly lose from any new formula or ad hoc quota increase currently on the table. Although something of a double-edged sword, it does at least cast the current chair in the role of an honest broker. By contrast, Latin American countries in general and Brazil in particular, stand to gain considerably from a formula which utilises PPP metrics. The incoming chair therefore has a vested interest in ensuring that the resulting outcome will favour this type of representation. This could in turn imply that the new chair would take a less moderate stance in negotiations thereby making compromise between developing country constituents and Europe/other developed countries more difficult.

#### **4.3 Publication of new PPP data**

A further risk associated with postponing negotiations to the new year is the planned release of new PPP data by the International Comparison Programme (ICP) due at the end of 2007. This will show significantly increased GDP for China and India and a number of other emerging market economies. The ICP’s previous datasets were either incomplete or otherwise compromised but the 2003-2006 round

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<sup>14</sup> IMF Survey Magazine, 1 October 2007. Available online at: [www.imf.org/external/pubs/ft/survey/so/2007/NEW101A.htm](http://www.imf.org/external/pubs/ft/survey/so/2007/NEW101A.htm)

has made a series of changes aimed at improving the quality, integrity and comparability of PPP data across countries and regions.<sup>15,16</sup> Some data has already been released for selected regions, including preliminary data coordinated by the Asian Development Bank (ADB) for the Asia and Pacific. The data estimate the China comprises 45% of Asian GDP and India 19%; together they account for 64% of the region's GDP.<sup>17</sup>

Any decision to incorporate the new data on PPP would make a compromise between developing and developed countries more difficult because it has far-reaching implications in terms of governance. The revised data which shows increases in the PPP of large emerging market economies at the expense of established economies in Europe and North America will not only lead to a change in the allocation of quota votes, but may also precipitate changes in other rules governing the IMF such as which countries have non-elected Managing Directors and their own individual chair. This may prove to be one revision too far for some developed countries. Developing countries by contrast are unlikely to block a new quota formula that uses older PPP data because they stand to gain from such a formula regardless.

#### 4.4 US domestic politics

Changes to the IMF's Articles of Agreement require the approval of the US Congress. This in turn means that the positions which the US Treasury/Executive Branch adopt in negotiations on governance reform is indirectly influenced by whether the proposals require Congressional approval and the likelihood of securing that approval. Historically, Congress has proven to be more conservative about funding and other issues related to the Bretton Woods institutions<sup>18</sup> than the executive branch. Thus, the spectre of a Congressional vote against a hard won negotiation package influences the position that the US is able to take when discussing IMF reform not least because the US holds the only 'veto' in the IMF due to the size of its representation. The risks of the US digging its heals in and refusing to budge on key points of negotiation are greater in 2008 because it is a presidential election year, and thus also an election year for many members of the Congress. Not only will attention be diverted to the domestic political arena and issues that have a direct bearing on the day-to-day lives of American citizens but Congressional members are likely to encounter staunch opposition to any reforms which imply a reduction in US power, particularly in such a politically charged atmosphere.

#### 4.5 Reform fatigue

The negotiation process on quota reform has been a time consuming and labour intensive exercise for G20 member states and the Executive Board of the IMF. There is a risk that if a deal is not forthcoming, the incentives to reach an agreement will decline and the process will run out of steam as reform fatigue sets in. The risks of this type of fatigue can clearly be seen with the ongoing efforts to resurrect the Doha Development Round of the World Trade Organization, which have thus far been unsuccessful. The sense of urgency which launched the reform process in 2006 is in danger of fading as we approach 2008. There is also a risk that as negotiations drag on, the positions of major players will become increasingly entrenched, making compromise more difficult. This in turn would undermine the entire project of governance reform.

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<sup>15</sup> <http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/ICPEXT/0,,contentMDK:20737401~menuPK:378190~pagePK:60002244~piPK:62002388~theSitePK:270065,00.html>

<sup>16</sup> Asian Development Bank (2007) 'Highlights of the Purchasing Power Parity Preliminary Report,' 2005 International Comparison Programme in Asia and the Pacific. Available online at: <http://www.adb.org/Documents/Reports/ICP-Purchasing-Power-Parity/Highlights.pdf>

<sup>17</sup> Asian Development Bank (2007).

<sup>18</sup> See the discussion of the 'Blue / Green' coalition of Democrats and Republicans who tried to undermine funding of the World Bank in the 1980s in Wade (2002).

## 4.6 Risk of financial market volatility or global downturn

Market conditions have been extremely favourable in the last five years, with high liquidity and low perception of risk amongst investors in both developed and developing countries. This has helped to stimulate the conditions discussed in section II – namely the growth of developing countries which rendered the idea of borrowing from the IMF either unthinkable or unnecessary. However, recent turbulence in the US financial markets has already impacted on European, Asian and Latin American markets. The Bank of China revealed that it had significant exposure to the US sub-prime market,<sup>19</sup> while the Brazilian financial markets suffered contagion from the US markets, despite the fact that the sector has little exposure to the underlying credit problem.<sup>20</sup> Banks in Europe have also been adversely affected. The risk of a major financial market crisis or global recession remains relatively small, but the risk of such problems recurring without an effective and adequately resourced IMF is very much higher. In the past, the IMF has acted as a lender of last resort to developing country economies but current dissatisfaction with the IMF and its limited resources cast doubt over its ability to continue in that role without reform. From a public goods perspective, there is a strong case for completing reform in as short a timeframe as possible: that is to avoid an uncontrolled experiment in how global financial markets behave and operate in a major crisis without the overarching and stabilising presence of an institution like the IMF.

This section has suggested that while there remain substantial differences between major players in terms of first-best options for IMF quota reform, these differences are only likely to multiply as time goes on, making an agreement that much more difficult. Today's key players moreover, will not have the power to influence events/outcomes in the future as they do now. South Africa's term as chair of the G20 comes to an end in December 2007 and Dominique Strauss-Kahn's honeymoon will not last forever. Meanwhile, European and US positions are likely to be weakened with the introduction of new PPP data and domestic elections. The implications of these risks are explored formally in the section that follows.

## 5 Modelling the political economy of reform

Building on the arguments presented in Section 5, this section attempts to formalise the risks and opportunities for IMF reform. It briefly reviews the theory behind the political economy of reform and suggests how one might go about modelling the conditions under which IFI reform is most likely. While much has been written on the political economy of reform, the majority of work has focused historically on the national level; in particular it has sought to identify opportunities for reform of economic policies in developing countries (see, for example, Williamson, 1993). International level analysis is much more complex given the number of actors involved in reform. Factors which affect success include domestic politics in the participating states, relations between states and international forces often outside the control of any one state. Nonetheless, the theoretical framework of two level games popularised by political scientist Robert Putnam is useful in analysing the opportunities and risks associated with completing reform at the international level (Putnam, 1988). More is said about this literature below.

### 5.1 Literature on two level games

The theory of two level games is originally attributable to Schelling, who argued that under certain conditions, domestic political constraints could actually contribute to favourable outcomes in international negotiations (Schelling, 1960). This has come to be known in the field of political science and international relations as the 'Schelling Conjecture', and was re-visited by Putnam in his seminal

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<sup>19</sup> Anderlini, J. et al. (2007) 'Bank of China in subprime provision,' *Financial Times*, 23 August.

<sup>20</sup> Wheatley, J. (2007) 'Brazilian markets slide after panic selling,' *Financial Times*, 16 August.

article ‘Diplomacy and Domestic Politics’ in which he coined the term ‘two-level games’ (Putnam 1988). Putnam’s argument was essentially two-fold: he claimed first that that the smaller the international ‘winset’ (the intersection of policy outcomes acceptable to all players), the greater the risk that international negotiations would break down and second, that a small winset could be an advantage when bargaining takes place across two levels – e.g. the national and the international realms (Putnam, 1988: 438-440).

Several attempts to formalise two level games followed from Putnam’s hypothesis (see, for example, Iida, 1993; Mo, 1994; Milner and Rosendorff, 1997). Despite this sizable literature, few attempts have been made to formally model international negotiations, presumably because of the complexity involved in so doing. The inclusion of the European Union as an actor in any modelling series complicates matters further because it requires the incorporation of at least three levels of analysis – international, regional and national. Meunier’s quasi-formalised contributions in the context of EU trade negotiations with the United States are a notable exception in efforts to model the European Union (Meunier, 2000). Broadly, she argues that the distribution of member state preferences and the institutional structures that exist to channel and shape those preferences have a strong impact not only on the position the EU ultimately adopts in negotiations, but also on the shape of the global trading system itself. A similar argument can be made about the role of the EU vis-à-vis the Bretton Woods institutions, particularly with regard to reform and the factors influencing ultimate outcomes.

How can this literature usefully be applied in the context of ongoing quota negotiations? Formal modelling of the win-sets likely in 2007 and 2008 can be compared, controlling for the conditions outlined in Section IV in order to see how the winset changes as the negotiation position shifts over time. Formal modelling of this kind rests on a series of assumptions elaborated below.

The preferences of various actors involved in reforming the IMF can be represented graphically in a unidimensional policy space where the policy under discussion concerns a change to the quota formula.<sup>21</sup> Desire for reform increases as one moves from left to the right along the policy continuum. Rather than modelling the preference of each individual country, the model is simplified to three ideal-type actors: the United States (US), the European Union (EU) and a group of Developing Countries (DC) which include large emerging market economies. While this taxonomy is somewhat arbitrary and overlooks the fact that there are nations which do not fit easily into these categories and which, moreover, stand to lose from the negotiations (e.g. Japan or Saudi Arabia), their preferences are thought to be less important than the archetypal preferences of developing countries, the EU and the United States in ‘shaping’ governance reform. It should be clear that while these groups are by no means unified or discrete actors – that is to say preferences vary both between and within groups and decisions are not necessarily co-ordinated – it is sufficient for the purposes of this exercise to group countries in this way because the preferences of group members are likely to be similar. It is reasonable to assume that the desire for reform among the developing country group is stronger than that among the EU group because developing countries have much to gain from a change in structure of representation while EU countries have much to lose. Here we imagine that the preferences of the US fall between the two groups but are more closely aligned with those of the EU than those of developing countries. This assumption is based on the following observations: first, the US is not expected to suffer any significant loss in voice irrespective of the formula adopted because its size and disproportionately large GDP preserve its power in most configurations and second because the US has repeatedly stated its preference for reform which includes granting more power and representation to large emerging market economies as a means of preserving the legitimacy and integrity of the IMF.

In the model, the US, EU and developing country groups are assigned a policy ‘ideal point’ – that is the reform outcome that they would most like to see. However, each actor also has a range of options around this ideal point, any one of which would, to a greater or lesser degree, constitute an acceptable

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<sup>21</sup> Other elements of the potential reform, such as an increase in basic votes or increased representation for African constituencies, is purposefully excluded as the major sticking point for the current reform package appears to be on quota reform.

outcome in negotiations. From these ideal points and range of acceptable outcomes one can draw a series of circles which represents the range of potential policies acceptable to each actor. The point at which all three circles intersect, if at all, is the winset, or the area in which compromise can be found. The size of the circles is determined by the variation in ideal points among the group's members and the groups willingness to compromise. In the examples below, the EU is shown to have the circle with the smallest radius because its members have a relatively homogenous cost/benefit assessment of quota reform and because their positions appear to be the least flexible of member states at present. Developing countries, by contrast, are shown to have the largest range of acceptable policy positions. This is due to intra-group diversity in preferences and a greater predisposition towards compromise given that most developing countries would prefer some reform (even if only moderate) to no reform at all. The circle of acceptable policy positions for the US meanwhile, falls somewhere between these two extremes.

## 5.2 Model over two periods

The stipulations outlined above allow us to consider how each actor's ideal points and range of acceptable policy outcomes change over time. Recall that there were six key factors identified in Section IV that affected the prospects for reform between 2007 and 2008. These were the short-lived honeymoon of the IMF's new Managing Director Dominique Strauss-Kahn; the replacement of the outgoing chair of the G20, South Africa with a Latin-American counter-part (probably Brazil), the publication of new PPP data and its likely incorporation in any new voting formula, forthcoming presidential elections in the US, general reform fatigue and the risk of an economic slowdown. What impact are these six factors likely to have on the size of each actor's circles going forward and how might they be incorporated into our model of uni-dimensional policy space outlined above? The first two – the Fund's Managing Director and the incumbent G20 chair – can alter the size of the policy circles by broadening or narrowing the range of acceptable policy options depending on their capacity to change the structure of incentives confronting various actors. The potential for both to increase the size of the circles and, by extension, the scope of acceptable reform options is comparatively high at present but will diminish as their influence wanes in 2008, causing the circles to contract. Similarly, reform fatigue will reduce the range acceptable policy options to all three actors as negotiations ware on and bargaining positions become increasingly entrenched.<sup>22</sup> How does the second more general risk of a global economic slowdown affect the bargaining positions of each player? This question is formally tackled in the next section which looks at how global economic growth affects countries' propensity to reform.

Finally, the US presidential elections in 2008 and the publication of revised PPP data at the end of 2007 will move the ideal point for the EU and the US, respectively. The PPP data, which will benefit developing countries at the expense of established economies will move the ideal point for the EU and the US to the left – that is to say, it will reduce their desire for reform. The US elections have a similar effect on the country's ideal point – moving it away from reform as it becomes increasingly unpalatable to domestic constituencies. Here the preferences of Congress are particularly important in determining the exact location of the US' ideal point because Congress' status as a 'veto player' means it must approve any reforms. This dynamic could be separately modelled as the 'second level' game where the executive and legislative branches bargain over the reform package, but is not done so formally in this paper.

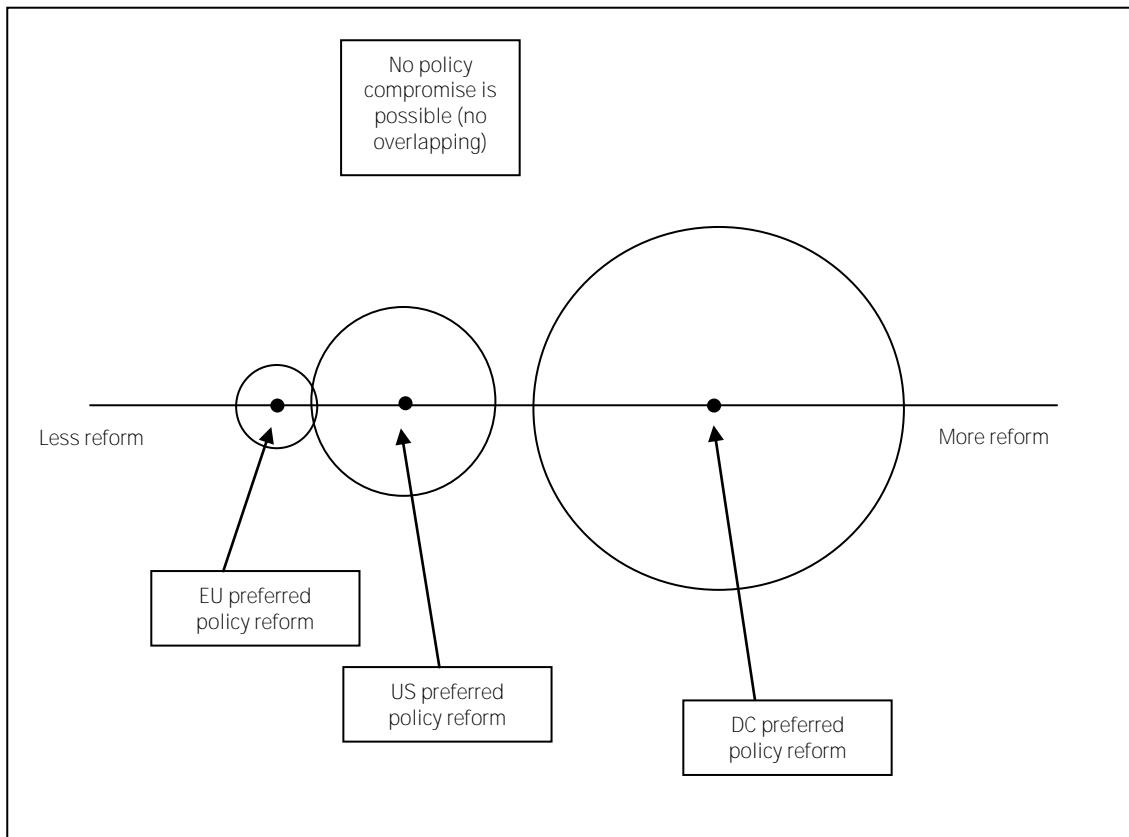
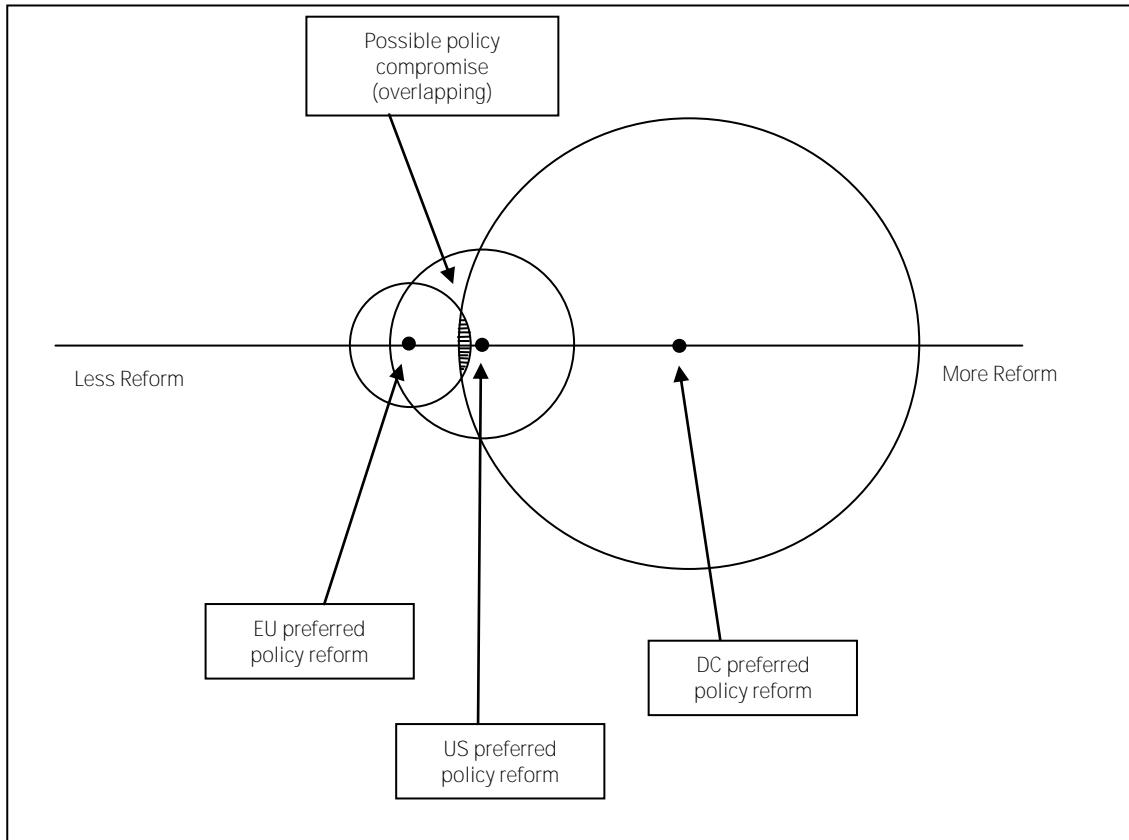
We may therefore conclude that while there is a small but feasible winset in which reform is possible in 2007, that winset contracts in 2008 if indeed it does not disappear altogether. In short, deferring reform from 2007 to 2008 will reduce the likelihood of all parties reaching an agreement on the content of reform. This is represented diagrammatically in the two figures below, which map the preferences

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<sup>22</sup> There is a plausible counter-argument that as the 2008 deadline for reform approaches, the potential for all parties to find a compromise increases. However, given the political and economic dynamics at play, it is unlikely that this would occur.

and ideal points of the three actors – the EU, US and a homogenous group of developing countries under relatively favourable conditions in 2007 and less favourable conditions in 2008.

Figure 1: Reform possibilities 2007(a) and 2008(b)



### 5.3 Further formalisation

While the diagrams above are useful in illustrating the potential for cooperative behaviour in the short-to medium term, to understand the incentives for countries to pursue reform over a longer and more sustained period of time in which global economic conditions are predicted to worsen, further mathematical formalisation is required.

In order to do this it is necessary to understand what the components of quota reform are. Here, we simplify negotiations by focusing on the distribution of votes according to two metrics: GDP and trade. While the IMF quota formula at present includes additional metrics (e.g. foreign exchange holdings and capital account variability), there has, throughout the negotiations, been a push to adopt a simplified and more transparent formula that prioritises GDP and reduces the role of trade. It is likely that European states will seek to maintain the trade element in any revised formula, as it benefits them while other countries will seek to move towards a more strongly weighted GDP metric. The simplification will therefore help to illustrate the key bargaining positions at stake.

Given these two variables, the representation of a given country in the IMF is a function of its share of global GDP and its share of global trade. This can be expressed mathematically as

$$R_i \equiv \alpha \left( \frac{GDP_i}{GDP_w} \right) + \beta \left( \frac{T_i}{T_w} \right)$$

Where  $R_i$  is the share of country  $i$ 's representation in the IMF,  $GDP_w$  is total global GDP,  $T_w$  is total global trade, and  $\alpha$  and  $\beta$  are the weights assigned via the formula to these two variables to determine a country's representation. A country's GDP and trade are known and fixed in the short term, but varying over time. By definition, the sum of  $n$  countries representation = 1, or

$$\sum_n R_i \equiv \sum \left[ \left( \frac{GDP_i}{GDP_w} \right) \alpha + \left( \frac{T_i}{T_w} \right) \beta \right] = 1$$

Additionally, by definition, the two weights sum to one:

$$\alpha + \beta = 1 \text{ and } 0 \leq \alpha, \beta < 1$$

so that

$$\beta = 1 - \alpha$$

Renaming a nation's share of global GDP as  $y$  and a nation's share of global trade as  $t$ , the equation simplifies to:

$$R_i \equiv \alpha y + (1 - \alpha)t$$

And through further algebraic manipulation to:

$$R_i \equiv \alpha(y - t) + t$$

All actors will seek to maximise their representation given the two components of the quota formula GDP and trade, and the first derivative of  $R_i$  with respect to  $\alpha$  is

$$\frac{\partial R_i}{\partial \alpha} = y - t$$

As such

$$y - t > 0$$

And a country is shown to be interested in quota reform contingent on a change in GDP representation if:

$$y > t$$

That is to say if its share of global GDP is greater than its share of global trade. While this result merely confirms what we knew instinctively, the implications are more interesting if one thinks of the game in a dynamic setting. The reform proposal recommended for approval by the Executive Board and later approved by the Board of Governors stated that: ‘Looking beyond the second round of ad hoc increases, it will be important to ensure that quota shares continue to evolve in line with changes in members’ positions in the **global economy... The Executive Board therefore proposes that the Board of Governors confirm that realigning quotas with members’ relative positions in the world economy will be an objective of future quota increases.**<sup>23</sup> The IMF reform proposal implies that the quota formula will in future be flexible, allowing adjustments of quota representation on an ongoing basis as the relative distribution of power in the global economy changes. Thus, an individual country’s negotiating position may in future, be influenced by its expectations as to the rate of its economic growth and share of global trade.

This has interesting implications for the bargaining positions of the three groups of actors modelled above. First, it suggests that the possibility for reform of the Fund is greater when countries are experiencing or expecting periods of high relative growth; this in turn implies that reform is more likely in 2007 than in 2008 if current predictions of a global economic slowdown on the back of the recent US credit crisis are to be believed. In addition, it yields insights into the conditions under which European states, which have adopted the strongest anti-reform positions, would be likely to revise their preferences in favour of reform. Stronger growth for EU members in general and for larger G7 European countries in particular would make the EU more predisposed to IMF reform, as their representation is more likely to be based on GDP than trade.<sup>24</sup> This means that the slowdown in European growth, forecasted in 2008 will make reform more difficult. Table 2 below shows the share of global trade and GDP for selected European countries and includes a ranking for each country on both metrics.

Note that only three European countries out of the 10 listed below satisfy the condition established above that a country’s share of global GDP be greater than its share of global trade in order to support IMF reform. These are Poland, Spain and the UK, whose ranking is equal. However, there are two issues with the data that would effect the number of countries that appeared to be pro-reform. The first is that intra-European trade is included in the export and trade ranking figures. Exclude that data and more European countries would rank higher in terms of GDP than trade. The second is that GDP rankings are based on purchasing power parity rather than market exchange rates, which may or may not be the case in the new quota reform package. This reduces the GDP rankings of larger economies and increases the ranking of countries with weaker currencies (e.g. Poland). There are some countries – most notably Italy and France – whose rankings are very close (GDP is only one or two points behind trade) which would find themselves firmly in the pro-reform camp if the data caveats above were applied...

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<sup>23</sup> Paragraphs 10 and 11 of SM/06/293 ‘Quota and Voice in the International Monetary Fund – Draft Report and Resolution,’ 25 August 2006.

<sup>24</sup> Particularly if the new quota formula excludes internal EU member state trade, as has been proposed by a number of pro-reform countries and academics working on the topic.

Table 2: GDP and trade rankings of selected EU countries<sup>25</sup>

	GDP at FX	GDP at PPP (ranking)		Exports (ranking) <sup>26</sup>		Y > T?
		GDP	Rank	Exports	Rank	
Belgium	350	325	32	270	14	No
France	2,055	1,816	9	443	7	No
Germany	2,730	2,504	7	1,106	3	No
Ireland	188	165	50	102	30	No
Italy	1,710	1,698	10	372	9	No
Netherlands	581	500	26	365	10	No
Poland	246	514	25	93	31	Yes
Spain	1,019	1,029	15	194	18	Yes
Sweden	348	268	36	127	23	No
UK	2,228	1,830	8	373	8	Yes <sup>27</sup>

Thus, drawing on the insights of the graphical and mathematical formalisations presented above, it is clear what is at stake for IMF governance reform. The prospects for immediate change to quota representation are more favourable in 2007 than in 2008 because the winset is larger. In the longer term, support for reform is likely to hinge on global economic conditions. Once again, the prospects for reform are better in 2007 than in 2008 on current economic forecasts.

## 6 Conclusions

This paper has provided an overview of efforts to reform the International Monetary Fund since 2006. It suggested that fears the Fund was becoming increasingly irrelevant prompted larger members such as the United States and the United Kingdom to pursue a reform package in which large, emerging market economies would have greater representation; this in spite of the long standing academic literature calling for reform on the basis of enhancing legitimacy and equality of representation. Since the spring and autumn meetings of the IMF membership in 2006, some progress has been made on ad hoc quota increases for large, fast-growing economies. There has been less agreement on other elements of the reform agenda such as changes to the formula determining quota votes, the representation of low-income countries through basic votes and other means and changes to the leadership selection process within the Bretton Woods institutions. Nonetheless, the negotiation process suggests that there is a general convergence towards changes in the quota formula which would simplify it and place a greater weight on GDP measured either in PPP or population terms.

The paper also suggested that 2007 presents a unique opportunity for finalising the reform package and enabling an agreement between developed and developing countries. The new Managing Director, Dominique Strauss-Kahn and the current G20 chair, South Africa, could capitalise on their positions to forge a deal. However, this window of opportunity is small and narrowing. 2008 will present a number of new challenges making agreement more difficult and reform less likely. These opportunities and risks were modelled both spatially and mathematically, clearly demonstrating that a mutually acceptable solution to outstanding issues on IMF reform will be easier to achieve sooner rather than later.

<sup>25</sup> Based on 2006 data.

<sup>26</sup> Includes intra-EU trade

<sup>27</sup> Rankings are equal.

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