TRAPPED IN HISTORY – THE IMF AND THE US VETO

Global economic governance is at risk if long-overdue IMF governance reforms are not ratified. The US veto hinders such reforms and a much-needed doubling of its secure lending resources, crucial to efforts at mitigating future financial crises.

The IMF is desperately short of secure lending resources. The US Congress is blocking ratification of an agreement reached in 2010 by all member states that would almost double the Fund's permanent or guaranteed lending resources. The US is the only country with the ability to veto major decisions. The Fund is currently relying on the good will of countries to increase its fire-power in an ad hoc way. This is not a solid foundation for the world's main lender of last

RECOMMENDATIONS

- US Congress should ratify the 2010 agreement on IMF governance reforms to bring the much needed doubling of the Fund's secure lending resources into effect.
- The Executive Directors of the Board of the IMF should advance the process of realigning voting shares in the IMF to better reflect relative economic weight.
- The Fund should amend its rules, bringing the threshold for decisions requiring supermajority down to 70 %, to substantially reduce the risk of becoming hostage to a blocking minority in the future.

Without changes in the supermajority rules, China may have a veto in twenty years' time, and the US may have lost so much relative economic weight as to lose its veto. This scenario might be enough to induce the US to give up its veto to prevent any one country having a veto.

> **Yet if it does not agree, the Fund will become a shadow of its former self, hostage to the US executive and legislature and without the resources to act even as an effective instrument of US foreign policy.**

resort to governments. The IMF is a valuable global public good, because its universalistic membership gives it strong network advantages over more regional or bilateral organizations for supplying the same stabilizing functions. Our study, which builds on five days of intensive interviews at the Fund in February, including with IMF staff and executive directors, shows that the multilateral governance order is at risk if the quota and board reforms, which are already overdue, are not ratified soon.

Since 2008 there has been a big increase in the stock of dollar-denominated debt in emerging markets and developing countries (EMDCs). Now, as US growth picks up and the US central bank withdraws its stimulus and starts to raise its interest rate, money is flowing back into the dollar, causing its price to soar. This could spell disaster for many developing countries.

Quota increase indefinitely blocked by US Congress

The Fund is obliged by its Articles of Agreement to review its quotas every five years. The latest in 2010 produced an agreement to almost double the Fund's quota, which would constitute a substantial strengthening of the multilateral safety net system. The 2010 agreement also included redistribution of quota shares away from the current concentration in the hands of advanced economies – whereby France and Germany hold a combined share of 10 per cent compared with the combined share of China and Brazil of a little more than 5 per cent.

But since 2010, the US Congress has declined to approve what the US executive branch agreed to. Part of the reason is that the Republicans do not wish to approve anything the Obama administration wants them to. Another is that most Republicans are hostile to the Fund, seeing it as a vaguely socialist institution which protects governments from market discipline by "bailing them out" in the event of a crisis. Further, the additional Fund resources would currently mainly assist European countries, and Congress asks why US taxpayers' money should be used to help Europeans. This criticism is also voiced by many EMDCs, upset at what they see as European states' use of their excessive voting power and IMF board representation, thanks to their unreformed quota allowance, to lend to other European states on an unprecedented scale.

The situation is complicated by the fact that the 2010 agreement included two different components. One was the quota increase and redistribution. The other was a change in the composition of the board of executive directors, which requires a change in the Articles of Agreement, and change in the Articles requires approval from shareholders holding at least 85% of the total quota.

The US vote share is more than 15%, which gives it veto power on decisions requiring an 85% majority. It is the only state with a veto. The necessary quota increase does not require an 85% majority, but the US insists that the quota increase and the board reform be legally linked, making the quota increase also hostage to the US veto. The US insisted on the link because if the quota increase went into effect before

the US had ratified it (in which case the US quota would not increase), the US share of the new, much higher total quota would fall and the US would lose its veto.

The IMF has prepared an "options" paper to explore how governance reforms can progress without congressional approval of the October 2010 package. The paper is top secret (it exists only in a small number of numbered copies), and clearly surrounded by competing interests and unresolved tensions. The IMF executive board issued a public statement in January urging its own board of Governors to adopt a resolution that would reiterate the need to resolve the problem, but without offering any solutions.

The US administration and the US executive director have remained silent on its preferences for going forward. They do not want to say anything that might jeopardize their difficult negotiations with Congress about ratifying the 2010 agreement - merely one of many issues on which the administration is trying to cut deals with Congress. Given that the IMF has zero salience in US domestic politics, congressmen and women can extract a high price from Treasury in return for their support on the IMF. However, senior officials are now seriously embarrassed in international forums (such as the G20) when they are admonished to shoulder their collective responsibilities by China, Russia, Brazil, India and others, rather than the other way around, as has long been the norm. The officials have to balance the US' loss of leadership legitimacy against the high budgetary price of getting the Congress to approve the 2010 agreement.

Stalemate continues towards the January 2016 deadline

As if this were not enough, the Fund must finalise the Fifteenth Quota Review by the end of 2015. But where does it start from, given that the 2010 fourteenth Review has not been put into effect? The issues of how to proceed will be the subject of heated formal and informal debate at the IMF Spring Meetings in April 2015. But it will be a miracle if agreement is reached by December, as required by the Articles. An extension beyond December would require a board Resolution (which requires an 85% majority). If the BRICS and allies decide not to agree to an extension beyond December they could block the extension,

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creating a constitutional crisis. But the BRICS are being cautious in pressing their case, always balancing their pressure for more representation against the need to keep the Fund effective and credible. The same applies to another main weapon in the hands of the BRICS and other EMDCs: the threat to discontinue participation in the Fund's New Arrangements to Borrow whereby countries lend to the Fund to preserve its short-term resources.

Will the US give up its veto to enable reform?

The Fund is trapped by its history. The US veto, inscribed into the Fund at the very beginning, is damaging the organisation and its ability to play its role. The veto gives the US the built-in leadership position; but it uses this position to block rather than to lead. The US executive and legislative branches clash in a context of political opinion hostile to multilateral organisations. The US can block any move that would end its veto, and is unlikely to agree to make such a symbolic statement of its own relative economic decline. Yet if it does not agree, the Fund will become a shadow of its former self, hostage to the US executive and legislature and without the resources to act even as an effective instrument of US foreign policy. In 2007, Brazilian finance minister Guido Mantega set out the consequences of a failure to reform the Fund: "We will seek self-insurance by building up high levels of international reserves … The fragmentation of the multilateral financial system, which is already emerging, will accelerate."

Without changes in the supermajority rules, China may have a veto in twenty years' time, and the US may have lost so much relative economic weight as to lose its veto. This scenario might be enough to induce the US to give up its veto to prevent any one country having a veto. Without this change, the danger is that the stability of the world economy depends on ad hoc and short-term increases in the Fund's resources and on a spaghetti ball of bilateral or regional safety net agreements, some of them out of sight beneath the table, their aggregate stabilizing effects unknown when another multi-country crises comes. That is a prospect to avoid.

The number of votes of each IMF member country is determined by how much money each is required to put into it: the quota. The quota is akin to a credit union deposit; the size of a country's quota determines its financial commitments to the Fund, the amount it can borrow, and its share of votes. The quota of every country, added up, determines the Fund's overall financial resources.

Read more:

Vestergaard, J. and Wade, R. (2015). 'Still in the Woods: Gridlock in IMF and World Bank reform puts multilateralism at risk', Global Policy, 6(1): 1-12.

Vestergaard, J. and Wade, R. (2015). Impasse at the IMF. Bretton Woods Observer, Spring Edition, 31 March 2015. London: Bretton Woods Project.

Jakob Vestergaard, DIIS (jve@diis.dk) and Robert H. Wade, London School of Economics.

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